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LIBERALIZING BANKING SECTOR FOR FOREIGN INVESTORS: IN ETHIOPIAN CASE

Alemayehu Gonfa Jabessa*

Abstract

The Ethiopian government recently adopted a new policy that liberalizes the banking sector to foreign investors. Concerning the policy, there are both pessimists and optimists views. There are people who suspect the opening of foreign banks entry in Ethiopian. There are also those who tend to see with passion.The entry of foreign banks to invest in banking business (FBE) has positive and negative consequences. The main theme of this article is to examine the admission of foreign bank and its repercussion on the national economy and domestic banks. The article employed a desk review and qualitative analytical research method. The major findings are FBE will help domestic banks for knowledge and technology transfer, modernize banking sector, transferring new capital from foreign, and foreign currency supply that ultimately facilitate the economic development of the country and create job opportunities for citizens. Contrary to this, FBE will have some negative effects. Some of these are foreign banks can easily smash domestic banks, and domestic banks can be out of the market, they can shift their funds to more attractive and peaceful markets during a crisis. Ethiopia banks face several challenges among them lack of skilled manpower, organization transformation, leadership commitment, efficient and effective data management system, and lack of digital transformation in Ethiopia. It is suggested that the reasonable choice is striking the balance between the two extremes to restrict the potential risks of accepting foreign banks. The Ethiopian government should enact prudent laws and implement them in a more stringent manner. It is important to develop legal and regulatory framework which meet the international standards, implementation of modern technologies, capacity building of domestic banks and improvement of financial system infrastructure.

Key words:domestic banks, entry of foreign banks, modalities of FBE

*LLB (Unity University), MA (Addis Ababa University), LLM (Oromia State University), PhD Candidate (Bule Hora University). He is an Assistant Professor of Law, Senior Researcher and Consultant at Oromia State University. He can be contacted at: tadego2010@gmail.com, Call No. 0936856804

1. Introduction

Literatures identified the benefits and risks of the entry of foreign banks particularly into banks of developing countries. The pressure of financial liberalization, increased openness to international capital flows, financial and technological innovations, banking systems, especially in developing economies have experienced plain transformation in recent years.[1] Foreign bank involvement will lead to positive or negative spill-over effects. The presence of foreign banks will stimulate domestic banks to reduce costs and increase efficiency of existing financial services through competition[2], as a result domestic banks may be worried to improve the quality of their services in order to retain their market shares.

Empirical studies have shown that FBE increases the efficiency of domesticbanks; improve credit availability for all categories of firms.[3] Foreign banks in emerging markets are thought to improve bank soundness particularly when the foreign parent bank originated from a well-regulated financial system and are themselves healthy.[4] Foreign banks enhance the country's access to the international market so enhances liquidity in the market[5]. Various researchers also argue that foreign banks particularly large international banks should be allowed to operate in developing countries[6] because existence of foreign banks may have positive effects on economic growth of host country and on domestic banking sector.[7] Foreign banks may

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[1] Ben Ukaegbu, *The Impact of FBE on Domestic Banking in A Developing Country: The Kenyan Perspective*, Banks and Bank Systems,(2014), Vol. 9 (1), P28.

[2] Clarke, G. et al., *FBE: Experience, Implications for Developing Economies, and Agenda for Further Research*,(2003), 18 (1), P29.

[3] Morgan, D.P. & Strahan, P.E., *Foreign Bank Entry and Business Volatility: Evidence from 42 US States and Other Countries,*(2003), P2.

[4]Jennifer, S., Crystal, B., Gerard, D. and Linda, S, *Has Foreign Bank Entry Led To Sounder Banks in Latin America? Current Issues in Economics and Finance*, *Federal Reserve Bank of New York*(2002), 8 (1),P37.

[5] Levine R.,*Foreign Banks, Financial Development and Economic Growth*, C.E. Barfield (ed.), *International Financial Markets: Harmonization versus Competition*, Washington DC, AEI Press, (1996), p11.

[6] Lehner and Schnitzer, *Entry of Foreign Banks and Their Impact on Host Countries*, Journal of Comparative Economics, No.36 (3),(2008), P42.

[7] Claessens, S., A. Demirguc-Kunt, H. Huizinga,*How Does Foreign Entry Affect Domestic Banking Markets*? Journal of Banking and Finance, 25 (5),(2001), Pp. 891-911.

facilitate international capital flows, spur excessive borrowing, and overwhelm the capabilities of domestic regulators.[8]

On the other hand, foreign banks would destabilize domestic economy and hurt long-run economic growth. An important concern of foreign bank presence is the tendency of foreign banks to leave foreign markets instantly in case of economic crises.[9] Some researchers worry that foreign banks focus mostly on incumbent and wealthy firms and may push domestic banks out of the market as the result of their superior efficiency.[10] Letting foreign banks has risks, unless due care is taken foreign banks may swallow the local banks within short period of time and make them out of market; since they are internationally working organizations, they are not always successful, hence their crises in another edge of the world may affect the economy of host country.[11]

The involvement of foreign banks in domestic banking sector has some potential risks such as foreign banks dominance in the financial sector, exposure of the economy of host country to economic shocks and fluctuations in home countries, less credit to small and medium-sized enterprises and profit remittances, and capital flight especially during economic crisis, which lead to shortage of foreign exchange[12]. FBE can be hampered when political and legal environments favor local bankers, such as when the legal system fails to protect the rights of arms-length creditors.[13]

In Ethiopia, in spite of the different reform made to development, the liberalization towards FBE has been announced after delayed for long time. The reason for the constraint of financial sector liberalization was the infant domestic banks, and worry for entry of foreign banks will skew credit allocation towards large-scale industries, real estate and service

[8] *Ibid.*
[9] Peek and Rosengren, *Will Legislated Early Intervention Prevent The Next Banking Crisis*? Southern Economic Journal: (1997), Pp.268-280.
[10] Alfaro,Beck& Calomiris, *FBE and Entrepreneurship*(2015), P32.
[11] Claessens, S., A. Demirguc-Kunt, H. Huizinga, (*How Does Foreign Entry Affect Domestic Banking Markets*?Journal of Banking and Finance, Vol.25 (5), 2001), Pp. 891-911.
[12] Tassew, T., *Foreign Banks Entry in Ethiopia: Possibility, Opportunity, Threats and Mitigations*,Jimma University(2015), P13.
[13] Peek and Rosengren, *supra* note 9.

enterprises.[14]Allowing foreign banks to operate in Ethiopia will bring both prospects and challenges to the incumbent banks in particular and the financial sector in general.[15]The opening up of banking markets can entail large risks since domestic banks need to undertake huge investments to become competitive with foreign banks. In the context of Ethiopian law, before the new law is made, the balance of pros and cons of foreign participation in banking has gone in favor of exclusion of foreigners[16] but the new law changes this scenario.

The Ethiopian government recently approved the opening up the banking sector to foreign investors. The Council of Ministers approved the policy on opening up the banking sector to foreign investors and decided it to be operational. Ethiopia is ready to end its restrictive banking policy which has prevented foreign banks from investing and setting up operations in the country for long period of time. As many scholars and politicians argued opening up the sector to foreign investors will enable supporting the sector's service whereas there are people suspecting the introduction of foreign banks. Thus, the aim of this research is to examine and identify the advantages and risks of the opening of banking business for foreign investors and entry of modality in Ethiopia.

