

Law of Banking and Negotiable Instruments Note¹

PART ONE

LAW OF BANKING

Importance of financial institutions

The main components of financial sector includes: surplus units, mediator banks, deficit units, market, capital market, market instruments, regulating laws are some of the chief components of the financial market. It is clear that peoples who have money need to lend and get interest rate, and government need money to invest in infrastructure, and also investors need money to invest on their projects. So to get the required amount of money which they demand should have source. And there should be a way to this entity to obtain money. These things lead us to look for certain financial system where such questions get answers. We said that surplus units need to lend their money; now the question is how they find borrowers in the financial market? It is at this time, financial institution such as: commercial banks, micro financial institutions etc can come into picture; in order to play the role of linking surplus units and deficit units.

Now the question is how financial institutions play a role of linkage between the surplus units and deficit units? It is because, financial institutions raise money from savers who have surplus money. Banks collect money from those units by financial instruments. Having collected the money from the savers and deposited it, they should not put this money for ever in their institutions rather they mobilize the money through appropriate financial

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instrument to the destination; meaning to those who are in need of money [borrowers].

As these financial institutions bridge the gap that might be occur between the surplus units and deficit units, these institutions mitigate the problems which the surplus units face or encounter from getting back their lone. It is very difficult for surplus units to get back their money at any time when they require it. But this problem is relatively less regarding banks. Banks themselves are not perfect in paying back to the depositors. Because if all the depositors come and ask the withdrawal of their deposit, and if the banks do not have enough money to repay, then we can say that the banks faced liquidity risk. Even though the banks face liquidity risk, they borrow money from the national bank as the last resort to repay. So as components of financial market, we have lenders on one hand and borrowers on the other hand.

The necessity to regulate banks

These financial institutions should be cautiously regulated by the national bank, because banks in their nature have risks. We said that these financial institutions should be regulated. Regulation of financial institutions can be two types. These are government based regulation and market itself. The regulation which we talk about here is not market based regulation rather government based regulation. Why does government intervene in regulation of financial institutions? Because financial institutions in their nature are not perfect, since they are imperfect and prone to failure. And if they fail then the social cost of failure is greater than the individual loss. So governments argue system of financial institutions should be regulated. Because we can notice various financial crisis even recently in Greece. Not only this, there are plenty of financial crisis, for example the Latin Americans financial crisis of 1980s, and of Asian financial crisis of 1990s these and other factors may be possible reasons to regulate financial

institutions. If not banks properly regulated various risks perhaps result which in turn cause bailouts of the government meaning the government through national bank inject money into financial institutions. Banks which do not have money to pay back to the depositors may be forced to the last resort borrowing. Finally, governments will be compulsory nationalize the banks.

Why do we regulate banks? What are the regulating instruments? And who regulate banks? Prior to we rush into answers of these questions, let's know what is bank? First we should know that banks are economic activities. In accord to, article 5 of the commercial code, banking is economic activities and whosoever engaged professionally and for gain is considered as trader. So aware of banking is very essential first of all. This is because that, after we know banks then we will discuss the risks that banks exposed eventually the regulating mechanisms will be addressed. As we said banks have multipurpose role they sometimes help us to borrow money directly from the financial market. This does not mean that banks themselves lend money to you but rather they help you by providing and facilitating a way to borrow from capital market. Banks make you to raise money from capital market by the following methods:

1. Lone commitment,
2. granting long lone and
3. Underwriting securities etc.

Now it is possible to assume in the absence of financial institutions how can lenders and borrowers get in touch with each other? Therefore, it is important to appreciate the existence of these financial institutions to play a role of passage to connect these entities. As we said above those entities who in need of money to invest on their projects.

Let us assume that there are no financial institutions which play a role of intermediary between the surplus units and deficit units. What would be possible problems that we can encounter in the absence of financial

institutions? 1. People may not trust you and lend the amount of money which you required to raise for your project. 2. There may be credit risk due to the asymmetry of information. 3. In absence of banks it may be difficult to find the one who is surplus units wondering to lend his money to get interest rate. 4. There would be high probability of exposing to lone sharks. 5. There is high probability of defaulting on the side of borrowers to repay their debt.

Financial instruments

Now the question is, how do they raise the required amount of money from the financial market? In order to raise money these entities including the government issue financial instruments so as to collect money from the financial market. By the way, financial instruments are nothing but promises to repay. If financial instruments are promises to repay they are to be recorded in a certain document what we call financial instruments. What are these financial instruments that use to collect money from financial market? These financial instruments includes: sovereign bonds issued by government to get lone from foreign, bonds issued by government to implement certain purpose in the country for example Abay dam, even different companies issue bonds upon the assistance of the government, not only this but also issue debentures to collect capital from the financial market, selling of corporate bonds, sale of shares etc. We said that financial instruments are promises to repay to the lender, because those financial instruments are considered to the lender as assets. Promises to pay fixed in interest rate of 5% per annum and maturity pay could be 5 or 10 years. Bonds can be denominated in local currency or foreign currency.

Financial market

A financial market is a place where surplus units and deficit units met. In other speaking, financial market is a place where money of capital raised for business or consumption. In the absence of banks it is difficult to think of

modern financial system. As we said that components of financial system consists of savers, lenders, borrowers, financial market, intermediaries, financial instruments; so as to run this financial system government should come into existence to regulate its well being. Because of the complexity of all these components of financial system, there should be set of rules that regulate smooth interaction of the system. Depending upon the maturity pay of financial instrument, financial market is classified into 3:

1. Money market,
2. Capital market which further classified into two as primary and secondary capital market and 3. Foreign exchange market.

Money market: If financial market itself consists these three components, what do we mean by each of the terms? Let's say that you need to get money in short period of time in the financial market, through the instrumentality of any financial instruments which allow us to borrow money for shorter period not more than a year conventionally, this way of getting capital from financial market is called money market. In money market we raise money for shorter period. Most of the time the maturity day of money market is 28, 30 or 3 months is the typical feature of money market. So here, we use market for short term loan. In this market you use highly liquid assets or highly liquid instruments. Which means financial instruments that can be easily converted into cash within one year? Because you need money for short term money, so you need to use appropriate financial instruments in order to raise that money. So if the maturity date of financial instruments that you are using to raise money is not more than one year, then you are in money market. The possible financial instruments that can be used in money market may be commercial instruments such as: promissory notes, bill of lading, bill of exchange, cheques etc.

Capital market: On the other hand, let's say that you need to raise money for financing a large amount of projects such as: factories, high electric

power stations, roads, etc which need large amount of capital, now then you have to resort to long term loan financing system. So if you need this long term capital raising mechanism, you have to use appropriate financial instruments such as: Bonds, corporate bonds, shares, and debentures, sovereign bonds which Government Issue to borrow from foreign. If you are in need of market where long term loan and financial instruments such as: bonds, corporate bonds etc you are in capital market. If the main objective of capital market looks like this, there are two types of capital markets.

In the foregoing paragraph we said that capital market is categorized into two. These are primary and secondary capital markets. What distinguish primary and secondary capital markets?

Primary capital market: Let's assume that a new company is established with five million Ethiopian dollars. Now to raise this amount of capital, the newly established company issue shares to those who are in need of buying the newly issued shares, these first issued shares are considered as primary capital market. Peoples assume that if the company which they bought its shares makes profit then they share from profits. It is for this reason that peoples resort to buy shares. The other reason why they opt to buy shares is that even if the company could not make profits they may sale back the shares to others. The other issue that should be considered here under are that the newly issued shares by new company is sold whether in the head office of the company or from the promoters who sell the shares.

secondary capital market : Now let's say that we bought shares which issued by newly created company, for many reasons let us say that you faced problems, now you need to tackle that problem, but you have no money in your hand, the only thing that you have in your hand is the share that you bought from the company. Then what can you do is that selling the share to get money, this type of market is known as secondary capital market.

The other question that should be considered here is that, once we bought bonds, corporate bonds, shares etc now how do we get market for these things? These financial instruments are assets, so we have to look for market to sell these instruments. The other question that should be answered is that, do we have stalk market in Ethiopia? If so, we should be sure that there are stalk-brokers who play role of meeting sellers and buyers of those financial instruments. In regard to this, the instructor is not sure whether the stalk market is possible or not in Ethiopia.

Foreign exchange market:

Foreign exchange market is essential engage in international trade. In order to make international trade we need foreign exchange market, because foreign currency is very important to trade with world nations. When we are trading with partner foreign nation, we cannot trade with our local currency rather we trade with them in foreign currency.

Asset transformation

Now let us say that you call for a large amount of money to invest on your project. At this time you cannot get such amount of capital from one or two persons. Rather it may require you to seek a lot of persons with surplus units to lend you, which is very chancy to do so. Therefore, it better to approach banks to get the required amount. Because banks collect lot money from small savers with little amount and make it to be a sufficient amount to the investors. This is what we call size transformation. Size transformation means, it is the system whereby the banks collect deposits from a lot of depositors and lend that collected money to investors. Through size transformation banks address the mismatch of the demand and amount money you require. This is one form of asset transformation. The second form of asset transformation is that issue of maturity, which means that you are entitled to your deposit at any time to withdraw from banks. In other speaking, the transformation short term loan to relatively long term loan is

maturity transformation. This in turn has its own risk on banks. Because once banks lend that money to long term loan, but in between if small depositors come to withdraw their money and if banks do not have money in its treasure then it encounter liquidity risk.

Risk mitigation

As we said that banking activities in its nature is risky, then the question is how do banks handle if one defaulted to repay what he borrowed? 1. Banks may occupy collaterals. Private individuals can also occupy collaterals but is not effective as banks even from vantage point of laws enforcement. 2. It may increase interest rate. 3. The other effective means to reduce its risk is through diversification portfolios, meaning the assets it holds. This means that banks diversify its assets discriminately distribute between industries. 4. Banks also discriminate between geographical locations. 5. The other mechanism throughout banks reduce its risks is that, there is strict regulation from national bank in regard to borrowing from single individual. 6. Banks are also involved in monitoring borrowers before and after they grant. The banks collect information about the project, the credit worthiness of the project, and the visibility of project.

What is notice indication? Notice indication address on one side the problem of size and on the other side it reduce exposure to credit risk. This in simplest understanding means, raising money by size transformation and excluding borrowing from single person.

What is transaction cost in assets transformation? Transaction costs during assets transformation are nothing but costs incurred to make study before and after banks grant lone to borrowers. These studies may include involvements of the banks themselves, counter checking, visibility study, monitoring and supervising etc. Banks have the advantages of economic of scale and economic of scope: In economic of scale banks are not dealing with single person rather they deal with different similar persons in order to

reduce marginal cost. Because they manage various borrowers and spread the risk towards different persons. On the hand, in case of economic scope, banks branch out their various kinds of assets in the form of product or service between geographical location and industries by diversifying its portfolios' to condense costs.

Why lenders/depositors prefer to lend to banks?

1. Lack of capacity on the side of the depositors

Maturity: means, a situation where depositors can get whatever time their money back from the banks without delay. For this reason, depositors favor banks to deposit their money, rather than private individuals who may default to repay what they already borrowed. In the event of liquidity where you are in need of money in cash, there should be better position that assist you to dig up your deposit why banks preferred more by savers. The other reason why savers prefer banks is that there is effective control by national bank to maintain the liquidity ratio.

Liquidation insurance means, it is system whereby the depositors trust in banks and deposit their money there.

Asymmetry information means, lack of similar information between the depositors and investors to lend to the investors projects without apprehension. When we say this lenders may not have possibility to observe or to go after the implementation of project. It is the borrower who knows more about the project and the risk for which the project is exposed. Even the lenders are not sure about repayment of the debt. It is for this and other reason why lenders fear. There are two problems allied with this regard to asymmetry of information these are:

a. **Moral hazard:** Moral hazards means, lenders may behave in manner that borrower perhaps default to repay. Or it is the terror that lenders may

fright to lend to the investors even before and after they grant loan to the investors for different purposes.

b. **Adverse-selection** means a situation where the lender cannot be able to distinguish who is the proper and qualified borrower among the approached a number of 20 or more borrowers and select unqualified person.

2. Comparative advantage of banks

Now the question is, do banks have comparative advantage in minimizing these problems compared to lending to private individual? Our answer in this case may be positive, due to the reasons of the following:

1. Banks hire expertise to study check and supervise the borrowers.
2. Banks have already a system which is called preference database system, in which any borrower's information is shared among the banks to protect cheating on the part of defaults. Through this data base at national bank it is possible to check borrower not to go anymore banks. This is one way of addressing information gap between banks.
3. Banks monitor borrowers before and after granting loan, and after you open account they monitor your account what type of money is saved and withdraw.
4. There is final way of gathering from borrowers in addition to monitoring before and after granting loan, some banks establish long term commitment, which means that banks do not simply grant loan and leave alone the company, in addition to monitoring some banks reserve in the loan contract the right to be a sitting but non-voting director management on the board of that company. Meaning the banks negotiate with the company in the loan contract the right to have position in the managerial board without voting right simply to be member of the management to ensure the well being of the company. In other speaking, banks negotiate

that, we have no sufficient information about your project because, you're being default affects our interest, therefore let us have a reserved position without voting merely to make sure about your project.