On the other hand, there are those who perceive the risk in the move. There is even a tendency to see government decisions as a result of imposition from the Bretton Woods institutions.[17] They understand that the banking sector in Ethiopia is not fit enough to compete with giant foreign banks.[18] With the coming of foreign investors in the local banking, the sustainability of the Ethiopian banks will be risked[19]. Therefore, this research endeavored

[14]Clarke, G. et al., *supra* note 2, P2.
[15]Matiwos Ensermu, *Prospects and Challenges of Foreign Banking Entry to Ethiopian Financial Market*, International Journal of Science and Research (IJSR) (2020), Vol. 9 (9), P1006.
[16] T/Haymanot Dagne, *Should Ethiopia Accept Foreign Banks*? (Unpublished), P 3.
[17]Yinebeb Bahru (2022), *Are Ethiopian Banks Prepared to Compete with Foreign Investors?* (2017), P12, Available at: https://borkena.com/2022/12/27/are-ethiopian-banks-prepared-to-compete-with-foreign-investors/<Accessed on October 13, 2023>.
[18]*Ibid.*
[19] Ethiopian News Agency, Opening up of Foreign Banks in Ethiopia Will Enhance Investment, Technologies: Economists, August 23/2023. https://addiszeybe.com/ featured/ national-bank-sets-conditions-for-the-entrance-of-foreign-banks-in-ethiopia, <Accessed on January 25, 2023>.

toexamine the admission of foreign bank and its repercussion on the national economy and domestic banks in Ethiopia. In doing so the following questions are raised: What are the modalities of entry of foreign banks appropriate and the new policy recognized? What could be the negative impacts of foreign banks entry on domestic banks and on the economy of the country? What is legal framework the country needs to adopt to mitigate the risk and enhances the opportunities of FBE?

Restriction of investment in banks for foreigners will increase concentration of financial sector in the hands of the state and will ultimately result in lack or shortage of availability of finance for investment.[20] In the context of Ethiopian law, the balance of pros and cons of foreign participation in banking has gone in favor of exclusion of foreigners for long period of time. But recently the Ethiopian government opens the door for foreigners to participate in banking market.

The main objective of the study is toexamine the admission of foreign bank and its repercussion on the national economy and domestic banks in Ethiopia. Hence in particular, the objectives include: to examine the modalities of entry of foreign banks appropriate and the new policy recognized to identify the negative impacts of foreign banks entry on domestic banks and on the economy of the country and scrutinize legal framework that the country needs to adopt to mitigates the risk and enhances the opportunities of FBE,and to propose the possible way of forward that may be used by policy makers.

The purpose of this study was to examine the admission of foreign bank and its ramification. The method employed for this research is a desk review and qualitative analytical research method. Analytical research was the major research method adopted in conducting this research. Legal analysis also employed to examine the gabs and restrictions in the existing laws. For this reason, both primary and secondary sources were employed. The primary sources are the rules of law such as proclamations, rules and directives were consulted. Secondary sources were commentaries, law journals or periodicals, articles, textbooks, legal opinions, legislative history, government reports, speeches of government officials, and media will be

[20] *Ibid.*

referred. The researcher used mainly qualitative data and not attempts to quantify their results through statistical analysis. The analytical method helps to analyze concepts and rules in relation to research topic. So, it is the appropriate method which enables the researcher to appraise the foreign banks entry in Ethiopian banking businesses.

2. Concepts of Foreign Banks Entry and Experiences of Some Countries

2.1 Concepts of Foreign Banks Entry (FBE)

In principle, there are different ways through which financial globalization can lead to financial sector infrastructure.Financialglobalization improvements lead to a greater competition in the provision of funds, which can generate efficiency gains.[21] Financial globalization improves corporate governance; new shareholders and potential bidders can lead to a closer monitoring of management[22]. The increase in the technical capabilities for engaging in exactness financing, results in a growing completeness of local and global markets. The stringent market discipline imposed by financial globalization has consequences not only on the macro-economy, but also on the business environment and other institutional factors.[23]

FBE is another way through which financial globalization can improve the financial infrastructure of developing countries. Foreign banks enhance financial development for at least three main reasons[24]. First foreign banks have more diversified portfolios as they have access to sources of funds from all over the world, they are exposed to less risk and are less affected by negative shocks to the home country economy. Second, foreign entry can lead to the adoption of best practices in the banking industry, particularly in risk management and also in management techniques, that leads to a more efficient banking sector. Third, if foreign banks dominate the banking sector, governments are less likely to bail out banks when they have solvency problems.

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[21]Stigliz J.E, *The Role Of The State In Financial Markets*, Proceeding of the world Bank Annual Conference on Development Economics,(1993), Pp.19-52.

[22]Sergio L. Schmukler, *,Benefit and Risks of Financial Globalization, Challenges for Developing Countries*,(2004), P31.

[23]*Ibid.*

[24]Pierre Richard, Agenor, *Benefits and Costs of International Financial Integration*, World Bank, Policy Research Working Paper No. 2699,(2001), P11.

FBE increases the efficiency of the domestic banking sector, increases competition that inclines to reduce costs and to increase profits[25]. The allocation of credits to the private sector may be improved[26]and this may help to foster higher growth. The existence of foreign banks helps to build a domestic banking supervisory and legal framework[27] and foreign banks provide more stable sources of credit since they may refer to their parents for additional funding and they have easier access to international markets.[28] Thus, domestic financial markets will be less vulnerable to domestic shocks. Foreign banks may reduce the costs associated with recapitalizing and restructuring banks in the post-crisis period.One possible channel through which foreign banks foster such a restructuring process is spillover effects from foreign to domestic banks, and the other possible channel could be the increase in competition[29]. However, the opening up of banking business can also entail large risks since domestic banks need to undertake huge investments to become competitive with foreign banks.

2.2 Experiences of Some Countries

In Turkey foreign banks exert competitive pressure on the domestic banks.[30]In Colombia, foreign bank presence generally increases competition in the domestic banking system as evidenced by reduced intermediations spreads[31]. In order to catch up with foreign banks, domestic banks experienced increased overheads because the need to upgrade the operations with advanced technologies. In Kenya, foreign banks largely behave like local private banks except that they have cheaper sources of finance due to

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[25]World Bank, *World Development Report, Building Institutions for Markets*, New York: Oxford University Press, *(2002),* P21.

[26]Clarke, G. et al., *FBE: experience, implications for developing countries and agenda for further research* (Oxford University Press. World Bank Research Observer, 18(1), (2003), Pp. 25-59.

[27] Levine, Ross, *Financial Development and Economic Growth: Views and Agenda*, World Bank, Policy Research Working Paper 1678, (1996), P3.

[28] Claessens, S., Demirgüc-Kunt, A., H. Huizinga, *How Does Foreign Entry Affect The Domestic Banking Market*?World Bank Policy Research Working Paper 1918, World Bank, (1998), P2.

[29]Kozo Kiyota, Barbara Peisch and Robert Stern, *The Benefit of Financial Sector Liberalization for Developing countries; A Case Study of Ethiopia*, International Policy Center,(2008), P10.

[30] Eugene Bempomg, *The Banking System in Africa: Main Facts and Challenges*, AEB Vol.6, Issues 5,(2015), P6.

[31]Ben Ukaegbu, *supra* note 1, P17.

their reputation capital[32]. Kenyan banks have expanded throughout East African and becoming dominant player in the region.[33] The Kenyan banks have entered East African markets mainly through subsidiaries. Foreign-owned banks have a strong presence in the East African countries controlling more than half the total assets of the banking system in Uganda, Rwanda, and Tanzania.

3. Historical Ethiopia's Argument against FBE

The Ethiopian banking sector has remained closed to foreign investors for long period of time. According to Banking Business Proclamation No. 592/2008 (Article, 9), the banking sector is among areas of investment exclusively reserved to Ethiopian nationals. The main concern of Ethiopian financial sector restriction was the government believes that the development of a viable domestic banking sector will be threatened by foreign banks, because they have more capital, more experience, and better reputations[34]. The Ethiopian financial sector is too infant and inexperienced to compete with other nations advanced banks. Ethiopian government officials also believe that entry by foreign banks will further skew credit allocation towards large-scale industry, real estate and service enterprises and away from agriculture, small-scale and medium[35].Opening banking sector to foreign capital is a subtle operation that involves more complicated policy considerations than the opening of other service sectors. Foreign banks entry could have a number of complications for the host country.

3.1 Threaten the Survival of Domestic Banks

The stiff competition with foreign banks may threaten the survival of domestic banks that may lead them to incur high cost in the short run and decline in profit and it may bring shocks from other country, destabilize domestic credit and may serve more productive sectors only.[36] The possible potential costs to Ethiopian due to FBE is domestic banks will be less

[32] JanekUiboupin,*Impact of Foreign Banks on Banking Sector Stability in Central and Eastern European Countries*,Working Paper(2004),P97.
[33] *Ibid.*
[34] Yinebeb, *supra* note 17.
[35] Teklehaymanot, *supra* note 16, P 4.
[36] Kozo Kiyota, *supra* note 29, P 10.

competitive as compared to those giant foreign banks due to their capital, experts, and diversification[37]. Therefore, foreign banks entry could exposé to a risk that domestic financial institution would not be able to withstand in the increased competitive pressure and might even risk be facing bankruptcy. Such a banking failure might have spillover effects on other banks and could possibly endanger stability of the Ethiopian financial sector.

The development of viable domestic banking sector will be threatened by foreign banks, because they have more capital, more experience, and better reputations.[38] The banking sector in Ethiopia is relatively undeveloped and till infant in terms of capital bases, assets, skilled man power, modern banking technologies compared with foreign banks[39]. On the other hand, the new and brutal competition with foreign bank may be a challenge for domestic banks and it may lead Ethiopian bank to incur high cost in the short run and face decline profit[40]. So, allowing FBE in this situation may threaten the survival of domestic banks in Ethiopia.

If care is not taken international banks may swallow the local banks within short period of time and make them out of market; since they are internationally working organizations, they are not always successful, and hence their crises in another edge of the world may affect the Ethiopian's economy.[41] Majority of the banks would be out of market within short period of time due to very low capital of the banks compared to the international banks, the capital of all private banks together couldn't compete with a single international bank[42].

Ahmed Shide, Finance Minister explained over the last four years, total asset of the local banks has soared from 1.3 trillion Birr to 2.4 trillion Birr, registering 92 percent growth; while total deposit increased from 899,811

[37] Clarke, G. et al., *supra* note 2, P25.
[38] Clarke, G. et al., *supra* note 2, P21 and Janek Uiboupin, *supra* note 32, P123.
[39] Song Inwon, *Foreign Bank Supervision and Challenges to Emerging Market Supervisors*, (2004), p35 and Fetene Bogale, Foreign Bank Entry and Efficiency, Stability of Economic Growth: Implication for Ethiopia from Sub-Sahara African Countries Panel Data, Adama Science and Technology University, unpublished, (2017), P52.
[40] Gebeyehu Raba, *Prospects and Challenges of Foreign Bank Entry in Ethiopia,* International Journal of Business & Management, Vol. 5 Issue 1,(2017), P30.
[41] Habtamu Dagnachew, *Opportunities and Challenges of Liberalizing Banking Sector in Ethiopia,* (Unpublished Thesis St. Mary University),(2017), P32.
[42] *Ibid*.

billion Birr to 1.7 trillion Birr. The number of banks has increased from 18 to 30 with the total capital of banks jumping from 98.9 billion Birr in 2019 to 199.1 billion in 2022, registering 27 percent average yearly growth[43]. So, an immense growth of banks in term of asset, deposit, capital and number of banks are radically scored. However, foreign banks have huge capital and can easily smash domestic banks, and as a result, domestic banks are out of the market unless various legal restrictions in placed.

3.4 Capital Outflow

The potential risk towards foreign banks entry in Ethiopia includes, there will be capital outflow and foreign banks lack interest in mobilizing domestic capital.[44] When the economy is unstable, instead of making some adjustment and contribute to the stability of the economy in the host country, foreign banks make a capital flow to another country.[45] Foreign banks could increase instability if they reduce their exposure during financial crises.[46] Foreign bank may decrease the stability of aggregate domestic bank credit by withdrawing or transferring funds from local markets in the face of crises either in host or home country[47].The fear of capital outflow as the major risk towards FBE, since those foreign banks are channels for inward and outward flows of capital and in this causes foreign exchange or liquidity shortages, with potentially adverse effects on the country's capital account, since there will be high capital outflow from the country by those foreign banks.[48]

3.5 Limited Supervisory Capacity

As foreign banks grow, it increases the complexity of the tasks facing supervisory authorities[49]. Domestic institutions facing competition from abroad, will seek new customers to stay in business. Domestic banks require

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[43]Yinebeb Bahru,*supra* note 17, P19.
[44]Direslign Dagnaw, *Assessment of Risk and Benefits of Foreign Banks Entry to Ethiopia*, Unpublished Thesis Submitted to Addis Ababa University, (2019), P51.
[45] Habtamu, *supra* note 41, P32.
[46]Clarke,G., R. Cull, M.S. Martinez Peria, and S.M. Sanchez, *Foreign Bank Entry: Experience, Implications for Developing Countries*, and Agenda for Further Research,(2001), P11.
[47]Gebeyehu Raba, *Supra* note 40, P130.
[48]Direslign Dagnaw,*supra* note 44, P52.
[49]Habtamu Dagnachew, *supra* note 41, P44.

information to screen and monitor their customers lending to be profitable. Better accounting standards and disclosure requirements and a more efficiently managed legal system will be consistent with continued domestic bank profitability.[50]

Numerous studies assert that financial sector spurs improvements in bank supervision with regulatory spillovers. The entry into emerging markets of foreign banks that is healthier than domestic banks implicitly allow a country to import stronger prudential regulation and increase the soundness of the local banking sector. Reliance on market discipline was viewed as playing an important role in prudential regulation by strengthening risk management among banks.[51]

Local supervisors in emerging markets may have to invest in upgrading their skills in order to evaluate more efficiently[52]. Other challenges for supervisors arise in the context of relationships with parent banks, and may depend on whether the foreign entry is accomplished through branches or subsidiaries.[53]

One of the possible potential costs to Ethiopian due to FBE is lack of domestic strong supervisory body.[54] The regulatory body (NBE) has a limited supervisory capacity to control foreign banks since some of the activities of those foreign banks need extra expertise and technology. On the other hand, developing and implementing effective regulation and supervision may be challenging to the regulatory organ (NBE) at initial stage.[55]Foreign bank may have adverse effect on financial system of the country if the domestic regulation and supervision are not strong enough in regulating and supervising foreign banks. Due to their advanced technology and unknown base, once they control the country's financial system they may be out of control of the government; the inability to regulate and manage the foreign banks might lead to malpractices by foreign banks that

[50]Goldberg, Linda, *Financial Sector FDI and Host Countries: New and Old Lessons*, (2007), P10.
[51]*Ibid.*
[52]Clarke,G., R. Cull, M.S. Martinez Peria, and S.M. Sanchez, *FBE: Experience, Implications for Developing Countries*, and Agenda for Further Research, (2001),P11.
[53]Bayraktar, Nihal, and Yan Wang, *FBE, Performance of Domestic Banks and the Sequence of Financial Liberalization Evidence using* bank-level data, (2005), P11.
[54]Habtamu Dagnachew, *supra* note 41, P55.
[55]Gebeyehu Raba,*supra* note 40, P128.

will harm the finical industry.[56] Their vast experience, very strong capital, high skilled man power, technology advancement together with their political dominancy may definitely lead to lose the control of this banks, because in some instances these banks may brought something very new technology and system which could not understand easily by the local financial authorities[57].