These are some of the ways through which banks addressing the gap of asymmetry information compared to as private individuals. It is for these and other reasons why lenders prefer banks rather than private individuals.

Raising fund from financial market

Somewhere in the foregoing discussion we mentioned that there are three ways through which banks assist you to raise money from financial market. The banks do not directly lend you money but rather they help us so as to borrow money from financial market through the instrumentality of the subsequent ways:

(A) Loan commitment: In loan commitment banks undertake or commit themselves to give you money, if you are unable to borrow money from financial market. Banks allow borrower to issue their financial instruments through which they raise money from domestic or international market. They moreover commit themselves in a situation where these financial instruments which they are issued are not capable to raise money, and then we will lend you. Furthermore, banks promise to you that issue your financial instruments to raise money from market, and again if you are unable to sell out the issued financial instruments, we will give you the money which you required.

(B) Granting loan: In case of granting loan, bank promise to lenders that, if the borrower default we pay you. In other word, banks undertake promise to pay to the lenders where borrower unable to repay his debt.

(C) Underwriting of security: In underwriting securities banks promise to borrowers that, issue your financial instruments and if could not sell out all

the financial instruments, we will purchase from you the leftover instruments.

Banks risks

If banks engaged in all of these services, they may expose themselves to different types of risks. The typical risks for which banks are vulnerable may include:

A). Credit Risk; It means Credit risk is the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.

b). Liquidity risk: It means Liquidity risk is the risk that a bank cannot meet payment obligations in a timely and cost-effective manner. It is also failure to properly manage liquidity can quickly result in significant unanticipated losses.

c). Market risk; there are two market risks such as: interest rate risk and foreign exchange rate. It refers Market risk is the potential that changes in the market rates/process may have an adverse impact on the bank's financial condition. In other words, it is the risk that the bank's earnings or capital position will be affected by fluctuations in interest rate and foreign exchange rate. In regard to foreign exchange rate risk, Exposure to this risk mainly occurs during a period in which the bank has a foreign currency open position, both on- and off-balance sheet, in spot markets. It is a risk of volatility due to a mismatch, and may cause a bank to experience losses as a result of adverse exchange rate movements during a period in which it has an open on or off-balance sheet position in an individual foreign currency.

d). Operational risk; It indicates Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk includes the exposure to loss resulting from the failure of a manual or automated system to process,

produce or analyze transactions in an accurate, timely and secure manner. This risk therefore is imbedded in all of the bank's operations, including those supporting the management of other risks. Managing operational risk is an important feature of sound risk management practice in any bank.

e). Legal risk; Legal risk is the risk arising from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect bank's operations or conditions.F). Reputational risk; this means Reputational risk arises from negative publicity, be it true or not, regarding a bank's business practices. These are some of risks for which banks are exposed.

Major types of banks in Ethiopia.

National bank of Ethiopia

National bank of Ethiopia was created for the first time by order No 30/1963 and reconstituted by the Monetary and Banking Proclamation No 83/1994 as an autonomous organ, which is engaged in the provision of regular banking services to the government and other banks and insurance companies'. Generally, the main purpose of the bank is to foster monetary stability financial system and such other credit and exchange conditions as are conducive to the balanced growth of the economy of Ethiopia.

In accord to article 7 of proclamation no. 591/2008 of the amendment of bank establishment proclamation, the national bank will have the following powers and duties that will help it to achieve its purpose:

License, supervise and regulate banks, insurance companies and other financial institutions such as savings and credit associations/co-operatives and postal savings; Act as banker, fiscal agent and financial advisor to the government; are some of the few examples. We said that the national bank act as a banker for government as the lender of last resort. The national bank also serve as an instrument to implement monetary policy in a sense

that whenever economic crisis transpire due to the inflation, deflation and any other reason, the central bank at this time Maintain price and exchange rate stability, by Conduct effective on-site inspection of banks, insurance companies and other microfinance institutions. First and for most, the central bank regulate the financial institutions through various prudential regulations and supervision.

It is very difficult so as to list exhaustively the major functions of central bank. For the economy of words and time, let's to be precise enough in mentioning its role.

Roles of national bank

Supervising and regulating financial institutions

The first major role of central bank is that, regulation and supervision of financial institutions; now the question is how does central bank regulate and supervise financial institutions? First it set in place an entry point to engage in financial institutions. And the main requirement to involve into financial institutions is that, obtaining license to operate banking sector. One cannot merely stand and claim to engage in financial institutions without acquire legal license. It is for this reason, that central bank put in place requirements to run banking business. So banking regulation begins with setting the minimum standard to engage into banking business. Once you want to engage in banking business, then it is required to meet the minimum required standard to run banking business. Once you get the entry point to run banking business, you should also keep rules required from you to operate the business. Finally, you cannot simply withdraw from the business, rather to the end of your business until you want go out of the business, there are rules governing the liquidation, insolvency and bankruptcy of the sector. By the way the issue of bankruptcy is not the area of banking law. Rather it is the business of another completely different subject law which is called bankruptcy law. Therefore, central bank

determine who can run banking business, after you are acquired the license the way how they operate the banking sector and if it believed that the operators of the banking sector misbehaved it dismiss the actors of the sector. What we can surmise from this that the operators of the banking business cannot freely exit from the sector without repay the deposits and windup the sector.

Rendering advice on how to curtail financial crises

The second major role of central bank is that, **advising government on monitoring policy**; at this point the central bank undertakes studies about inflation, deflation of the economic fluctuation occur due to the various crises and the way how to overcome this crisis. In order to prevail over these problems the central bank employ different instruments as monitoring device. The most crucial instruments to curtail this crisis includes:

1. Through interest rate.
2. Through open market operation,
3. reserve system and
4. Through selling government securities.

So any government has monitoring policy.

1. Interest rate

The first instruments at the disposal of central bank to overcome inflation are an issue of interest rate. If the central bank increases the interest rate, borrowers might not be so vigilant to borrow money from the banks. On the other hand, if it decreases an interest rate, borrowers become watchful to borrow money from the banks which in turn create a lot of opportunity to engage in investment due to the low cost of interest rate, on the other side create plenty of opportunities for employees to be hired and if they hired they get income and will have capacity to spent. By doing so the central

bank makes the circulation of money stable through instrumentality of interest rate.

2. Open market operation

The other instrument to control financial crisis is through an open market operation. This instrument assists the government directly to borrow from the financial market by selling treasury bills, bonds and etc. Now the question is that why do government borrow from the financial market? It is at least for two reasons. First for expense purposes. Meaning the government borrow from the financial market in order to meet its expenditure. Second so as to alleviate market fluctuations caused by financial crisis. Because of this reason, if money supply is big enough in a market far more than the amount of goods and services available in the economy, then you should be worry for the inflationary pressure. By doing so, the government suck up the large amount money from the market, in order to maintain the equilibrium of demand and supply. For example, let's take renaissance dam which the Ethiopian government is building, when the government issues bonds, first it is an incentive to realize its deficit budget to meet the expense and on the other hand this swallow up the large amount of money from market.

3. Reserve system:

This is the third instrument through which government control the financial crisis. Through reserve system the central bank oblige the other banks to maintain at least two accounts as the reserve in the central bank. From the two accounts it is only the one that they can withdraw their money to run the banking business. This implies that the central bank serve as banker for other banks as commercial bank serve as banker. As the matter of requirement other banks are duty bound have an account in a central bank as reserve system. From the two the one which the banks are not allowed easily to withdraw their money is somewhat, needs the good will of the

central bank through which it control the market equilibrium. From this account they cannot withdraw money but it is the one which is allowed them that they can withdraw their money to pay their debts to depositors.

We can easily understand from this that, the central bank achieves two main purposes. By doing so, first the central bank serve as banker to the other banks since it occupy certain interest rate from these banks, second by doing this, the central bank suck up the large amount of money from the financial market. These are some of the monitoring policy instruments applicable at national level to control the economy as whole.

Minting coins and printing notes

The third major role of national bank is that, minting coins and printing national notes. This means, it mints coin, print and issue legal tender currency that can circulate all over the country.

The national bank in addition to this **implements exchange rate policy, allocates foreign exchange, manage and administer the international reserve fund of Ethiopia**. This reserve fund consists of gold, silver, foreign exchange and securities, which are used to pay for imports into the country and pay foreign international debts.

Bank for the government

The fourth major role of national bank is that, it is the banker for the government. This means, the government deposits its national budget at national bank. Even the government borrows money from the national bank to expense its deficit. We somewhere previously said that, the national bank serve both the government and other commercial banks to borrow money as the last resort. We also said that, the government uses the national bank as an instrument to raise money from financial market. So the central bank acts as the banker for the government. If government does not find lenders from the financial market, the last place where the government goes to

borrow is the central bank. It is for this reason that why we say it serve as the last resort for borrowing.

By the way, what enforce banks for preparation of the last resort? For example, if their asymmetry of information among banks they do not trust each other. At this time banks fail to lend each other and this problem is called **credit crunch**. The other reason that pushes banks to go to the last resort is that, there may be temporary shortage of cash in their treasury due to the long term loan they granted to the borrowers. In order to overcome your liquidity after you exhausted all possible option the thing what can do is that going to the last resort. The central bank also serves as the last resort to pay to the government its foreign deficit in foreign currency. For example if the government want to import certain commodities into the country, it needs a foreign currency to pay for the commodities which it buys. So to undertake these activities the government uses the central bank as the last resort to get foreign currency.

In regard to sovereign risk, we said that when the national bank fail repay its international debt. In other speaking sovereign risk, this means probability that the government of a country (or an agency backed by the government) will refuse to comply with the terms of a loan agreement during economically difficult or politically volatile times. **Sovereign risk** is also refers to **risk** that a central bank will impose foreign exchange regulations that will reduce or negate the value of foreign exchange contracts. When do we say that the national bank default to repay its debt, does it mean that it lacks paper money of its own? Surprisingly it is not so! Rather it for the reason that, it does not have sufficient international reserve. That international reserve might be in the form of foreign currency, gold, silver, or any other instruments that can easily convertible into international security instruments.

We repeatedly talked about natural risks for which banks are exposed. A certain bank may fail a great risk in the financial market to obtain money. Let's assume that bank 'A' fail to get money from parallel banks, to borrow from the financial market, then let's say that it opt to go to the national bank, to obtain the amount of money which it requires. Now it is possible to say that bank A faced a liquidity risk crisis. In point of time, let us say that customars or depositors, creditors, even the shareholders heard about liquidity crisis that bank a facing. Now it is possible to think of that these peoples do not stay at their home. Rather they go to the bank A in order to take out their money from bank A. Because it is quite enough to know that these peoples bother about repayment of their money. In order to know the fate of their money to be paid or not, all those peoples will go to the bank A, to discern about the upshot of their money. Now it is potential to be acquainted with that, when all depositors or major creditors of bank a meeting in a bank A; it is clear to us to judge that banka failed liquidity crisis. And this problem is known as 'bank run risk.'

On the other hand, let's assume that many people deposited their money in a bank. And these deposits are liability for a bank. Because peoples deposit for an interest rate. On its part, banks do not simply put the money which they collected in the form of deposit in their treasury. Instead, banks give that money in the form of loan to other investors whether for short or long term loan. This is because banks need to cover their liability lending the money to the borrowers with an interest rate higher than the one with which they deposited. In addition to this, they are duty bound to serve certain amount of their capital in the national bank as a reserve system. Now bank an already lent out the money to investors. Now let's say that everybody decides to vacate their deposit from bank A. Now the question is that does that commercial bankmeetits liability? No, commercial bank will not do so! Because part of the money is already lent out. At this time we can say that bank A faced a systemic risk which is one of inherent risks of the

banks. Now again the central bank can come into picture so as to assist this bank to repay its debts. By the way, do not be surprised! Because the national bank can come into picture at any time throughout this section as it is an instrument to government to regulate the well being of the financial market. We said that banks should keep certain amount of their capital in national bank as a reserve to tackle problems during financial risks. At this time what the national bank can do is that, it can make risk assessment studies for which the banks are vulnerable. If it believed that the bank can simply surmount the risks, for which it is susceptible, the national bank at this time grant loan. Unless, it is not sure about its recovery from the risk, it may order the nationalization of that bank.

2. Commercial banks.

Commercial banks mean accepting deposits for money from the public for the purpose of lending or investment. Commercial banks provide financial services to businesses, including credit and debit cards, bank accounts, deposits and loans, and secured and unsecured loans. Commercial banks are banks with the power to make loans that, at least in part, eventually become new demand deposits. In our discussion formerly we said, because a commercial bank is required to hold only a fraction of its deposits as reserves, it can use some of the money on deposit to extend loans. When a borrower receives a loan, his checking account is credited with the amount of the loan; total demand deposits are thus increased until the loan is repaid. As a group, then, commercial banks are able to expand or contract the money supply by creating new demand deposits.