3.4 Menace of Instability

Foreign banks may bring shocks from other country in case of crises, destabilize domestic credit and may serve more productive sectors only.[58] Foreign bank may decrease the stability of aggregate domestic bank credit by withdrawing or transferring funds from local markets in the face of crises either in host or home country. This “cut and run” behavior of foreign bank may destabilize the aggregate credit in case of any shocks that might happen in a country[59]. In support of this foreign banks could increase instability if they reduce their exposure during financial crises. Allowing FBE in Ethiopia may destabilize domestic credit in case of crises. Multinational banks have branches or subsidiaries in different countries. As a result, they may bring shocks from their home country or other country they operate[60] to Ethiopian financial system.

3.5 Skewing of Credit Away from Small and Medium Enterprise

The potential cost due to FBE will be retains credit to small firms, skewing of credit away from small and medium enterprise, for this specific matter, foreign banks may choose only the best clients with a potential of growth there focus area might be the large firms and they will ignore those small firms. Most of the time foreign banks focus area is large scale firms which operate in forging trade and with firms which operates in activities which requires high investments and return like real estate business. In addition to these foreign banks also wants to operate in urban centers which have

[56]Habtamu Dagnachew, *supra* note 41, P57.
[57]Habtamu Dagnachew, *supra* note 41, P55 and Direslign Dagnaw, *supra* note 44.
[58] Kozo Kiyota,*supra* note 36.
[59]Habtamu Dagnachew, *supra* note 41, P55 and Gebeyehu Raba, *supra* note 40, p35.
[60]Gebeyehu Raba,*supra* note 40, P37.

infrastructure. So, they do not want to make the bank business to the rural are of the country which requires additional efferent to have customers.

Foreign banks may likely to have little interest or expertise in dealing with smaller domestic companies which may not satisfy international accounting standard due to this small firms will come to domestic banking sector with their high risk, in addition to these domestic banks will not get a chance to work with those large companies and in foreign trade,[61] since the majority of those large firms may prefer foreign banks which operates in various countries.

4. Suspicion against Allowing of Foreign Banks

There are those who see risk in the move. There is even a tendency to see government decisions as a result of imposition from the Bretton Woods institutions. They see that the banking sector in Ethiopia is not fit enough to compete with giant foreign banks.

Commercial Bank of Ethiopia President, Abe Sano spoke to state media regarding the government's decision to open up the banking sector for expatriate investors. He underscores the importance of exercising caution in the implementation of the policy. He sees the menace that opening the door wide could bring about to domestic banks. As much as closing the sector to foreign investors has impacted the growth of local banks, opening the banking service door wide to the world market could have dangers.

Solomon Desta, NBE's Deputy Governor of Financial Institutions Supervision noticed that the entrance of foreign banks would also usher in threats, until the experience in the sector develops well a limit on the number of foreign banks entering the country will be laid including undertaking the proper follow-up.Concerning the risk factors the allowance of foreign banks would create. Mulugeta Girma said "With the coming of foreign investors in the local banking, the sustainability of the Ethiopian banks will be risked.[62] But the local banks can avoid this through various means such as unification

[61]Habtamu Dagnachew, *supra* note 41, P45.
[62]Ilyas Kifle,*National Bank sets conditions for the entrance of foreign banks in Ethiopia,* (2022),P29; https://addiszeybe.com/featured/national-bank-sets-conditions-for-the-entrance-of-foreign-banks-in-ethiopia<Accessed on January 27, 2023>.

by working less than one sectoral umbrella. Basically, the performance of foreign banks in Ethiopia will be affected by the performance of their parent banks abroad. Therefore, the NBE must be able to supervise the parent bank too. But unless there is transparent and regular information exchange, foreign banks can cause a crisis in Ethiopia.[63]

The policy has therefore given a one-year grace period for local banks before they open up. In that one-year period, local banks will be forced into a scenario where each formulates a competition strategy, working closely with the central bank. Though the draft proclamation allows foreign banks, many restrictions are still in place in the Ethiopian banking industry. If the NBE is able to maintain the same restrictions and strong supervision on foreign banks, the open-up will be successful.

5. Legal Barriers in Foreign Banks Entry

One of the most prominent restrictions under the existing Ethiopian law is the requirement of nationality for investment in banking business; it is only Ethiopian nationals who can invest in bank business[64]. Barriers to entry in the banking sector reinforce inefficient state-owned enterprises by protecting them from competition. The government's anxiety is that if foreign banks were to be allowed to operate in Ethiopia, it may miss of control over the economy. Prohibiting FBE would protect the domestic banks from being enfeebled because of unfair competition from foreign banks. Under Banking Business Proclamation No. 592/2008 Article 9, 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". Thus, in this proclamation foreign nationals as well as foreign nationals' Ethiopian origin are completely prohibited from participating in domestic banking sector.

The Ethiopian banking sector, before the new policy is issued, known by the most restrictive and prohibiting system[65]. Ethiopia's Banking Business

[63]Ashenafi Endale, *Banks Granted Same Entry Capital as Local Banks,*(2022),P13https://www.thereporterethiopia.com/27476/< Accessed on January 27, 2023>.
[64] Getenet Temechew, *Investment Limitations in and by Banks in Ethiopia*, Thesis, (Unpublished, Addis Abeba University School of Law Library),(2010), P5.
[65] Kozo Kiyota, *supra* note 29, P9.

Proclamation was last amended in 2019 evidently prohibits foreign nationals or organizations from fully or partially owning or opening banks or branch offices or subsidiaries of foreign banks in Ethiopia or acquire the shares of Ethiopian banks. This implies that this proclamation did not allow foreign nationals to operate banking business in Ethiopia. On the other hand, the banking amendment Proclamation No. 1159/2019 (Article 9(1)), allows foreign nationals of Ethiopian origin to invest in banking sector by lifting legal restriction previously in placed,however, foreign nationals of foreign origins are not permitted to engage in banking business in Ethiopia by this proclamation. Consequently, foreign nationals of Ethiopian origin, organizations fully owned by foreign nationals, and organizations jointly owned by Ethiopian nationals and foreign nationals of Ethiopian origin have been allowed to invest in the banking sector. However, such organizations should be registered under the laws of Ethiopia and have its head office in Ethiopia. Also, foreign nationals of Ethiopian origin and organizations partly or wholly owned by such persons are only allowed to invest in the acceptable foreign currencies. This implies that such persons or organizations can only acquire shares in an acceptable foreign currency.

Ethiopia is now decided to end its restrictive and prohibitive banking policy which was prevented foreign banks from investing and setting up operations in banking business in Ethiopia. The preamble of the draft proclamation of foreign bank entry[66]envisages that it is initiative compulsory to allow foreign nationals to invest in the Ethiopian banking sector by exciting legal restriction in placed. It is indispensable to embrace new provisions and update some existing provisions in the Banking Business Proclamation No.592/2008 that contribute to safety, soundness and effectiveness of banking sector. The draft law defines bank as “a company, or a subsidiary of, or a branch of a foreign bank, or a Federal Government bank and licensed by the National Bank to undertake banking business”. This draft seems widen the meaning of bank by including the subsidiary banksand branch banks. The new draft law includesamong other categories, issues like banking activities by foreign nationals, employment of foreign nationals, establishment of a

[66]Draft Amendment to the Banking Business Proclamation, Final English Version 2022,https://www.studocu.com/row/document/addis-ababa-university/business-law/63-draft-amendment-to-the-banking-business-proclamation-final-english-version-2022/57354780< Accessed on December 27, 2023>.

subsidiary, cooperation and collaboration with foreign supervisors and local authorities, and the adoption of international banking principles and standards.

The new draft legislation stipulates that "a foreign bank may be allowed to establish a subsidiary, or open a bank branch, or a bank representative office, or acquire shares of Ethiopian banks". It also declares "foreign national other than banks or an Ethiopian organization may be allowed to acquire share/s of Ethiopian banks"[67]. Thus, the restrictions in placed against foreign banks by previous proclamations are lifted by this new law.

A foreign bank's equity investment as a strategic investor in an existing or new domestic bank is limited to 30percent, while such investment by a non-bank foreign national or an Ethiopian organization is limited to five percent and the total equity investment in a bank by foreign nationals and Ethiopian organizations is covered at 40percent.[68] However, Ethiopian organizations (organization organized according in Ethiopia) fully owned by foreign nationals can invest in a bank only through foreign direct investment (FDI) in an acceptable foreign currency. Owning a stake in local banks is allowed for foreign banks. However, this is not allowed for local banks (local banks cannot acquire stakes in other countries local banks), Local banks can also open subsidiaries in other countries, and vice versa is also true. Basically, the performance of foreign banks in Ethiopia will be affected by the performance of their parent banks abroad. Therefore, the National Bank Ethiopia (NBE) must be able to supervise the parent bank too. Nevertheless, unless there is transparent and regular information exchange, foreign banks can cause a crisis against Ethiopian banking business. In fact, if the NBE is able to maintain the restrictions and strong supervision on foreign banks operating banking business in Ethiopia, the open-up will be successful.

6. Advantages of FBE in Ethiopia

Ethiopia has taken a cautious approach towards the liberalization of its banking industry and the Ethiopian bank industry was development is low as a result of closed to foreign bank investors. Similar to other developing

[67] *Ibid.*
[68] *Ibid.*

countries experiences, allowing of foreign banks to participate in banking industry of the country could have both benefits and risks in Ethiopia. Removing foreign bank restriction will entails ample of advantages for the economy of the country as well as for the efficiency of domestic banks. The following are some of the benefits of foreign banks involvement in the financial system.

6.1 Credit Availability

The entry of foreign banks in the market will boost access to stable and massive amount of credit. Financial liberalization allows capital to flow from plentiful capital countries, where expected returns are low, to capital-scarce countries, where expected returns are high[69]. Capital inflows may foster growth by increasing the amount of funding available to domestic projects. More in general, in countries with underdeveloped financial systems, financial liberalization should increase the supply of finance and thus expand the national financial system of these countries. In this respect, financial liberalization is expected to spur faster growth across the board.[70] The beneficiaries of financial market integration may well depend on the nature of the capital flows. Wider availability of funds decreases the interest rate and the ensuing decrease in the cost of capital should abet all firms.[71]

Foreign banks entrance will improve the existing financial infrastructure of Ethiopia and provide enough credit access. Allowing the foreign banks help to have enough credit to emerge small scale enterprises as well as large investors and the presence of foreign banks are generally increasing the amount of funding available for domestic market.[72] Thus, foreign banks presence may increase the amount of funding available to domestic projects by facilitating capital inflows, and diversifying the capital and funding basis.

[69]Obstfeld, M. & Rogoff, K., *Foundation of International Macroeconomics*,(1995), P121.
[70]Rajan, R.G. &Zingales, L.,*Financial Dependence and Growth*, American Economic Review(1998),p30.
[71] Giannetti, M. & Ongena, S., *Financial Integration and Entrepreneurial Activity: Evidence from FBEin Emerging Markets*(2005), P39.
[72]Habtamu Dagnachew,*supra* note 41, P36 and Direslign Dagnaw, *supra* note 44, P21.

6.2 Sounder Lending Practices

Foreign bank presence may contribute to the stability of available lending by diversifying the capital and funding bases[73]. In some countries, domestic banks have difficulty in diversifying because their lending is concentrated in the home country. In contrast, foreign banks tend to have more diversified portfolios and also usually have access to sources of funds from all over the world through their branching network[74]. This diversification contributes to economies of scale and scope in the domestic market.[75]

6.3 Competition, Stability, and Dynamic Effects in the Banking System

In developing countries, FBE may stabilize the financial system. Foreign banks may be more resilient to negative shocks because of their direct access to foreign savings[76]. Foreign banks which are, in the majority of cases in possession of huge amount of capital and skill management, would better absorb and endure financial crises which are prevalent in developing countries. In general, FBE may foster competition, efficiency, and stability[77]. In that case the net effect will also depend on the dynamic response by other competing banks.

6.4 Introducing New Banking Technologies and Financial Innovations

The potential benefit of foreign banks entry in Ethiopia bank industry will introduce new financial innovations and attract foreign direct investment (FDI) because they have various exposures in various economy activities[78]. Foreign banks entry could make development in the financial sector includes accounting and transparency, and financial regulation.Foreign banks have advanced technology and financial systems, their entrance may improve the existing financial infrastructure of the country.[79]

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[73] Song Inwon, *supra* note 39, P37.
[74] *Song Inwon, supra* note 39*,* P37.
[75] Morgan, D.P. & Strahan, P.E.,*FBE and Business Volatility: Evidence from US States and Other Countries,* P107.
[76] Crystal, J.S., Dages, B.G. & Goldberg, L.S., *Has FBE Led to Sounder Banks in Latin America?*(2002), P73.
[77] Giannetti, M., *supra* note 71, p41.
[78] Habtamu Dagnachew, *supra* note 41, P36.
[79] *Ibid.*

6.5 Develop the Financial Market and Foreign Currency

FBE leads to greater efficiency in the functioning of national banking markets, with positive welfare implications for banking customers.[80] Empirical evidence shows that greater foreign bank ownership indeed reduces overall expenses of domestically owned banks. These results suggest that FBE leads to greater efficiency in the functioning of national banking markets, with positive welfare implications for banking customers.[81] The reduction of restrictions on FBE may similarly reduce domestic banking profits and force domestic banks to cut costs, but with positive overall welfare implications for the domestic economy[82].

In general, the advantages of allowing foreign investment in the banking sector includes acceleration of economies of scale, availability of foreign currency, easier money transfers, facilitation of the import and export of goods and services and others. Foreign banks entry in Ethiopia will increase country's stock of foreign currency. n addition, allowing foreign banks to join the bank industry may solve the problem of foreign currency that Ethiopia currently faced.[83]

The Ethiopian economy would benefit from financial sector liberalization, especially from the entry of foreign banks. FBE to the domestic market will bring immense opportunity to the Ethiopian banking market[84]. Ethiopian banking market will further fuel competition and competition will force including domestic banks to innovate to survive and thrive.

Foreign banks may encourage the competency and efficiency of domestic banks.[85]FBE in Ethiopia would enhance the efficiency of the banking sector and promotes financial development by introducing new banking technologies and financial innovations; improves financial system infrastructure such as good banking practice and know-how, financial regulation, managerial and supervisory skills and effective risk management

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[80]Yinebeb, *supra* note 17, P1007.
[81]Habtamu Dagnachew, *supra note* 41, P22.
[82] Song Inwon, supra note 39, P. 63.
[83] Habtamu Dagnachew, *supra* note 41, P36.
[84]Yinebeb, *supra* note 17, P1009.
[85] Habtamu Dagnachew, *supra* note 41, P4.

mechanism[86]. Moreover, as foreign banks come with additional capital, the competition among banks and their capacity tend to increase and the need for finance may get solution[87]. FBE will benefit the domestic bank by improving the quality service as well as enhance customer satisfaction and then economic potential of the country would be improved.