We have two types of commercial banks. These are includes: **1. Retail banks and 2. Wholesale banks.** Retail banks are customary based and highly distributed branches. Retail banks deal with large volume of transaction. These banks service the general public as a whole. This is said so, because when you want to open saving account, whatever it may be low

or high it does not matter. How much your saving does not its subject, it collect money as deposit from the public starting from individual to large companies who need to save money. Even may save 100 Ethiopian Birr, because it pulls together all these low amount of savings and serve the large public at whole. Retail banks operate in transaction of payment system. Obviously, these banks are commonly uses financial instruments such as cheques and ATM cards are very common. These banks are approached the general public at village level. So they transact in a large volume of system to serve the whole society. Retail banks are interest rate based system.

But on the other hand, the wholesales banks are completelydifferent from retail banks. Because they handle a very small volume of transaction. But the transaction has higher quality in volume. They have higher value loan. For example, they set in place a minimum amount of money to accept deposit. What surprising here is that! No one can bring 50 or 100 Ethiopian birr to open saving account in wholesales banks. For example, English banks can ask you 250 thousand pound. As they require minimum amount money to save, on the other side they set maximum amount of money to borrow from wholesales. If this is so, which types of banks are available in Addis Ababa? It is retail banks that are abundant here in Addis. The instructor is not quite sure about the existence of wholesale banks in Ethiopia. At a rumor level the instructor think that Zemen bank is considered as wholesale bank as he heard. Wholesale banks are fee paid based system or of balance sheet. Wholesale banks do not mean that they lend money, but they lend money however, their main income is based on fee paid system. In regard to its customers concerned that it lend most of the time to large companies.

Regulation of banks

Why do banks are highly regulated compared to other economic sectors? Because, financial markets are inherently imperfect, characterized as they are by asymmetric information in the relationship of borrower to lender. Given the interconnectedness of the banking industry and the reliance that the national (and global) economy hold on banks, it is important for regulatory agencies to maintain control over the standardized practices of these institutions. Among the typical objectives of regulating banking institutions can be: The most dominant objective of regulating bank is to maintain safety, soundness and stability of banking sector; the other main objective of regulating the banking sector is to promote competition spirit among financial sectors; to create or encourage savers to deposit their money by making them to have confidence towards banking sector; in order to regulate the circulation of money supply in the financial market. By the way, we are not talking about a system where banks are centrally owned only by the government. Because there no need to talk about centralized banking sector. Since there no competition, in the financial sectors, there is no unfair competition, there is no market failure.

But what we are talking here is about free market where the market led the financial system. Therefore, in a situation, where banks compete together a lot of customers, there may be high probability of market failure, if there is no regulation. Since you have freedom of choice to do what whatever you want to make profit. By and the large, if money supply circulating in the financial market, is not regulated, the value of money will be devaluated due to the market failure. Because of the reason that, the money used as legal tender is not made of gold or precious which value is not devaluated. If the people loss confidence in the financial system, that money will be

considered as garbage by the people. It is for this reason, why we say that financial market should be regulated. So if we regulate money supply, we are regulating inflation, if we regulated inflation, we are in turn promoting employment rate; and even the balance of our payment system will be maintain.

In the very earlier, we said that, there are various instruments at the disposal of the government to regulate the monetary policy. Among the typical instruments used to regulate the monetary policy may possibly includes: First, Interest rate; an interest rate is the most instruments which government even enacted directives on interest rate how it should be controlled. Banks accept deposits on a certain amount of fixed percent, but the lending percent of an interest rate, is not considered by the directive which the government enacted. If the minimum and maximum amount of interest rate to lend is not prescribed by the law, it is possible to think that, lending interest rate is freely determined by market. In regard to minimum lending rate, as the instructor's readings goes, in anywhere of the statutes he didn't came across of a such thing. For example, if saving rate is 5 percent, it is obvious to think that banks lend with an interest rate which greater than this saving rate. And we also said that, the government uses an interest rate, to control market fluctuation by increasing and decreasing the rate.

The second instrument available at the disposal of the government to regulate the financial monetary policy is that, through open market operation: How does open market operation used to regulate monetary policy? I am sure that you can remember from our previous lecture, we said that, through the instrumentality of open market operation, the government absorb a large amount of money from the financial market, by issuing treasury bills, bonds etc. When the government wants to regulate the supply of money in the financial market, the national bank issue these financial instruments and sell them to the financial market. Meaning, we

said that, financial market includes: money market, capital market, which is further categorized into primary and secondary market and foreign exchange market. By doing so, the national bank regulate the money supply in the financial market. So if money supply circulation is regulated properly, it is possible to overcome market fluctuations.

And third system through which the government regulates monetary policy is that, through reserve system: how do the government regulate banking sector through reserve system? This is carried out by national bank of Ethiopia. The national bank of Ethiopia obliges the banking sector, to maintain a reserve account at the national bank. The banking sector is obliged to keep certain amount of its capital at the national bank. Because deposits are liabilities of the banking business, because they required to pay interest to depositors. In order to do so, banking business lend that money to borrowers with an interest rate greater than the saving rate.

Probably, the fourth instrument through which government regulate monetary policy is that, through regulating foreign exchange rate: The foreign exchange rate should not left to the banking business. If foreign exchange rate is not cautiously regulated, the import and export balance will be negatively affected. So everybody is obliged to surrender a foreign exchange to the banks. It is not allowed to hold foreign currency for more than 30 or 45 days. So you need to have appropriate policy to regulate the amount of money in the market. Unless, the fate of national economy will invite a negative consequences which do not easily tackled. It is for this and other reason; the government seriously regulates the monetary policy.

The other key objective of regulating the monetary policy is that, to ensure the security of banking system. Why do we interested in ensuring the security of banking system? Because banks deal with public money so we need to protect borrowers, savers and creditors of the banks. It is for reason that, government should be watchful that people should not lose their

money. Since savers or depositors should not lose their savings because of the bankruptcy and insolvency of the banks. So if we maintain the security of banking sector, we are protecting the public as whole. We also need to protect the interest's customers and borrowers. Why do we protect the interests of borrowers? Because the profitability of banks is dependent on borrowers. Since if there is no borrower, there is no interest to the banks. Because the banks profit is the difference between savings interest rate and lending's interest rate. So in order to maintain this mutual relationship between the banks its customers, we should ensure the security of banking system.

The other crucial objective of monetary policy is that, maintaining the safety, soundness and stability of the sector as a whole. We need to protect the safety, soundness and stability of the banking system, because failure of banking sector is not only affect the life of individuals engaged In that sector, but also impinge on the whole economy. This means that, there is no depositor, if there is no borrower, even if there is borrower, there is no money to lend, if there is no money, there is no payment system. Now this instability causes economic recession as a whole. Thus, ensuring the safety, soundness and stability of banking sector may help u: To control the supply of money, prevent systemic financial instability, and meliorate concerns about the efficiency and equity of financial intermediation.

The business of banking has a number of attributes which, if not managed properly, has the potential to generate financial system and macroeconomic instability. As we said in the near moment, the risks that banking sector costs the country, when it compared to other companies is relatively very costly. It affects the financial system as a whole, not the shareholders alone but also upset the national economy. Because banks occupy a central place in the payment and settlement system of the country's economy. As banks play an important role in economic development through mobilization of funds from within and outside the country and channeling such funds to

various sectors of the economy. Thus, it is essential to regulate financial sector to achieve these objectives.

As the banking sector raises money from the public through various financial instruments, government fears that this banking sector may dominate the financial industry. Unless, certain activities are prohibited to the banking sector. Even though, the activities are allowed to be undertaken by banking sector, the government put in place a certain regulating measures. For example, the banking sector is not allowed to engage in investment activities. First and foremost, the business banking are not allowed to engage in insurance activities. As we said above, even if it create a trivial situation to engage in an investment activities, the national bank legally determine the way in which banking business involve in various activities.

As one of the objectives of regulating monitoring policy is to promoting competition in the financial sector, it imposes the same entry point rules which are identical to all banking sectors. Also as banking business commenced, operational rules are also similar. And finally, when you decided to exit from the banking business, you need to keep the rules applicable to all. Some peoples argue that, there are no fairness competition rules to state owned bank and privately owned. Because privately owned banks are obliged to buy security instruments about 27 percent from their profit. But the state bank which is commercial bank does not oblige to do so. In a situation where such discrimination exists, it is very difficult to talk about equality of competition rules.

What are the social objectives that the government wants to achieve? The government wants to address various objectives through regulation of monetary policy. The typical objectives which government wants to achieve may include: First financing of state borrowing, meaning the Government Issue financial instruments to raise money from financial market, to carry

out infrastructures. Such as constructing hospitals, schools, rail ways, roads, etc. This state borrowing may take different forms. One of these is the state is required to maintain reserve system in national bank. The rate at which banks borrow money from financial market is lower than the rate at which government borrow money from banks is greater. Because the government forces private banks lend money to it with an interest rate of very small. The government borrows from these private banks of an interest rate 3 percent. And when we borrow money from the banks, the borrowing interest rate greater than the one with which government borrow from the private banks. Through these borrowing government is charging a hidden tax. Or the government compelling us subsidizing to the revenue of the government.

The second objective that government want to achieve is that, prevention of foreign ownership: The government's concern that financial liberalization may lead to a banking crisis that may culminate into an economic crisis is also misplaced. In accord to the concern of government opening the banking sector to foreigners has a distractive effect to its economic growth at this level. The government's concern is that if foreign banks were to be allowed to operate in Ethiopia, it may lose of control over the economy. Because the argument of the government is that, its banking sector is on the infant industry stage. For example, in a country like Ethiopia where the banking sector is inefficient, banking practices are outmoded, and credit is not allocated on commercial criteria, foreign banks may be able to reap higher profits than domestic banks. Therefore, in order to protect domestic banks the government closed its door to foreigners.

The third objective of social monetary policy is that, central financing: The government wants to achieve certain sector developments. It tries to promote certain sectors which have immense economic developments. And therefore government wants to channel money into the financing of such sectors. These sectors are sectors which government believes that they

should be encouraged and supported as they are expectant for the future development. So in order to achieve this purpose the government regulates the banking sector, unless this sector regulated, it will be difficult to foster the sustainability of those sectors which government wants to be developed. It is for this reason that, government forces the banking sector to lend money to those sectors such as: export industry, manufacturing industry, agricultural industry etc.

The fourth social objective is that, to promote the culture of saving.

The fifth social objective is that, the government is promoting financing of housing. These are certain objectives which government is trying to achieve.

Argument against opening of the banking sector to foreign ownership.

However, as far as the current government of Ethiopia is concerned, foreign banks are viewed as a liability to the country. As a consequence, entry of foreign banks is prohibited. Why do the government of Ethiopia closed its door to foreign ownership of banks?The government's rationale is based on the infant industry argument as follows:

First, since the banking sector in Ethiopia is young it will not be able to compete with more mature foreign banks that have more capital, professionally qualified and seasoned managers and employees, and better reputations. So as Ethiopia is not capable to administer this giant economic industry,therefore there may be high probability ofbanking crisiswill be occur as a result of weak supervision.

Second, there is evidence in the literature about the association between financial liberalization and banking crises. Even the current situations show that countries open their banking sector to foreign ownership hit by financial crisis. By the way, this does not mean that! Domestic owned banks are not prey to financial crisis; rather it is relatively not vulnerable as such.

Third, since foreign banks, if allowed to operate in Ethiopia, are likely to engage in cream skimming behavior, preferring large scale operators for clients, such as commercial agriculture, big industrial, real estate and service establishments. They inevitably will skew credit allocation in favor of these very large and established enterprises.

Fourth, foreign banks may concentrate on lending rather than mobilizing of savings. Then there will be unfair competition among foreign owned banks and domestic ones.

Fifth, the government believes that at present Ethiopia is poorly endowed with the financial experts to design and operate the regulatory and institutional structures needed to supervise the banking sector.

Sixth the capital out flow has an adverse impact on the national economy. Because the issue of sovereignty may also be in question. Since if most of the economy backbone which are banks owned by foreigners, it may be difficult for government to control monetary policy.

Argument against closing door to foreign ownership.

Contrary to the government's view, the potential benefits that can result from opening the sector for foreign direct investment remain substantially very crucial: opening of banking sector for foreign nationalities or foreigners has two fundamental reasons; 1. It creates effective and increase quality service; If we open the banking sector to foreign nationalities, that may generate an effective and quality service to the financial sector as a general. Because foreign nationalities come with experience and capacity to

introduce new services and technologies that boost the banking sector. 2. Spillover effect; If the banking sector is opened to foreign nationalities, (A) transfer of technology; meaning foreigners are more technologically equipped than that of domestic banks. So if we open the banking sector, there will be technology transfer. (B) transfer of knowhow; again if banking sector is opened to foreign nationalities, knowledge will be transferred into the domestic banking sector; because foreigners are more experienced and skilled personality than that of domestic banks.