6.6 Promotes Financial and Economic Development

Ethiopia as non-bank globalized countries performed very low performance in bank penetration, depth, efficiency and competitiveness.[88] Foreign bank improves economic growth directly and indirectly through improving efficiency[89]. The potential benefit towards foreign banks entry in Ethiopia bank industry will accelerates the economies of scale[90]. So, allowing foreign banks to join the bank industry will facilitate the economic activities and growth of the financial sector in to international standards.

6.7 Integrating Financial System of the Country with the Rest of the World

FBE in Ethiopia could introduce new banking technologies, financial innovation and promote financial development.[91] In addition, it enhances access to international capital and may precipitate the overseas expansion of domestic banks and greater integration of Ethiopian banks into international financial systems, which may enable them to provide a broader range of services, particularly to larger local firms with international operations[92]. Opening up of the banking business to foreign competition helps the country's financial system integration with the rest of the world that will enhances the link between domestic and global economy[93]. Foreign bank

[86]Gebeyehu Raba, *Prospects and Challenges of FBE in Ethiopia,* International Journal of Business & Management (2017), Vol. 5 (1), P30.
[87]Mekonnen Hurisa, *Potential Effects of Opening the Ethiopian Banking Sector to Foreign Banks,* (Unpublished, 2017)*,* P38.
[88] Fetene Bogale, *FBE and Efficiency, Stability of Economic Growth: Implication for Ethiopia from Sub-Sahara African Countries Panel Data*, (Adama Science and Technology University, unpublished) (2017), P 36.
[89]Habtamu Dagnachew, *supra* note 41, P35.
[90]*Ibid*, P38.
[91]*Ibid*, P19.
[92] Gebeyehu Roba, *supra* note 40, P130.
[93]*Ibid,* P129.

existence inclines to attract foreign direct investment as foreign bank presence through skill and technology transfer, local banks may look outward for better alternatives. Competing with foreign counterparts may initiates Ethiopian banks to be competitive at international level.

7. Arguments for Opening Banking Sector to Foreign Investors

Ethiopia has adopted a new policy that liberalizes the banking sector to foreign investors as a result; foreign banks can operate banking business in Ethiopia. Toward the policy of "investment of foreign nationals in the Ethiopian banking sector", there are two main views (pessimists and optimists of the FBE) which means there are people who suspect the opening of foreign banks entry in Ethiopian whereas there are also those who tend to see with passion, the decision as something that would transform the sector in terms of service delivery and making more finances available for borrowers. The main division of views is based on the potential benefits and risks of the foreign banks involvement in banking sector in Ethiopia.

When banking sector is liberalized two key benefits are expected. The first is economic access to the global financial market and modernized financial industry, which is expected to improve efficiency and boost interbank competition. Second, foreign banks will give access to a global banking network (no banks operate its business solely without the cooperation of other banks in abroad or sister banks) are and they can contribute to the economic development of countries[94]. The higher officials of the government tried to justify and defend opponents of the policy measure. Pursuant to this the Ethiopian Prime Minister, Dr. Abiy Ahmed stated "Ethiopia is currently amending its laws to allow foreign banks to operate in the country, a policy amendment is already being prepared to this effect. Opening the sector to expatriate investors would help make service knowledge and technology-based, and transform the level of Ethiopia's economic integration to the world market. Ethiopia which is Africa's second most populous country with a population of over 100 million people, only has 28 banks, data from the World Bank shows that only about 20% of Ethiopia's adult population have bank accounts. Ethiopia is finally ready to end its restrictive banking policy which has prevented foreign banks from investing and setting up

[94]Yinebeb Bahru,*supra* note 17, P35.

operations in Ethiopia and plans are underway to open up the country's banking sector so that foreign players can set up operations and compete with the 28 local banks currently operating in the country"[95].

"We will bring foreign banks because we need additional wealth and hard currency. Regarding this, the government is now preparing a policy amendment. Once preconditions are met and banks are prepared, we will implement that"[96]. It is indicated that opening up the sector to foreign investors will enable supporting the sector's service with technology, enhance the networking of the country's economy with the international market, and strengthen the competitiveness and efficiency of the finance sector.

On the other hand, Ahmed Shide, Finance Minister stated that "the decision to open up the banking sector to foreign investors will help to attract Foreign Direct Investment (FDI), advance financial inclusion, and create service competitiveness and it is part of the Homegrown Economic Reform program that has been implemented".[97] He added "once operational, the policy will attract significant investment into the country in terms of additional finance and will expand the banking sector in general. It will also introduce competition in the banking sector, further boosting the financial inclusion agenda of the government and modernizing the banking sector."[98]

According to Ahmed, Ethiopia is striving to improve the investment climate and attract private sector investment and this historic decision will boost the competitiveness of the financial sector by unlocking the potential of the financial market[99]. On top of improving macroeconomic imbalance, the decision will help to create efficient, technologically equipped, and

[95] The speech of Dr. Abiy Ahmed, Prime Minister of Ethiopia, Ethiopian News Agency, February 22, 2023.
[96]*Ibid*.
[97]An Interview made with Ahmed Shide, Finance Minister, by Ethiopian News Agency, Addis Ababa September 29/2022.
[98]*Ibid*.
[99]*Ibid.*

competitive banking industry that triggers critical chain effects on all economic activities[100].

The Minister elaborated "significant investment will be facilitated as a result of this, and by introducing additional capacity, competition, modern technology, and new financial services, the policy will further boost the financial sector in general, advance our financial inclusion agenda and enable more our business sector,"[101]. Ahmed stated, "domestic banking sector growth will be enhanced as a result of this competition. They need to consolidate, upgrade, and be ready for the competition"[102].

Solomon Desta, NBE's Deputy Governor of Financial Institutions Supervision told "the Ethiopian News Agency that since foreign banks come up with their rich experiences in the sector, it would create an opportunity to motivate local banks"[103]. "Moreover, the capital foreign banks bring in is expected to alleviate the shortage of foreign currency in the nation which in turn facilitates additional investment and allowing foreign investors into the local finance sector can be a chance to share their knowledge and financial technology advancement with the local banking sector.[104]

8. The Entry Modalities Proposed for Foreign Banks and Their Pros and Cons

8.1 The Entry Modalities Allowed, Policy and Amendment Law

Foreign banks internationally expanded by incoming domestic banking sectors abroad through establishing foreign subsidiaries and branches, mergers or by acquisition domestic banks abroad[105]. Thus, foreign banks

[100] *Ibid.*
[101] *Ibid.*
[102] *Ibid.*
[103] An Interview made with Solomon Desta, NBE's Deputy Governor of Financial Institutions Supervision, by Ethiopian News Agency, Addis Ababa, September 29/2022.
[104] Ilyas Kifle, *National Bank Sets Conditions For the Entrance of Foreign Banks in Ethiopia*; (2022), P38:https://addiszeybe.com/featured/national-bank-sets-conditions-for-the-entrance-of-foreign-banks-in-ethiopia,<Accessed on January 27, 2023>.
[105] Aliber, R.Z., *International banking, a survey*, Journal of Money, Credit and Banking.Banking (1984), 39 (2-3), Pp 259-294.

enter the domestic banking sector either through acquisition of domestic banks or through green field investment[106].

Banks primarily expanded their services abroad in order to assist their home-country customers with international transactions. The actual model of FBE depends on a wider range of factors. In precise, the profit opportunities in the destination market have become a key factor in determining the model of FBE[107]. As a result, forms of foreign involvement have become more wide-ranging, including targeted purchases of specific activities, full acquisition, joint ventures, alliances with local banks, and outsourcing of administrative and financial services.[108] Also, the mode of FBE may also determine its effects on local financing.

The policy document "Investment of Foreign Nationals in the Ethiopian Banking Sector,"[109] recently ratified and the draft Banking Business Proclamation amendment, permit four entry modalities for foreign banks. These include opening of representative offices, the opening of branches, subsidiary formation and acquisition of stakes in existing banks.

a) Representative offices

A representative office is the most limited but most easily established form. It does not engage in attracting deposits and extending loans, but is generally established to test the possibility of further involvement[110]. It is generally prohibited from performing any banking operations. It can only do promotional activities and most importantly, cannot offer services to customers. However, they offer opportunities for contracts with the parent bank and its clients concerning a variety of commercial and financial business that relates to the foreign market.[111]

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[106] Levine,Ross,*International Financial Liberalization and Growth*, Review of International Economics, 9 (4),(2001), Pp 688-702.
[107] Lensink, R. & Hermes, N., *The Short-term Effects of FBE on Domestic Bank Behavior: Does Economic Development Matter*? Journal of Banking and Finance, 28 (3) (2004), P142.
[108] *Ibid.*
[109] A Policy of Investment of Foreign Nationals in theEthiopian Banking Sector, 2022.
[110] Gopalan, S. & Pajan, S., *Financial sector De-Regulation in Emerging Asia: Focus on FBE*, The Journal of World Investment and Trade, 2010), P101.
[111] Teklehaymanot, *supra* note 16, P14.

The current Ethiopian policy and draft law states that the representative office will conduct market research and advice, as well as facilitate trade financing and investment[112]. There are many representative offices in Ethiopia already but since they are not authorized and regulated by the NBE. In Ethiopia since 2015, nine foreign banks are operating a representative office[113]. The banks include: European Investment bank, Standard bank, Commerz bank, German bank, KCB bank, Bank of Africa, Ziraat Ban and Export-import Bank of India. After the coming to power of the current regime and before the new policy is issued, two major progresses made were National Bank of Ethiopia granted financial service license to a foreign-owned company, Africa Asset Finance Company, and Ethiopian-born foreign citizens are now allowed to invest in the financial sector.The representative office, which was opened in 2015, is led by an Ethiopian banker chosen by the Standard Bank who has helped the bank foster a relationship with both the Ethiopian government and clients. The office also serves as a regional center for neighboring countries[114].

b) Foreign branch

A branch is unison with its parent and constitutes a higher level of commitment than a representative office[115]. Home country supervisors supervise branches and no local lending limits are involved for branch; they rely on the capital of the foreign parent[116]. Foreign bank branches are typically involved in wholesale banking. Foreign bank branches will be the easiest for foreign banks, however, it will be the most difficult to regulate for the host countryregulatory body. Crucial provident requirements such as solvency cannot be supervised at the branch level as well as capital adequacy can also be problematic to monitor at the branch level. Thus, generally, home authorities are the ones that can exercise regulatory authority over foreign branches of their domestic banking institutions. From the practical point of

[112]Gopalan, S. & Pajan, *supra* note 110.
[113] Ermias Wadajo, *Foreign Banks in Ethiopia: The Thin Line In Between Strategy and Law*, (2020), P33: Available at https://furtherafrica.com/2020/01/14/foreign-banks-in-ethiopia-the-thin-line-in-between-strategy-and-law/< Accessed on November 12, 2023>
[114]*Ibid*
[115] Habtamu Dagnachew,*supra* note 41, P56.
[116] Naaborg, I., FBE and performance with a focus on Central and Eastern Europe (2007), P27.

view, branches can expose the Ethiopian financial sector to the risk that shocks in other countries can easily spill over into domestic financial systems, risks that NBE cannot prevent because it cannot sufficiently regulate the branch concerned.

c) Bank Subsidiaries

Bank subsidiaries are incorporated separately from the parent bank, it is an independent legal entity whose financial commitment to the subsidiary consists of the capital invested. Subsidiary regard supervision, risk and performance, local supervisory authorities supervise subsidiaries and subsidiaries are subject to local lending limits associated with the level of their capital. Subsidiaries are usually involved in retail banking markets[117]. However, subsidiaries in some countries are involved in wholesale investment banking operations.

A subsidiary bank is a banking operation that is incorporated in the country where it operates, but is owned by a parent bank that is incorporated in a different nation. This particular banking model is useful, in that the arrangement only requires that the subsidiary operate according to the regulations that apply to banking in the host country. Subsidiary banks are not bound by banking regulations that apply to the parent bank in the country where the parent bank is incorporated. In terms of charges for the services offered by the subsidiary bank, these must be in harmony with any regulations that apply to all banking establishments that operate in the host country. This allows the banks to be competitive with domestic financial institutions as well as other foreign owned banks that have a presence in the country.

Subsidiary formations look like the most appropriate FBE model. Both the policy and the draft legislation provide a subsidiary as one of the options. Such a subsidiary can be a wholly owned subsidiary or a majority-owned subsidiary of a foreign bank. In particular, subsidiaries of foreign banks will be on equal footing with local banks. The subsidiary is an arm of a foreign bank that will be fully incorporated in Ethiopia. They will have to meet the minimum paid capital threshold, among other requirements.

[117] Habtamu, *supra* note 41.

Since a subsidiary is a separate legal entity, according to the policy, the parent bank may not support it above and beyond the initial minimum capital requirement. However, some foreign banks may be willing to guarantee the solvency of their subsidiaries in order to maintain their international reputation. Ethiopia would have a relatively heavier fiscal burden if it had to bail out a subsidiary than a branch. If shocks originate from the home country, according to the policy, the subsidiary model is much better than a branch in terms of fiscal cost.

d) Mergers and Acquisitions with Existing Banks

Merger and acquisition form of entry as equity investors in existing or new banks allowing majority ownership for Ethiopian investors is advantageous for knowledge transfer and strengthen local banks as well as ensuring their survival that should be recommended to the regulatory organ. Among the entry options mentioned, mergers and acquisitions with existing banks is the one made clear so far. It is clearly stated that foreign banks will be allowed to acquire stakes in local banks.According to the draft law, the maximum foreign shareholding combining foreign banks and non-bank foreigners will be 40Percent in one bank. Apart from the consequence of the mergers and acquisitions between foreign banks and their local counterparts, there should also be questions about the process of such mergers and acquisitions. There is a need for regulatory guidance on whether foreign banks will be required to be issued new shares or will bid for existing shares from the shareholders. The draft amendment proclamation is replete with references to future directives to be issued by NBE.

e) Joint Venture

Joint ventures usually involve taking minority stakes in local entities, and the level of involvement in the management of the local banks by the foreign bank is normally low. This mode is formed by more than one firm. They generally have a financial interest and a board membership. A joint venture is an arrangement where the firm is required to share equity and control of the venture with a partner from the host country[118].There is no mention of joint ventures both in the policy and in the draft of new amendment

[118] Habtamu, *supra* note 41, P16.

proclamation. A joint venture in the banking industry is a company formed by different banks, often as an entity strategy in new markets.

8.2 The Pros and Cons of Each Mode of FBE

Banking institutions look closely at what they want to achieve in terms of starting a presence in another country. If the goal is to be able to offer loans in the host country, then the foreign branch bank model will be the logical choice, since this approach allows the bank to offer more in the way of loans and loan options. If the main reason is to buy and selling security in the host country subsidiary bank is more preferred.In Ethiopia, the suitable mode of foreign banks entry can be seen in two perspectives. From the strength of controlling capacity aspect of the National Bank of Ethiopia, subsidiaries and joint venture might be preferred. But from the risk minimization point of view, branches are the preferred organizational forms. It is because in the case of losses depositors have the right to claim from the parent office of the branch and large parent offices are strong enough to absorb these possible losses.