First, foreign bank participation may have the potential for a positive impact on the efficiency of the Ethiopian banking sector. Competition demands that domestic banks continuously upgrade their skill and technology levels to stay in business.

Second, entry of foreign banks may improve bank regulation and supervision the entry of foreign banks in emerging markets that are healthier than domestic banks implicitly allows the introduction of stronger and more prudent regulation, increasing the soundness of the local banking sector.

Third, the entry of foreign banks to Ethiopia will strengthen the financial sector and may have a positive impact on economic growth. There is a positive correlation between financial sector openness and economic growth.

The opponents of liberalization argue that, the determining factor for banking crises is not financial liberalization but the quality of the regulatory and supervisory apparatus. The relationship between liberalization and a banking crisis depends strongly on the strength of capital regulation and supervision. Thus, those opponents' summaries the typical advantages of liberalization as follows:

To begin with, foreign banks have a number of advantages compared to domestic banks. By servicing client's active in more than one country, they can achieve benefits from spreading best-practice policies and procedures. Second, they may be able to diversify risk better, allowing them to undertake higher risk, but also with potentially higher returns on investments. Third, foreign banks have advantages in the form of more diversified funding sources, including having access to external liquidity from their parent banks, which may lower their funding costs. Finally, by being larger they may achieve other scale advantages such as utilizing more advanced and sophisticated risk assessment models to give them a competitive edge over fragile Ethiopian banks.

Now once we agreed that banks must be regulated for many reasons. And we entertained those reasons why do we regulate banks. Now the question is who is to regulate banking sector? The government through the national bank regulate the banking sector. The national bank of Ethiopia stringently regulate and supervise the financial institutions as a whole and the banks in particular. Now the question is do you think that there is single regulatory model? The answer is no! because universally there is no accepted single regulatory model. Depending upon history, culture, political system, legal system, economical and social objectives a country may want to achieve various goals, for this reasons there is no single accepted model. For example, if you want to achieve certain social objectives, you may design a model fit to achieve the intended goal.

The following regulatory models are somewhat employed to regulate the financial sectors. 1. Certain legal jurisdictions regulate the banking sector through the line of ministry. In certain countries ministries are responsible to regulate the banking sector such as ministry of finance. In a jurisdiction where ministries are relevant to regulate the banking sector, they give the responsibility to that ministry. 2. The other aspect of regulating model is that, through national bank or central bank. Certain countries give the

responsibility to regulate banks to the national bank. For example, the Ethiopian government regulate the banking sector through national bank. The national bank is responsible to regulate and supervise the banks. 3. In some other jurisdictions they establish a certain specialized agencies to regulate the banking sector. These specialized agencies are part of an executive body of the government. The responsibility to regulate and supervise the banking sector are left to this body. For example, the financial services authority of UK . 4. In a certain jurisdiction the responsibility to regulate and supervise the banking sector may be mixed system. Meaning, the ministry of finance, national bank and special agencies may organized to regulate the the banking sector. 5. In certain jurisdiction there is principle called self regulation. This form of regulation is different from the above mentioned regulatory models. In a sense that regulatory models mentioned above are part of the executive or government involvement is direct. Whereas in this selfregulation model, it is not the government who regulate the banks; but it is the banks themselves who regulate their relationship. It is the association of the banks who regulate the behavior and their interrelation. This type of model is not common, most of the time this is applicable to developed countries.

Now it is clear that we overcame the question we raised in regard to who is proper to regulate the banks. Now let's shift towards what matters are to be regulated? For the purposes of simplicity we categorized the matters that to be regulated. The first one, is that regulating an entry point of banking business into existence. We can remember that in point of time, we said that banks in their nature are vulnerable to various risks. Therefore, in order to protect from these risks, banks should be regulated starting from their commencement. At this level who can carry out banking business? What requirement should be fulfilled? These are some of the questions that might raised. By the way, we cannot intertain these questions at this time but we will come over them later.

The second matter that should be regulated is that, during operational system, meaning as banks are exposed to risks, care should be taken before such risks happen. Even though they happen we have to opt to solution that mitigate the risks. Operational regulations can be carried out very seriously by national bank of Ethiopia. Because the failure of banking sector do not only affect the individuals but also has an enormous economical impact on whole society. What we have to understand here is that, we cannot totally stop the risks from happening but to minimize the effect. The prudential regulations carefully applied to mitigate the risks by employing various strategical mechanisms to curtail the probable problems.

The third one is that, if unfortunately the risks materialized and loss has been incurred, The main target of this third regulation is that to reduce the probability of the risks. Now once the risk is materialized, and what is required is is that you have to do your best effort to conquer the risks.

Now let's go back to the point that we raised earlier about the entry into banking business. In that particular point we raised two questions and left unanswered. First let me remind you the questions, who can carry out banking business? What requirement should be fulfilled to start banking business? First we have to be sure that the investor who need to run banking business is an Ethiopian national. After we determined the issue of nationality, now who can undertake banking business? It is only allowed to the share companies even from the share holders one cannot hold more 5 percent in the banking sector. It is for this reason, why do regulate the identity of personality. When new banks set up as banking business, it should be regulated very carefully. Here what is the assumption is that newly established banks are more vulnerable to risks. Therefore, we should worry to who is proper one to run the banking business. As we said that new banks are vulnerable to risks, if these new born banks are vigilantly

regulated, their vulnerability entail risks which in turn causes instability in the financial system.

Now for the purpose of unfussiness, let's classify them as follows: 1. An entry requirements that intend to grant market oriented license requirements. In this license requirements the government wants to ascertain certain market structure. Because there are many market structures where banks compete. For example, there are many market structures such as: pure monopoly market structure, oligopoly market structure, etc. So it is very important to much with certain market structure which fit with newly created banks. The determination of market structure assist the government to determine the number of banks in the market. As far as the instructors knowledge goes, there is no restriction of numbers of banks in present Ethiopia.

2. The geographical limitation. Do you think that the government restrict the banks to operate in a certain geographical area? When we read the national bank directive on branchbanks, you need to establish business, you need open branches, you need to operate in a certain place, if this is so, once you acquired license to run business in a certain place, you should not go elsewhere without prior approval of the application by the national bank. There is no restriction but you cannot move your branch from one place to another place without permission of the national bank. We said that you have a right to run banking business, but when you require to move from place to place, you have to apply to the national bank in writing, and it is then that you can run or branch your business to other geographical area.

3. The other entry requirements are related with the bank itself. Here the issue is are you capable to carry out the banking business? Because banking business is defined under sub article 2 of article 2 of proclamation no. 952 of the banking establishment defined as, "banking business" means any business that consists of the following activities: a)receiving funds from the

public through means that the National Bank has declared to be an authorized manner of receiving funds; b)using the funds referred to under paragraph (a) of this sub-article, in whole or in part, for the account and at the risk of the person undertaking banking business, for loans or investments in a manner acceptable by the National Bank; c)the buying and selling of gold and silver bullion and foreign exchange; d)the transfer of funds to other local and foreign persons on behalf of the banks themselves or their customers; e)the discounting and negotiation of promissory notes, drafts, bills of exchange and other evidence of debt; f)any other activity recognized as customary banking business, which a bank engaged in the activities described from paragraph (a) to (e) of this sub-article may be authorized to undertake by the National Bank."AsOnce you fulfilled the requirements to be a bank. Now these requirements may include:

1. Legal form; Now you are in need of running of banking business and you are new company. So you are going to be constituted under Ethiopian law as company.Because in your trade and business organization law course, one of the requirements to have rights and obligation as a traders, you need to fulfilled the legal form which has a constitutive effect. 2. The other requirement that this new bank should be realize is that, the minimum paid up capital of that company. Since as it is a share company, the liability of the share holders is limited to the contribution they already made.When we visit national bank regulation of minimum capital under article 4, which says, minimum paid up capital to acquire banking business license shall be 5 hundred million, which shall be fully paid in cash and deposited in the name of newly established bank.So the law is stringent in regard to paid up capital when new banks are establishing. What would be happen if the new bank could not fulfill the requirements? If the licensed newly established business bank fails to fulfill the minimum paid up capital under article 4 of this regulation, at this time the national bank of Ethiopia prohibit such bank,from accepting uniform lone and conducting an international banking

business. Or require to merge such bank with another bank. Or close such bank. Or take any measures that fit to administer of such bank.

3. registration. Now the question is how do a juridical person acquire legal status? When we are speaking about juridical person, we should required to know that there many different types of juridical person based on their how they get or acquire legal personality. Because there are many kinds of juridical persons. The most obvious ones are: Universities, companies of various business, NGO.s, Public entities and administrative departments. Now when we are observing at these terms, it is obvious to distinguish the way how they acquired legal status. For example, business companies acquire their legal personality through registration. And it is possible to think of that some other juridical persons acquire their legal status through an enabling acts such as: proclamations, regulation or charter etc. Here the discussion is mainly about banking business. So it is a juridical person. Now the question is that by what it acquired its legal status? The answer is very obvious, because banks are acquire their legal personality through “bank establishmentproclamation.”

4. The other requirement is that the business plan that new company need to run.

Now the question is why do we interested in talking about the requirements of banking business and management? Is there any reason for the law maker to regulate who is going to be the manager of a certain bank? We are talking about banking business, and when we look from the history itself, most of the banking crisis or systemic failure that banks faced are attributed of mismanagement. So we need to have a good leader not only for the government leadership but also for the banking sector. So it is required to regulate the behaviors of these management personalities. By the way, the regulation of managerial persons is constituting the most

dominant and central regulatory issue. We can remember that the measure of national bank of Ethiopia took, towards the Oromia cooperative bank.

So instead of dealing with day to day operation of the bank, which may be difficult for the regulator. Because 1. The regulator both physically and emotionally distanced himself from the bulk of banking transaction. For example, you may assume that how the banking transaction is very bulk. Let's take the commercial bank of Ethiopia, how many branches does it have? And it may not be difficult to think of with increase of number of banks, numbers of managers also increases. So banking transaction so bulk as it involve mass transaction. 2. Because of the distance between the regulator and regulated persons and banks themselves. When we talk about the distance, we are not talking only about the physical distance but also the distance of the task which they carry out. For example, the job of national bank and commercial banks its regulates do not have similarity. Meaning the job of national bank and commercial banks is not the same thing, The national bank is not trader, It doesn't lend and borrow money from the individuals. This is the task of the commercial banks who has direct relation with the lending and borrowing from the individuals. So instead of regulating micro management which is bulk of management, regulators focuss on regulating the managers. The management is responsible for translating of the general directives and proclamations of the national bank governing the operation of banking business, into specific instructions to the staff. Instead of regulating the details, the national bank focus on the management of managerials regulations. So as we said central bank focus on the management of the banking managerial staff.

So personal licensing requirements may take two main forms. These are 1. Personal reliability and 2. Professional qualification. When we are talking about personal reliability, it is all about the public confidence. Here what the national bank wanted to achieve, is to create public awareness towards the banking sector. It is to make people to trust the banking sector to save

or deposit their money. So personal reliability is all about personal conduct and business conduct. What the national bank is going to measure is whether he is the trust worthiness as personal individual and is going to measure the trust worthiness of person as the manager of the business.

By the way, personal reliability requirements are not only about the behavior of the managers, directors, senior executive officers or CEO. But also it covers the conduct of influential shareholders. Meaning of those who have a capacity to influence on the activities of the bank. Who are influential shareholders in Ethiopia? It is clear that those who have shares more than 2 percent. If persons who have more than 2% share holders exists in the banking sector, it is those who influence the activities of the banking sector. Do we have maximum limitation of share holders? This is also clearly prescribed in the laws of that regulating banks. One can not occupy share more than 5% of the capital of the bank.

According to the directive of the national bank on influential persons under its article 5 reads, "persons with significance influence shall be honest, reputable and diligent." In determining of persons integrity with significant influence or relevant factors shall be considered. When the integrity of persons with significant influence shall be examined whether he or she has criminal record, or record of disciplinary misconduct, financial soundness, etc. For example an interesting issue what is prescribed under article 5 sub article 3 sub 5 is that, whether the person's minimum networth at the time of acquisition of shares at least must be greater than shares acquired or to be acquired from the financial institutions." Whether the persons account has been closed or not reinstated by any bank in line with relevant directives of national bank. When we are saying that person's networth should be greater than the share he which he buys from financial market. If you are going to spend more than what you have, in order to buy shares then that you are in question mark.

So in short, you can not buy shares by borrowing from the banks. This is strictly forbidden under the Ethiopian law of banking regulations. So person integrity, financial soundness or these requirements should be continuously observed through your term as managers, directors, senior executive officers or CEO. It is not only the managers but also organizers during the time of formation of banks should meet these qualifications. So no one can merely stand as the one who is going to set up banking business, and collect money of the public and can go away as he need. It is not as the other companies who are not financial institutions. It is in some companies that the organizers, promoters, project managers can collect the money of the public and say we stopped the establishment of the company. Financial institutions are seriously supervised and regulated compared to other companies. And there is no such gap in regard to financial institutions.

What are professional qualification requirements? A certain project manager at least shall have first degree from recognized high education institution, business experience preferably in banking sector, honesty, integrity, reputability, etc. Article 14 sub article 1 of proclamation no. 592/2008 states, "Without prejudice to sub-article (1) of Article 15 of this Proclamation, a director shall be a person with honesty, integrity, diligence and good reputation to the satisfaction of the National Bank." On the other side, for influential share holders and senior executives should fulfill the following requirements according to the same article under sub article 4 implies the power of national bank to enact various directives to regulate the following. a) qualification of competency to be fulfilled by directors;

b) the minimum number of directors in the membership of the board of a bank;

c) the duties, responsibilities and good corporate governance of the boards of directors of bank;

d)the maximum number of years a director may serve in any bank and the conditions for his re-election;

e)the maximum remuneration of directors; and

f)the maximum number of employees of a bank who may be elected and serve as members in the board of directors of the bank.

So the following professional and qualifications inputs such as: knowledge, experience, age are very crucial. In ccord to professional requirement, at least the member of the board shall have first degree. And members of board directors shall have adequate business experience preferably in banking sector. As ages concerned the director manager at least should attain age of 30. As far as senior executives concerned they should have at least with first degree and experience of 8 years. In regard to chief officers concerned should have at least with first degree and experience of 10 years. These are some of qualifications required in regard to professional qualification.

In regard to professional qualifications there is tention between the national bank and commercial bank of Ethiopia. The cause of tention was that the national bank of Ethiopia has no competent personality with required qualification in market to hire. So in order to obtain these personality, the national bank resort to take from the commercial bank who have developed experience for a lot of times working in that sector. On the other hand, the commercial bank of Ethiopia objected to the action of the national bank. Because the national bank is making its experienced employees to flea towards it. Because as it trained those personalities for a lot of time, the national bank should not snatch out its employees without any contribution. The point is the national bank shall reconsider about professional qualification requirements.

The other key personnel of banks are to be restrain engaging in outside managerial activities. Do you think simply being a senior executive, member of board constraint your right? Due to the mere being of senior executive, member of board may to some extent limit should be regulated very carefully. Because you should avoid conflict of interest. You need to avoid conflict of interest of your and the bank you govern. The main objective is that, you need to provide undivided attention to the bank that you are managing. Because any mismanagement, any misjudgment lead to serious risk. So outside managerial activities are strictly managed and regulated.

What do you think that Ethiopian national bank require in regard to regulating outside managerial activities? In regard to personal requirement, the banking establishment proclamation no. 592/2008 sub article 1 of article 15 states, "No person who has been convicted of any offence involving a breach of trust or a fraud, whether in Ethiopia or elsewhere may be a director or an employee of a bank." In the same article under sub article 2, it is strictly forbidden to be a manager of certain bank without the approval of national bank, if one take part in management of another bank whether in Ethiopia or abroad. This article under deliberation reads, "Without prior approval of the National Bank, no person who had been a director, chief executive officer or senior executive officer or otherwise directly or indirectly participated in the management of any bank that wind up, whether in Ethiopia or abroad, may act as a director, chief executive officer or senior executive officer or otherwise be directly or indirectly participate in the management of a bank."

In regard to avoiding conflict of interest, the same article under sub 3 asserts, "A director or chief executive officer of a financial institution may not, at the same time, serve as a director of a bank. Moreover, a business entity or a company in which such director or chief executive officer has ten percent or more equity interest may not serve as a director of a bank." What we can infer from this sub article is that one cannot be director of two

independent competing bank manager. A company may serve as a director of bank, but if one of the director of that company holds or more than 10% equity in that company, that company is disqualified from being a director of bank.

In addition to so far we said, the same article under sub article 4 declares, "An employee of a bank may not be a chairperson of the board of directors of that bank or a director of any other bank." An employee of a certain bank may not be chairperson of board director of the same bank or any other bank director. In regard to this, the national bank of Ethiopia come up with directive, limits on board remuneration and numbers of employees who sit on a board by directive no. 42/2011. When we look at article 5 of this directive it reads, A numbers of employees who sit on a board, no employees of a bank being permanent contractual shall sit on board of any bank. The national bank is doing this in order to regulate risks. Because conflict of interest is one source of risk. So the law tries to come up with appropriate mechanism so as to avoid conflict of interest.

Nationality or residence: Do you think that there should be restriction on nationality and residence of managers? The other question that should also considered with this, can a foreign national sit as board member in a bank fully owned by Ethiopia national? If Ethiopian law allows that sole share holder can be a member of board of director of share company, there is no possibility to foreign nationality to sit as member of board. We know that Ethiopian laws strictly prohibit foreigner to hold shares in the banking sector, so you can think that no share holder can be a member of board. What about chief executive and senior executive? Can they be foreigners? The law do not oblige chiefe executive or senior executive to have share in the bankin company. There is no requirement to hold share to be chief executive or senior executive. Anyone who can be competent and qualified can be employed as manager. So you can employ foreigners who are qualified to serve your bank.

There is a principle called “four eyes principle” The principle of four eyes represent that two persons. So you need to trust a management of two personsto govern your bank. What does it mean? It means that if one manager is not there, the other one can be there. It also help to strengthen of internal control. One checks upon the other and which in turn reduce risk you commit mistake. It is also advised that this four eyes principle is an effective way of managing banks. Now the question is do we have four eyes principle in practice? When we see Ethiopian experience, there is no two equal status rank to management. What is practiced here in Ethiopia is that, there is president and vice president. So what can we infer from this is that the law demands the system of four eyes principle. But we are not exactly practicing as the principle need.

Change in ownership or merger: Now the bank is licensed and started operating the businessand in the middle of time there would be change. There can be change in ownership, meaning change of composition of share holders. People sell their shares and go away from the bank. So do we require to regulate transfer of share? What is main difference between share companies and private limited company in regard to transfer of shares?Because we said very earlier that banking business in its nature is risky. Therefore, we need to regulate the transfer of shares in banking companies. Because if we worry about the entry of persons into banking sector, and if we require them to acquire license, we should worry at the same time when they change their ownership. Because some peoples are not allowed to run banking business; and we should worry for that reason that those people who the law don’t want to get into banking sector.

So for example, foreigners are not allowed to own shares in banking industry. So can we sell our shares to foreigners? No, we cann’t sell our share to foreigner. So we need to worry about transfer of shares. We regulate transfer of shares to protect transfer of ownership to foreigners, second to control risk. You can look article 9 of the establishment

proclamation no.592/2008 clearly stipulates “Foreign nationals or organizations fully or partially owned by foreign nationals may not be allowed to open banks or branch offices or subsidiaries of foreign banks in Ethiopia or acquire the shares of Ethiopian banks.”But transfer of share between Ethiopian peoples is not protected.

But when say this that Ethiopian peoples themselves should not pass the red line. We said that transfer of share that make person influential share holders must be approved by national bank. The banking establishment proclamation no. 592/2008 under article 10 sub article 3 specifies, “Any transfer of share that makes any person influential shareholder shall be approved by the National Bank before such transfer is recorded in the register of sharer.”Even an Ethiopian national can not hold more than 5% of companies share.If we look at article 11 sub article 4 of proclamation no. 592 states “An influential shareholder of any bank may not acquire shares in other banks.” For example,if you acquire or own 2 % share in bank A,you are not allowed to own another 2 or 3 in bank B or C. Apparently there is no striction upon Ethiopian people, but there is limitation of maximum percent of share.

What about the question we raised above and left unanswered about merger. Merger is one way of acquisition of share or changing of ownership. Merger is when two existing banks merge to form a new another share company. Or one bank may move towards the other bank and remain part of that bank; and loss its legal entity as one independent. So this one form of acquire ownership. So as merger affect ownership it should be approved by national bank. So transfer of share is not only to protect from foreign ownership but also from maximum share holder not exceeding more than 5% and also to regulate risks.

In point of time we raised that one cannot buy shares from a bank by borrowing from another bank. We can assert this argument from the

proclamation no. 592/2008 banking establishment under article 11 sub article 5 of this proclamation states, "No person may buy shares of a bank using bank loans or advances." Here what is the assumption of bank when it grant you loan is that, you may invest in that money you borrowed make profit from the project you invest in. So in case of buying shares from another bank do not have granty to make profit. Even if you say that profit can be made from investing in bank, it is not possible to be sure in this regard. Because banks in their nature are risky activities. There is fear that on the side of national bank, because you may cause risk by investing in bank by the money you borrow from another bank.

The other dimension why the national bank of Ethiopia prohibit borrowing of money from one bank and investing that money in another bank is to avoid conflict of interest. When you borrow money from bank A and invest that money in bank B, it is obvious that you are debtor of bank A and creditor of bank B at the same time. So this may not be okay for the fair competition between banking sector. When you borrow money from bank A and if you deposit that money in bank B, you creating unfair competition between the banking sector. The other thing thwat should not be over and done is that when you borrow money and investing with that money for yourself and giving that money you borrow from the bank that and invest in another bank is not equally the same in risk management. What we have forgotten from the previous discussion is that, if you are director of any financial institution, you are strictly forbidden to be a director in a bank. A board member of unusual company cannot be a board member of any bank.

Reduction of the probability of risk: How do we reduce the probability or the occurrence of bank risk or bank loss by prudential regulation? We have talked more and more about risk for which banks are exposed. Therefore, if risks are inherent nature of banks, what can we do to mitigate those risks? There are many measures that banks employ is that, diversifying the assets. The other one is that banks require more collaterals. The other visible

potential mechanism is that, monitoring borrowers. In order to monitor borrowers there should be a tool to fulfill this gap. In regard to ordinary private lenders and borrowers, we said that there are asymmetry information which further divided into moral hazards and adverse selection.

We said in point of time, there is credit reference bureau at national bank which serves as a data base, from where banks acquire information about borrowers. Or banks may sometimes oblige to disclose information about herself or himself for those who come to borrow money. By and large to reduce the probability of risks for which banks are vulnerable can be discussed below. The first most crucial instrument to reduce the probability of risks is asking information about the borrower. Generally we can classify this mechanisms into two. 1. Duty to supply information: Here what can we do is that, we can enforce impose an obligation on borrower to supply information. He is duty bound to disclose any information about his personality, the project carry out and the possible consequences that the project may expose. We enforce this obligation through two possible ways. 1. Directly asking him to disclosing information. 2. Using a system of credit reference. Meaning we said that there is data base in central bank that use as a source of information for banks about borrowers.

When we directly ask the borrower to disclose information, we may ask the following questions. First who are you? Tell about your personal conduct, business conduct and why I lend you? Whether you before borrowed money from a certain bank? And did you pay that money on time? And are you trust worthy person etc? But in this regard, certain individuals are not willing to disclose their personal information. They believe that such type of disclosion is an intrusion into personal life and business. Then this individuals opt to serch to another banks which are not intrusive. Now the individual go from bank A to bank B and if he asked similar question that is intrusive to his personal life, he may further go to bank C and etc.

On the other hand, banks need deposits to repay their debts of their customaries. In order to do so, banks are remain reluctant to ask direct disclosion of their personal life and business. Because they need not want to loss customaries. This in turn cause competition among banks. Now in order to compete with other parallel banks, banks do not ask much information as such. This in turn cause the asymmetry information to be bigger and bigger. This in turn cause credit monitor will decrease and default risk will in turn increase. Now in order to avoid this type of problems the national bank of the government, put in place certain regulating rules to the banks when they lend money to borrowers. The central bank regulate commercial banks not to lend to borrowers who do not disclose certain informations which it think more credible to risk management.

When we come into indirect way of getting of information about borrower, by credit reference bureau. So as to provide information to banks the national bank of Ethiopia established a credit reference bureau, where banks are obliged to give information about their borrower to this center. There is standard format prepared by national bank that should be fulfilled by commercial banks and entered into the central bank. In this standard format, the banks are required to fulfill certain informations about their borrower and send that information to central bank with in 3 days from the borrower asked them lone. Unless, there is no granting of lone and extending credit to borrowers without the permission of the central bank of Ethiopia. As said above, no bank can renew lone term, reschedule any payment system, extending lone credit, and etc to its borrowers without prior permission of central bank of Ethiopia. Through these two modalities, banks may minimize the susceptibility of banks to various risks . In present Ethiopia there is no bank allowed to do business with any borrower without using credit reference system. By doing so, the national bank regulate probability of risk or embark upon asymmetry of information.

The second possible crucial instrument to reduce the probability of risk is improving internal decision making process. How do we improve internal decision making process of certain bank? In order to improve the internal making process of a bank, we need to set up special division of sub committees and committees that specialized in certain activities. As the board body of bank is the decision making body, so in order to pass proper and discernible policies and strategies of the bank, they need to have competent and qualified training must be provided with. So as to make decisive and effective decision about the business transaction, you need to gather information in a way that make your decision more easy and quickly cost-effective. To do so, you need to have appropriate mechanism to record and keep that information; and you need to communicate that information to branches. One man one vote do not apply for common types of commercial banks. Because commercial banks are dealing with public money, and how can we say that one can have a voting power over the public money. This principle is applicable to cooperative banks. Because from the very beginning the fundamental objective of cooperative banks is not profit making. But profit making is the main purpose of commercial banks. In cooperative banks people come together and mobilize their limited resources to self help purposes.

Bank corporate governance is characterized by a complex framework as it encompasses a wide range of stakeholders including not only shareholders but also depositors, creditors, suppliers, employees, and regulatory bodies. The unique features of banks necessitate strict government regulation through bank supervisors and a range of banking laws and regulations. The interface between these elements determines how well the performance of a bank conforms to the best interest of shareholders, while complying with regulatory standards. Hence, for shareholders and regulators the bank corporate governance framework is critical for the bank's success and its daily operations.

On the other hand, poor corporate governance may contribute to bank failures which could, in turn, trigger a bank run or liquidity crisis. The overall standard of corporate governance in Ethiopia is inadequate. Among the factors which show such a poor standard is, firstly, the absence of an adequate legislative framework to regulate modern complex bank governance issues give rise to inefficient banks. Secondly, political parties' involvement in business enterprises is impeding effective competition by the private sector. Thirdly, inadequate shareholder protection laws and the ineffective judicial system that causes expropriation of shareholders' wealth by denying businesses legal safeguards. The absence of an organized share market also makes valuation and price discovery of banks difficult. Besides this, there is a major credibility problem in the Ethiopian banking regulatory environment, since the regulatory rules are enforced discriminately between state and private banks.

The third possible way to reduce the probability of risk is that, limitations on functions of banks. The activities of banks should be limited in order to achieve certain goal. Banks should not allowed to transact in any business. So as to limit the functions of the banks, the national bank of Ethiopia amended the directive on limitation of banks on investment in 2015 to properly regulate the banks. The main issue of this directive is to provide structural solution to various problems of risk.

By doing so, we are limiting the area in which banks carry out their activities. We need to make separation between banking transaction and non-banking transactions. Even it is more important to make separation between the banking transaction itself. Because we have to distinguish between commercial banks and investment banks. We need to limit the amount of share or equity that banks are allowed to participate in other companies. So we have to let them to focus on their core banking activities. By making separation between banking activities, it is possible to reduce the probability of risk, even though we avoid the risk all in whole.

Ways of the limitations of functions of banks can be summarized as follow:

First making separation between commercial banks and investment bank. Making separation between banking business and investment banking should be distinguished; According to establishment proclamation no. 592/2008 under article 2 sub article 2 define what banking business mean. The provision reads, “banking business” means any business that consists of the following activities:

a)receiving funds from the public through means that the National Bank has declared to be an authorized manner of receiving funds;

b)using the funds referred to under paragraph (a) of this sub-article, in whole or in part, for the account and at the risk of the person undertaking banking business, for loans or investments in a manner acceptable by the National Bank;

c)the buying and selling of gold and silver bullion and foreign exchange;

d)the transfer of funds to other local and foreign persons on behalf of the banks themselves or their customers;

e)the discounting and negotiation of promissory notes, drafts, bills of exchange and other evidence of debt;

f)any other activity recognized as customary banking business, which a bank engaged in the activities described from paragraph (a) to (e) of this sub-article may be authorized to undertake by the National Bank. From the reading of this article, we can understand that national bank of Ethiopia regulate the banking sector strictly. Because banks are required to get the approval of national bank to undertake certain activities mentioned under this article.

If banking is defined in this manner, now the question is, what is an investment bank? An investment bank is a financial institution that assists individuals, corporations and governments in raising capital by underwriting and/or acting as the client's agent in the issuance of securities. An investment bank may also assist companies involved in mergers and acquisitions, and provide ancillary services such as market making, trading of derivatives, fixed income instruments, foreign exchange, commodities, and equity securities.

In addition to this, the investment bank may undertake the subsequent activities. Accepting bill of exchange. Accepting bill of exchange means, granting the payment of of face value of the debt of instruments. It is undertaking to pay sum of fixed money without condition. This means that the bank of investment grant the payment of the debt upon the failure of debtor. Investment banks grant the payment of debts if the maturity date is arrived and if you have not sufficient money to pay, the investment bank take the position of guarantor.

An investment banks also provide lone arrangement. In the case of lone arrangement, investment banks do not directly lend money. At this time what they do is that, they arrange lone for you. According to lone arrangement the investment banks help you to borrow the money you need from the commercial banks. Meaning, if you need money from the commercial bank, the investment bank assist you to access that money from the commercial banks. Here what you can do is that instead of directly going to the commercial banks to borrow money, you go to the investment bank and then the investment bank make an arrangement with the commercial banks, in order to they grant lone to you. This is typical form of lone indication. For example, Ethiopia needs 80 billion birr tfor the certain dam project, no one is able to provide this much money which is too much. According to national bank plan, there is maximum limit beyond which you cannot lend to single person. This happen for many reasons, for one or

other thing, first a single bank may not be willful to grant such amount of big money, second it is legally prohibited and third banks for the interest of diversifying their risks, they do not want to do so, or incur risk.

Therefore, what an investment banks do is that, they make an arrangement for lone in the form of lone indication. Which means, they organize banks which are going to provide you with lone by using a single lone document. Instead of dealing with different 12 or 16 banks separately, you deal with them as a group once. By using such a single document, all those banks who are ready to grant lone to your project may be ascertained. This is very important instead of borrowing from 15 or more at different time, it may be better to get a huge amount of money at a time for your project. So an investment bank assist you to get lone from commercial banks without dealing separately with each banks. It also make you to obtain large amount of money at a time from the banks through investment bank. Here what you should be care of is that, the investment bank doesn't directly lend you money but by organizing banks which need to give lone, it provide you with huge money from those banks.

The other business of investment bank is project financing. An investment banks help you for project financing. Now the question is how investment bank help you for project financing? Now let us say that you want to carry out a long term project, in order to financing this long term project, you need long term lone. Now in order to find this long term lone, you need a market to raise such a huge amount of money which will stay for long term, until you finalize your project and make profit to repay that debt borrowed. Now you are in need of large capital to pfinancing your project, and it is not possible to raise such a large amount of capital from money market.

So in order to raise such a huge amount of capital from the market, you need to go to the capital market. By the way in point of time in our discussion, we said that there are three types of market. These are money

market, capital market, and foreign exchange market. Now let us say that you are in capital market, to finance your project, and you are in need of long term of lone, so as to raise such a long term lone, you opt to go to the capital market. Now the question is that how do you raise money from the capital market?

We said above that there are instruments used to raise money from market which are one of the components of financial sector. Among these instruments which we use to raise money from capital market and instruments we use to raise money from money market and foreign market are not the same. In order to recognize this difference you need to memorize what we said so far in regard to these instruments. There is no need of talking about these instruments again and again.

Now let's shift our attention towards our main discussion about raising of money from capital market for financing your project. So as to finance your project the investment bank help you to borrow money from financial market particularly from capital market. An investment bank help you to issue shares and bonds to raise large amount of money. Investment bank do not only allow you to issue shares and bonds but also help you by promoting and selling those instruments. In addition to this, investment bank promise you that in a situation of where those instruments are not sold out in the capital market, it will buy you the remaining or left over instruments. This special promise which the investment bank declares is known as Underwriting. Meaning, after you sell to the capital market to the public at large and you are not sell out all the instruments, the investment bank take the left over instruments.

Furthermore, investment banks deals with securities. This means that investment banks engage in selling and buying of securities. What do we mean by security? Investment banks selling and buying securities of equity shares and bonds with the view of making profit. Investment banks also

assist you by being guarantor to borrow money which we already conversed about. Now we have seen different features of commercial banks and investment banks. This helps us to distinguish and regulate each financial sector in accordance to the nature of their business activities.

An investment bank is crucial for Ethiopia for the following reasons in addition to raised above: 1. An investment bank helps by playing a middle role between the borrowers and the public at large. The investment bank buys new shares from newly emerged companies and sells those shares to the public by changing the shares into smaller portions. So investment bank is important to reduce the load of companies by meeting them with public without searching for purchasers' who need to buy shares. 2. Plus to this, investment bank is also important by providing service to foreigners who need to invest in Ethiopia. Because foreigners do not have sufficient knowledge about Ethiopian financial sector. These foreigners do not know detail information about market situations of Ethiopia, so an investment bank helps them to provide with the appropriate information. 3. An investment bank may also be very important in order to fulfill the gap created due to the absence of capital market in Ethiopia. What do we mean by this? Because investment bank may assist you to raise money from financial market, by allowing you to issue instruments such as shares and bonds. And if these instruments do not sell out they may buy the left over from you. Furthermore, they help you easily change these instruments into cash.

As it is important to distinguish the activities of commercial banks from investment banks, we can not be confused by functions of investment bank with commercial bank. Because investment bank and commercial banks functions should be separated from universal bank. Since these banks are not allowed to undertake any financial service as universal bank. Since they are not universal banks. Universal banking is a system of banking which undertakes every activities of banking. It provides every type of services of

banking of retail banking, wholesale banking, commercial banking and investment banking in a single institution etc. Universal banking provide you with any financial service at time in one institution. Thus, it is very important to distinguish between the commercial banks and investment banks activities allowed to them to undertake. So as they are not universal bank, they are not allowed to undertake any financial service as they need. For example, commercial banks are not allowed to carry out insurance business. To some extent they may permitted to to buy a certain amount equity share which is not more than 5%.

Second,the other thing is that, no commercial bank is allowed to participate or engage in any activities that are not prescribed under article 2 sub 2 in the definitional part of proclamation no. 592/2008 except the permission of national bank.In addition to this, this proclamation under article 50 stipulates, "The conditions under which banks may engage in any non-banking undertakings shall be determined by directive to be issued by the National Bank."So banks activities and non-bank activities should be distinguished and banks should not be engage in non-bank activities. Even this banks are not permitted to engage in related financial activities to take any activities. Here what we have to stress on is that, even if banks allowed to buy equity from non-bank activities, it is not permitted to buy more than 10% of its paid up capital. On other side, no commercial bank is allowed to carry out or deal in security. Banking establishment proclamation no. 592/2008 under article 22 puts limitations on banking sector. This proclamation under sub article 1 of the same article reads, "The conditions and limitations on investments of banks, and a loan, advance or other credit facility, financial guarantee or any other commitment or contracts given by a bank, directly or indirectly to a person shall be determined by directive to be issued by the National Bank."

Third one is that, separation between long term and short term credit business. This means, commercial banks functions in regard to dealing with

long term and short term credit business, limitation of functions should be undertaken. Because long term and short term credit has its own risk. Therefore, it is to be considered very watchfully. In some jurisdiction certain countries consider long term and short term credit separation as an instrument to tackle risks. As far as the instructor's reading goes there is no clear requirement of separation between long term and short term credit, prescribed under Ethiopian prudential regulation laws. In this area there is no apparent separation between long and short term credit business obligation. Thus, any commercial bank can transact whether by long term and short term credit business. The requirement is that banks should respect all the appropriate rules and regulations put in place by national bank of Ethiopia, in order to regulate and monitor risks.

Fourth one is that, limitation of share holders in banking sector. The question is that, do we require to put limitation on share holding? Obviously the answer is affirmative, we need to regulate the maximum limit on share holder to insure the wide spread of share ownership, so as to reduce the exposure of banks to various risks on the ground of certain influential individuals. In regard to this, the bank establishment proclamation no. 592/2008, article 11 under sub article 1 stipulates, "No person, other than the Federal Government of Ethiopia, may hold more than five percent of a bank's total shares either on his own or jointly with his spouse or with a person who is below the age of 18 related to him by consanguinity to the first degree."

Therefore, we can recognize the limitations imposed on share holders in the banking business. The same proclamation under the same article under sub 3 declares, "The amount of shares that may be held in a bank by a company, which is partially or fully owned by persons who have share in the bank, shall be determined by the National Bank." Look the how the the national bank regulate the share holders in the banking sector. By the way this requirements are very stringent that if you do not adhere to these

requirements, the national bank may take its own measures. The amount of share that you can acquire in a bank is determined by national bank.

In point of time we raised that an influential share holder is regulated in a very careful manner. The same article under sub 4 articulates that, "An influential shareholder of any bank may not acquire shares in other banks." Under this sub article, an influential share holder in bank A cannot hold share in another bank B. We said that the purpose of limiting influential share holder is in order to widen share ownership and few individuals should not monopolize the banking sector and which in turn minimize risk.

When we are reading this provision, we can understand that anyone who want to hold share should not pass the red line put in place. However, the exception is that the federal government has a freedom to own any amount of share. There is no limitation for federal government to own shares. Let leave alone holding of share without limitation, the federal government can own a bank solely. What do you think the justification? So the main purpose to limit the maximum share is in order to not influential share holder affect the lending decision. We said that the purpose of limiting share holding is to reduce the possibility risks caused due to the influential share holders.

But the possibility of occurrence of risk through the window of government look like less, according to the understanding of the government. But I do not think so. I think the assumption is that government take into consideration public interest when it deal with banking business. But other commercial banks which are not owned by the government chase profit rather than public interest. I leave the justification for you regarding about the question raised above.

By the way, what do you think the justification for the limitation for share holding? The justification for the limitation of share holding is for the sake of safeguarding the public interest. Now the question is that, what is public interest in banking industry? Because banks mobilize public fund.

Therefore, when banks mobilize public funds, they may fail in the banking business. So the failure of banks do not only affect certain individuals but has adverse impact on the public at large. It is for this and other reasons that national bank regulate stringently the share holders.

The Fifth banking function where certain limitations may be undertaken is that regulating insider lending. Now the question is that, who is insider ? Insiders could be natural persons or juridical persons. These are special persons that may lead banks into special risks. These insiders are those who able to influence the lending process and lone terms. It is for this reason why special regulation is necessitated. Generally insider persons are managerial personel and share holders. That is why we need to regulate their functions when they undertake banking business. The reason why we regulate insiders is that, they are influencial decision making. So if they want to borrow money, it is very difficult to prohibit them from borrowing. So when we grant lone them we should regulate the terms of the lone. By the terms of lone, how much lone should be allowed? When do the repayment period? How much interest rate should be fixed? Generally it is very essential to regulate terms and conditions of lone to those insiders in order to regulate risks.

So as to regulate insiders there are three approaches. The first one is controlling the decision making process of the insiders. When we are saying controlling decision making process of insiders, these insiders are managerial or share holders. So when they require lone, they should not carry out their normal task as they under take in normal time. For example, let's say that X wants to borrow money and who is member of board in that bank. And now he applied to get lone, and granting the lone or rejecting the lone is going to be decided by the board members. Now it is possible to assume that the borrower is going to be a judge on his own case to decide on this matter. Even if he himself does not borrow the money, there is a probability of his relatives come to borrow money to that bank. At this time,

he may discriminately decide on the conditions and terms of lone. As all of we know that there is a jurisprudence that prohibit, "one cannot be a judge on his own case." Thus, it is very important to control the decision making of the insiders.

The second approach of regulating insiders is reporting requirements. In accord to reporting requirement, whenever insider lone is granted, you may required to report immediately to the national bank. So as to enable the national bank to regulate the banking sector as whole, whenever lone is garanted to the members of board or his or her relatives, the bankis required to report immediately to the national bank. The national bank of Ethiopia is very vigilant on this type of decisions. Because it fear the adverse consequence that may resulted due to the laxity of insiders during their carriage.

The third approach of insider lone controlling mechanism is substantive limitations. This substantive limitation in turn can take three forms. First prohibition of any special favor to insider lone granting form. This is prevention of preferential and diferential treatments. In light of this requirement, you have a right to borrow money from this bank, but you are required to fulfill what the law requires from you. You are entitled to get lone but you are subjected to the same conditions and terms of lone as any other borrower.

The second form of substantive limitation is maximum limit on certain types of lones. In maximum limitation of substantive limitation, you can borrow money from the bank; but there is a limitation on certain types of lones. For example, lone granted to finance agricultural industry maynot be the same granted to real state. There are certain sectors which government want to promote to achieve certain goals according to its policies and strategies. Therefore the national bank may put certain maximum limitations of lone to be granted to finance various projects.

The third way or form of substantive limitation is structural limitations. Here you can not borrow more than certain percentage of bank's capital. The limitations may take structural form where you cannot get more than certain percentage of bank's capital. You are allowed to borrow money but you cannot pass the limitation beyond you allowed to do so.

The national bank of Ethiopia come up with a directive on single and related counter parties. And this directive defined what is related parties in regard to insiders, under article 3 sub article 7 define related parties as "related parties to special bank means, the share holder, director, senior officer, or chief executive officer of that commercial bank and or the spouse or relation to first degree of consanguinity or affinity of such share holder, director, senior executive officer or chief executive officer; on the other hand, the partnership, common enterprise, private limited companies, share companies or any other business in which the share holder and other listed managerial persons has business interest. So it make distinction between managerial stuff and those related to him or her and juridical persons who have an interest in the bank. Insiders or managerial stuff in the bank are subject to heavy regulation.

Limitations on lone, article 6 sub article 2 reads, The aggregate sum of lone or advances extended to outstanding directly or indirectly to one related party at one time shall not exceed 15% of the total capital of commercial bank. So substantive limitation is defined in reference to the capital of the bank which is structural limitation. In the same directive under article 6 sub article 3 reads the aggregate sum of not extended or permitted to outstanding directly or indirectly to all related parties shall not exceed 35% of the total capital of the commercial bank. The first one is related to single party. The second one is related to all related parties, they may be 3 or 4 in number. So interestingly, commercial banks should not extend lones beyond certain limit. This is one way of regulating insider lending. Even the national bank may prohibit any form of lone to this group in accord to

article 6 sub article 4 of this directive. Or the national bank may also prohibit on any ground the commercial banks from extending or advancing lone to any person in accord to the same article of article sub 5.

The final regulatory tool to reduce the probability or occurrence of risk is through regulation of liquidity. Now the question is what is liquidity? Liquidity is the ability of asset to serve as a means of payment. It is an ability of an asset to be converted into cash for the purpose of payment. What is possible sources of liquidity? Banks may put cash as deposit in other commercial banks. Or you may have certain reserves in central bank. You may also borrow money from inter bank or go to money, capital and foreign markets. These are three sources of liquidity for bank.

What is the problem of liquidity? Banks take deposit for short term and transform that deposit to long term lone. They take lone deposit for short term and grant long term lone. Which may cause mismuch between maturity of deposit and lone granted to borrowers for long term. Then if maturity date exigency reap, and banks may fail to pay because it has already lent that money to borrowers for long term.

The directive on liquidity management defined Current liability of banks, as deposits which may refered as to sum of demand of current deposit, saving deposit and time deposit and similar liabilities with less than one month maturity. Therefore the liquidity ratio of this liquid asset to current liability must always be 15%. The national bank may prohibit you undertake banking business if liquidity ratio fall below the percent required by the law.

Still now we were talking about the very foundations of banking regulatory rules, which help us to regulate risks. We said that banks are risky in their nature. And if banks are risky in their nature, they should be regulated very carefully. And then we started by entry requirements of banks into existence. We said that banks are business share companies and required to obtain legal personality. In order to obtain this legal requirements, it is

subject to certain legal frame works. And these legal frame works that banks undergo to have rights and obligations under the law. Because if they do not fulfill the entry requirements particularly licensing, their acts and performances will not have constitutive effect. So first we started by looking at entry requirements specifically licensing prudential regulation.

Then second we considered about regulations in regard to reduction of probability of risks. The main objectives of these prudential regulations in this regard are to reduce the probability or occurrence of risks. Here what we regulate is risks before their occurrence or happen to our banks. These prudential regulations are carried out during operational time. And we mentioned various forms mechanisms to reduce the probability or occurrence of risks.

Now let's shift our attention towards regulations used to reduce effects of risk after it materialized. Here what we can do is that, once the risks are materialized, and we do not sit without any job, rather we required to minimize the effect of the risk that already materialized. Even though the risk is materialized, we need to take possible measures to curtail or reduce the harm materialized. You cannot totally prevent risk. If risks are totally preventable there is no need of regulation.

So what regulations aimed at limiting of the effects of already materialized risks? Before we address this question, let us take one example from the general contract of law. In general contract of law, you enter into agreement to perform or procure certain obligation. But in a time, the counter part may default to undertake his or her obligation. Now it is obvious that non-performance cause damage. Because a contract concluded with consideration, and you may expect certain benefit from the performance of the contract. Now you lost what you already expected from the performance of the contract. Now it is possible to assume that you incurred damage.

So you may not remain without option at this time. Because you already materialized damage. Now you may think for solution to recover that damage you incurred due to the non-performance of the counter part. The possible solutions that are available at your disposal may be 1 cancellation of the contract. 2 Asking for forced performance. 3 Or you may ask compensation. Now these are possible solutions to reduce the damage that already materialized. If there are solutions to reduce or minimize the risk that already materialized in contract.

Now the question is that is there any possible solutions, in banking sector to reduce or minimize the risks that already materialized? There are certain ways by which the effects of risks may be minimized. As we said that there are many ways through which the bank may mitigate the risk that already materialized.

The first possible way through which we minimize the materialized risk is that, risk transfer. Now the question is what is risk transfer? And how risk already materialized transferred to third party? In your law of insurance there is a concept known as risk transfer. Firstly you have learned in law of insurance that risk is transferable. Contract of insurance is risk transfer mechanism or an economic device whereby a person, called the insured/assured transfers a risk of a possible financial loss resulting from unforeseeable events affecting property, life or body to a person called the insurer for consideration. For instance, let us take a case of an owner of a motor vehicle, who always runs the risk of suffering a financial loss resulting from the loss or destruction of his property because of unforeseeable events such as fire, collision, overturning or even theft. Therefore, if the person purchases a motor insurance policy covering these risks from an insurer, it means that he transferred this possible financial loss to the insurer.

First the main classic way of risk transfer is lones indication. Now the risk is already materialized to a certain bank called bank A, now in according to lones indication principle, the risk already materialized by bank A should not only born by bank A. According to principle of lones indication, instead of the risk hitting bank A, so hard, the risk has to be divided by several banks to mitigate the risk. So even though the practice of lones indication is not quite realistic, there is probability for lones indication is possible under Ethiopian law. Because it is well documented in the laws that governs the law of banking.

Now the question is how do you enforce lones indication upon other banks which don't face risk? By the way, lones indication is contractual agreement among several banks to provide lone to certain individuals. A single bank may not have such amount of money to lend. Even if the bank has such big amount of money to lend, it may not do so, because it has its own consequences of risk. Furthermore, there are limitations on maximum amount to lend by a certain bank. So as not to violate the directives, regulations and proclamations, banks may not be willing to provide such amount of money to a single individual. In addition the business may be highly profitable but as well highly risky. It is for this and other reasons, why banks want to share risks with other counter part banks.

But let's assume that banks do not agreed to share risks with bank A, is there possibility for national bank to enforce, the other banks to share risk with bank A? In the opinion of the instructor, there is no justification why national bank forcefully oblige banks to share risks. It seems so intrusive into freedom of banks. By the way the personel of the national bank may informally attempt to intervene banks to accept loss indication. But the instructor doesnt imagine the formal means by which the national bank enforce the principle of lones indication.

But the instructor believe that the national bank may achieve the same purpose by compelling them to share risk. Through other means of regulations indirectly. One of which is regulation on exposure to single or large credit. By prohibiting them to grant lone beyond certain percent to single person or insiders, the national bank may indirectly enforce banks to lend money to bank which already hit by risk. How can this be possible? If the national bank prohibit lending beyond certain amount, the banks may be forced to lend that the extra money to group of persons or other bank. Because banks take deposits from depositors, so in order to repay this deposits which is their liability, they required to make profit by lending the money to borrowers with certain percent of interest rate. So banks may compelled to arrange lone indication, if they limited to lend over certain amount.

Think of the typology of risks we considered so far; we raised plenty of risks in regard to banking business. One of the risks is that we said that credit risk, where borrowers default to repay his or her debt to the bank granted the lone. Now we are talking about the materialization of risk and the solutions to mitigate the harm we sustained. And among the risks we already entertained is that market risk. In concern to this we said that, Market risk is the potential that changes in the market rates/process may have an adverse impact on the bank's financial condition. In other words, it is the risk that the bank's earnings or capital position will be affected by fluctuations in interest rate and foreign exchange rate.

The second way of risk transfer is buying of an insurance policy. Now the question is that, do we have an insurable interest in market risk, under Ethiopian law of bank? Or can banks legally insure their market risk? Market risk is change in interest rate or change in exchange rate. And the business of banks is collecting deposit from the public with certain interest rate. And they lend that money to borrowers to get an interest rate of higher value than they accepted deposit. What we can infer from this

business is that, deposits are the liabilities of banks; and loans are the assets of banks. We already said that, loans are assets of banks, because they get interest rate.

Now let's assume that, bank G lend money to person called X, with an interest rate of 10%. And now due to the movement of interest rate or exchange rate, during the payment time when the person called X is going to repay that money, the interest rate or exchange rate fall down; at this time for obvious reason, banks may face market risk. Here the value of the interest rate during granting loan and the face value of the interest rate at the time of payment, may fall due to the market fluctuation either for exchange rate or interest rate; which is risky for the banks. As far as the literatures of banks whether here in Ethiopia or elsewhere concerned, an interest rate or exchange rate movements are uninsurable interest.

The third way of risk transfer is holding collaterals or securities. Now the question is that, who is going to bear the loss of risk during default? How do you compel banks to buy an insurance policy? So here what can the national bank of Ethiopia can do is that, it may force the banks indirectly to buy an insurance policy; or it may have to go directly require them to buy an insurance policies to cover their certain risks. When we look the directive issued by national bank about preconditions to enter into banking business, which talk about conditions for commencement of operations, under article 6 sub 3, 5 require you to have certain insurance policies for the following reasons: fire and other related risks, burglary and theft related risks, fidelity and cash and valuables in the premise and transit. What type of banking risk is covered? The banking risk insured here is the operational risk. During carriage of your business, employees may steal the bank.

This policy under article 6 sub 3 , 5 which talks about theft, burglary, fidelity and cash and valuables is related with operational risk. Because we are in time where banks operate through on line system of account. There

are customers' accounts on line which we call internet banking. So this is challenging for regulation for banks. Internet banking or mobile banking is not safe as for regulation as we regulate normal banking system. This on line account system is vulnerable to hackers. Because these peoples may hack your customers account and perhaps entail liability on the bank. Because banks are guarantors to depositors saving. And in point of time, we said that deposits are liabilities of banks.

The same requirements also apply in case of branch banks. Meaning if you need to open new branch bank, you need to have the same insurance policy. This similar risk which is operational risk may may also go with that branch bank. This is clearly stipulated under directive on branch banking 58/2004, you have an insurance policy for fire and Percy, for the banks of branches premise, cashes and valuables and premises, and transit, fidelity and appropriate policy for such risks. Therefore, buying insurance policy for banks is compulsory to insure their branch banks. But for very unfortunate reason. This insurable interest is not covered for other risks. Meaning it is an operational risk that banks can insure.

When coming back to the question posed in regard to, who is the bearer of collaterals or securities? When collaterals are realized it is the third party or the person who has offered collaterals who sustain the loss. This means that it could be the debtor himself or the third party who offered his assets as securities or mortgage who can loss. Can you imagine other classes of losers, when collaterals are realized? In regard to this, secured creditors stand first, meaning they have priority to get their share from the securities. But what about those who do not secured? It is these peoples who are going to loss. Because these poor creditors who do not enjoyed the priority could loss. Unless, the property given as security or collateral suffice those poor creditors will loss. But if it suffice to cover the creditors claim, it is at this time that poor creditors who do not secured can get their payment.

The second possible way through which we can minimize the risk that already materialized is that through asset diversification. How can we minimize the risk materialized through asset diversification? How can national bank of Ethiopia force banks to diversify their assets through directives, regulations, proclamation and other any means? Generally, you need to diversify your assets and also your liability. If bank need to diversify its assets, what is its assets? In point of time, we said that loans are the assets of banks. Because banks grant lone to borrowers with certain amount of interest rate is greater than the deposit which they accept from depositors. So instead of lending to single person or group of one entity, banks prefer to lend to many different persons. In moment go, we discussed that one of the main purposes of prudential regulations of banks, limiting banks from granting large amount of lone to single party or related group. The national bank does not want to banks to give large amount of money to single party. Because if risk occurred to that single party, it is not only that single party who face the risk. But above all, it is the banks who granted a large amount of money to that single person. And if the bank do not able to get its lone, because of the default of the borrowers, it may face risk of credit.

So through regulatory means, the national bank force banks to diversify their lones portfolios. Therefore, whether the banks grant single scale lone exposure or large scale exposure to many persons or groups, the national bank uses the following standards or approaches banks, to diversify their assets.

The first approach is that, defining the lone in reference to bank's capital. Here loans put as standard to limit the bank to grant lone which is in reference to the bank's capital. The national bank may put in place that, individual lone should not exceed a certain amount of the bank's capital. Or it may put in place that sum total of certain loans or large amount of lone should not exceed certain percentage to the bank's capital. This is one way

of determining the size of lone which banks can grant at a time. By the way it is advantageous for avoiding all banks loans from falling in a single person hand. It is also disadvantageous for that, it discouragethose who established a good relationship with the bank. Good persons who have great worthiness to the banks may discourageor affected due to this situations.

The second approach to diversify assets of banks is that, total credit volume or total loan volume. This is not in reference to bank's capital. But it is about the size of a single or individual lone. We have talked about single or individual lone or the sum total of all loans. This approach is considered not to in reference to the capital of the bank. But it is limited to in reference to the amount of the lone which the bank already granted. In this standard, one large lone should not be greater than 5% or 4%, of the sum total of the bank's loans. Meaning, if that bank granted lone for 50 or 100 persons, and if one person need to get lone, this person's lone is considered in reference to this sum total of all loans of the bank. Any way the reference is not in reference to bank's capital, but in reference to the bank's sum total lone or in terms of credit volume available by the same bank to other creditors. By the way we do not have uniform standard in reference to sum total lone. And it varies from country to country. A certain country may allow 70% or 80% of their sum total of lone.

The third approach through which we can diversify bank's assets is that, in reference to bank's liability. Now the question is that, what are bank's liabilities? Repeatedly, we raised this concept in relation to the deposits which banks receive from the depositors in the form of deposit. We also said that banks mobilize funds from the public in the form of deposits, and channel that money to borrowers. Therefore, when we say that banks assets diversified in reference to bank's liabilities, it mean that large lone or exposure to large loans may be determined in reference to bank's liabilities.

So individuals lone should not be greater than a certain percentage of bank's deposit. This individual's loans or large exposure loans should not be greater than sum total percentage of the bank's deposits. By the way this standard is from perspective of the bank's deposit. Your right to allow lone is limited in reference to bank's deposits. A certain amount of lone should not exceed a certain percentage of bank's deposit.

What do you think about the position of Ethiopian's banking law standards? The appropriate yardstick which the national bank regulation shows us is that, it is in reference to bank's capital. The national bank regulation is based on the standard in reference to bank's capital. What do you think the reason? Because it is the bank's capital which is going to be the garanty of depositors. It is reasonable to limit banks lone from the perspective of bank's capital. In this regard we have national bank directive governing exposure to single or related parties based on the ratio of lone to capital.

The main purpose of this directive is to insure the commercial banks are sufficiently diversify their credit risks so as to minimize the loss resulted, because of exposure to single or related parties to repay loans. How does this directive limits or regulate exposure to single or related persons? This directive under article 6 it defines in reference to bank's capital. It says that person cannot borrow more than 25% of the bank's capital. And a single related person cannot borrow more than 15% of the bank's capital. And all related parties taken together cannot borrow more than 35% of the bank's capital.

Sometimes the national bank can forbid any lending. Meaning the national bank may prohibit any lone to any person. Whether it is related or not related. In addition to what we have already said, this directive under its article 10 states, if a single person borrow more than 10% you need to report to the national bank. And any related party should be reported as the same. This is how the national bank over sees banks asset diversifications.

Under article 7 we can notice exemptions. Under this article if you have cash collaterals, you can borrow any amount of percent. Because this collaterals can be converted easily into cash. Any collateral which can easily substitute may be deemed to cash. And if you hold them as collaterals you can have whatever money.

Here what do we should not forget is that, banks are not only required to diversify their assets or loans; but also their liabilities should be diversified. When do we say this, what do we mean? How do banks diversify their liabilities? As we talked repetitively about the liabilities of banks should not be new concept for us. We said that deposits are the typical liabilities of banks. If deposits are liabilities of banks, how do they diversify these liabilities? Banks diversify their deposits by not borrowing or taking a large amount of money from a single person. Banks are required to avoid exposing themselves to a few large depositors. Because if those few depositors come on one day to withdraw their money, the bank will face a risk of liquidity.

When we are talking about deposits, there are three types of deposits. These are: 1. Time deposits; 2. Saving deposits; and 3. Demand deposits. Even though the time deposits are collected after elapse of certain period of time, the depositors may come to withdraw their money at a time. Therefore, there should be certain regulations that oblige banks to diversify their liabilities. When we visit our banking law regulations, there is no clear regulation that compels banks to diversify their liabilities. But in some jurisdictions there are such kinds of restrictions imposed on banks to diversify their liabilities.

Even if the national bank of Ethiopia does not impose certain obligations to banks to diversify their liabilities, but it required banks to report their 20 top depositors to the national bank. This is one way of regulating the liquidity risk.

The other way of assets diversification by banks is that, they are required to diversify their assets in regional and sectorial places and institutions respectively. This is for the reason that, if a certain economic crisis hit a particular region where you invested a lot, now you are going to face troubles. So you are not required to expose your assets by investing in certain region or sectors. As far as the instructor's knowledge goes there is no specific provision that compel banks to diversify their assets to various regions. But what the national bank of Ethiopia regulates in its regulations, banks cannot open branch whenever they need without the national bank approval. This means that you cannot open branches at any place without national bank approval. In relation to sectorial diversification, you should not excessively expose your assets to certain sectors. The classic example to which banks exposes their assets to a risk is petroleum or energy related sectors. This sector is specially, exposed to up and down movement of price, which may imperil the activities of banks. Thus, you may impose certain amount of percentage of lone, not to be granted to certain sectors. You are not allowed to give more than certain percentage of your capital. But this is not a case, in Ethiopia because banks can grant any amount of lone to a certain sectors.

However, the Ethiopian national banks do not require banks to expose to excessive lone to certain sectors. The national bank fears certain risks and do not want banks to expose their loans. Nowadays the national banks interfere informally in regulation banks to grant loans. The current financial crisis alerted the national bank to impose certain amount of percent, not to be granted specially to real-estate and construction sectors. These sectors are not as such much more profitable business.

The third key tool to regulate risk that already materialized is that, capital adequacy ratio. Now the question is what is capital adequacy ratio? Banks do business by borrowing or accepting deposits from the large public and lend that money it raised by deposits to borrowers. So in accord to the

principle of capital adequacy ratio, this bank's collecting money from the large public in a form of deposit and which it lend to the borrowers should kept its balance. What does this mean? This means, the bank's capital which it raised in the form of deposit should not be less than the capital which it lends to borrowers as lone. Because if the borrowers who already borrowed the money from the bank default, the ultimate guarantor to the depositors is the bank. Let's say that a certain bank granted lone to certain individuals, now let's assume that these individuals defaulted to repay the bank's money. Upon default of borrowers the bank becomes the last guarantor of the depositors.

By the way! Banks cannot lend their capital to borrowers. The minimum paid up capital of the bank should not be prone to the lending of banks. Banks are not allowed to do business by lending their capital. But rather, banks do business by lending the money of depositors which they accepted or collected in the form of deposit. This means, banks make business by money of somebody else. Because banks are not allowed to do business by their capital. Their capital is the final security of the depositors. This will be upon the event of where borrowers default to repay their debt to banks. So you need to keep prudential relation between your capital and lending. Hence, this relationship between your capital and your assets or loans you granted should be balanced. This balanced relationship between your capital and your lending is called capital adequacy ratio. Or the prudential relationship between the bank's capital and its lending to borrowers, which is called capital adequacy ratio. Therefore, if the bank's capital is the guaranty of the depositors you need to maintain prudential and healthy relationship between the capital and the loans you lend to borrowers. So relationship between the capital of the bank and bank's loans which it lent out to borrowers is referred capital adequacy ratio. In simple speaking capital adequacy ratio means, it is ratio between bank's capital and bank's lending. Here the main purpose of capital adequacy ratio is instead of

lending from the capital of shareholders, it is better to lend from the money which you collected in the form of deposit. Sometimes this concept is known as capital labor age ratio. In their nature banks need to do business by lending loans to borrowers. They want to make more by granting a lot to borrowers. So it is for this reason why banks required to maintain the balance between their capital and lending to the borrowers.

Because of this reason, banks should not expose themselves to excessive lending. Meaning they should not require to lend from their capital, rather it is better to lend from their money they collected in the form of deposit. Because depositors may save their deposits to withdraw in bit or small fraction. This means they deposit a large amount of money at time, and they do not withdraw that large amount at once. So it is at this time, that banks lend the remaining deposits which depositors do not vacate out. From putting that large amount of money in their treasure, they rather lend out to get interest rate from the loans. So you need to maintain certain amount of proportion of your capital visa-vis your lending.

Recent developments uses risk a weighted asset. Which means, each assets of the bank or loans is going to be measured in terms of its riskiness. For example, if you lent money to ordinary person, this lending is highly probable to risk. Capital adequacy ratio should be measured or to be calculated based on the riskiness of the assets or loans. Meaning, loans are classified, and capital adequacy ratio should be calculated based on the type of lone which you are going to grant. Because different loans do not have the same risk. So what is accepted capital adequacy ratio? Most of the time, the accepted capital adequacy ratio is from 5 to 8%. According to Basil agreement the accepted capital adequacy ratio is 8%. According to Basil agreement this standard to capital adequacy ratio is considered an acceptable standard. In this regard the Ethiopian national bank directive on minimum capital of the banks, there are two things which we should be aware of in this directive. The first one is the minimum paid up capital of

bank should not be below 5000, 000,00 or five hundred million of Ethiopian Birr. The second one is capital adequacy ratio. This directive requires every bank to maintain capital asset ratio a weighted at 8% at all time. This means, your capital should be divided by all your lending and the remaining minimum capital should not be below 8%. Because if borrowers defaulted this money should be guaranty of the depositors. So this is central issue in banking regulation.