Foreign branches can facilitate a more efficient allocation of savings mobilized globally, lower intermediation costs, and improve access to credit. Likewise, the establishment of branches of foreign banks in Ethiopia means the free flow of deposits mobilized in Ethiopia to other countries where the bank operates. However, the draft law prohibits cross-border lending. As branches can minimize the supervisory intervention of Ethiopian regulators, it may also give an added advantage. A branch bank can be a less brave strategy because foreign banks can simply follow the main clients working in Ethiopia, and prize them away from local banks instead of attractive financial inclusion. Foreign banks can have branches in Ethiopia and sub-branches. To this extent, branches of foreign banks can be threats to domestic banks. This is the reason why most African countries do not allow branches of foreign banks. It would be easy to close a branch and run away during a crisis or economic downturn, but it can be ring-fenced through a capital equivalency requirement. Branch banking will have to meet the minimum capital requirement to be determined by the NBE.

A subsidiary is better to generate more foreign currency for Ethiopia. The policy document also states that subsidiary and equity acquisitions are the best ways to generate foreign currency for Ethiopia. Among the entry options prescribed, efficiency may favor bank branches, but financial stability and regulatory simplicity imply that subsidiary banks and mergers and acquisitions with local banks are the better entry options. Foreign subsidiaries can be strong competitors to local banks. But considering the investment they make and the technology and knowledge transfer as well their contribution to financial inclusion due to the bigger scope of operation, subsidiary banks are preferred. Thus, National Bank of Ethiopia is under big pressure to adapt its regulatory framework without compromising key prudential and corporate governance requirements. It has to be innovative enough to create solutions to newer challenges resulting from the entry of foreign banks into the market.

On the other hand, the President of Commercial Bank of Ethiopia, Abe Sano, reflects his fear on the modalities of foreign banks entry. He states "subsidiaries and branches will be difficult to control for the National Bank of Ethiopia" because its supervisory capacity. He adds that equity can bring better skills, technology, and knowledge for Ethiopia but will force local banks to keep putting aside provision because of the parent company's status reflecting on the subsidiaries. In the case of equity acquisition, it is also not clear how the foreign banks will have representation in the local banks' management. He recommends 'joint venture' is a better modality as it is easy to supervise and control though it is not included in the new drafts of amendment proclamation.

Gebeyehu Roba (2017), recommends as a policy, FBE via subsidiary may be preferable to resource mobilization and enhancing access to finance for the majority. Similarly, the vice governor and chief economist of the National Bank of Ethiopia, Fikadu Digafe, says "a subsidiary bank entry is better to generate more foreign currency for Ethiopia"[119]. He states irrespective of the form of company, a subsidiary of a foreign bank needs both supervisory and

[119]Ashenafi Endale, *Banks Granted Same Entry Capital as Local Banks,* (2022), P19: https://www.thereporterethiopia.com/27476/<Accessed on January 27, 2023>.

executive boards composed of the parent bank and non-shareholder Ethiopians which is also postulated in the new amendment proclamation.

As per the new amendment proclamation, if a foreign bank intends to open a deposit taking branch, it must remit a minimum capital equivalency. A non-deposit taking branch of a foreign bank is only allowed to engage in lending and collecting repayments in Ethiopia and borrowing from foreign sources or repayments thereof. However, the new law clearly stipulates that a foreign bank is not allowed to open both deposit taking and non-deposit and other debt taking branches. In other words, foreign bank branches that collect deposits are considered conventional commercial banks, whereas a bank that only lends is an investment bank. This is intended mainly to encourage capital inflow, instead of taking capital from the domestic economy and lending it. This approach is in line with the main purpose of the banking open-up, which is to attract foreign currency, transfer skills and technology, and, above all, improve the efficiency of local banks.

9. Conclusion and Recommendation

9.1 Conclusions

From the analysis it is possible to conclude that FBE into Ethiopian financial industry will have both positive as well as negative effects. The entry of foreign banks into Ethiopia bank industry will pushes local banks to modernize their services, giving customers access to the latest financial tools, and operational techniques from around the world. In addition, banks may support the development and spread of new financial products by importing new Fintech products. It will also enhance international market access and FDI. Foreign banks are expected to increase foreign currency inflows into the country and local banks will have a chance to get a greater experience and expertise from foreign banks.

FBE will help for knowledge and technology transfer. International trade allows countries and businesses to access the newest financial instruments, technological advancements, and operational methods from around the world, resulting in increased industry efficiency and effectiveness. The entry of foreign banks will also create job opportunities for employees. If the industry is regulated and governed by law, it may modernize the country’s banking sector. In general, by introducing a modern system, transferring new capital from abroad to the country, and enriching capital, deposits and foreign currency supply can be facilitated and economies of scale can be increased.

Contrary to these ample benefits, FBE will have some negative effects. Foreign banks can easily smash domestic banks, and as a result, domestic bank can be out of the market unless they get various legal restrictions from the National Bank of Ethiopia. Foreign banks will be more likely to shift their funds to more attractive and peaceful markets during a crisis. Political instability inevitably disrupts the smooth running of businesses and the free flow of goods which in turn pushes foreign banks to limit their operations. This could finally culminate in clients committing illegal acts like money laundering (capital outflow).Foreign banks can easily control the financial industrial capacity of the country partially or wholly (which is called modern-day economic colonialism). Another concern is that when banks allow foreign currency for imported items, the banks may give priority to their home country’s products; this makes Ethiopia a destination of a dumping ground for unwanted or expired products.

Regarding the performance of home-grown banks in Ethiopia the first is the underdevelopment of human capital. Ethiopia banks face several challenges related to this, among them lack of skilled manpower, organization transformation, leadership commitment, efficient and effective data management system. Another key point is the lack of digital transformation in Ethiopia. Digital transformation is the process of using the latest technologies to offer online and digital services and shift its services from manual to automatic. These drawbacks of domestic banks will make them uncompetitive with foreign banks those have rich experiences, advanced technologies and skilled human resource.

Domestic banks in Ethiopia did not offer world-class services. With a growing number of import-export businesses and increasing international trade and relations, the current banking system is unable to provide efficient and reliable world-class services; hence the urgent need to initiate capacity-building measures to modernize the whole system. Although allowing foreign banks to operate in Ethiopia has its own pitfalls, the merit to be derived from their involvement surpasses the problems associated with them and hence they should be welcomed.

9.2 Recommendations

The opening of bank industry for foreign investors become inevitable for three major reasons; these are first, global financial market, modernized financial industry, and global banking network; second limited capacity of domestic banks to finance mega projects, and third the pressure from global financial institutions like the International Monetary Fund (IMF), World Bank (WB), and many countries such as the United States and other development partners. These factors enforce Ethiopia to liberalize the financial industry. Thus, for Ethiopia, opening banking sector to foreign nationals becomes inevitable. However, in order to mitigate the risks of foreign banks there must be strong policy and legal framework.

Ethiopia now opens the door for foreign bank involvement in the banking sector and should reap all the good benefits of it. On the other hand, in order to restrict the potential risks of accepting foreign banks, the Ethiopian government should enact prudent laws and implement them in a more stringent manner. Hence, the reasonable choice is striking the balance between the two extremes. Therefore, regulated foreign banking institutions have a lot to offer to financial system of the country.It is important to develop legal and regulatory framework, implementation of modern technologies, capacity building of domestic banks and improvement of financial system infrastructure.

There must be strict regulations that consist of some incentive actions for domestic banks to protect themselves, and to withstand the tough competition with the foreign giants. To avoid harm to local banks, there is a need to limit shares to expatriate banks that is local banks be higher shareholders when the banking market opens for foreign investors. When foreign banks enter Ethiopia, instead of entering independently, they need to enter by merging with local ones until local banks develop their capital, managerial and human resources abilities, and also a grace period need to be given to local banks.

Ethiopian domestic banks need to get prepared to design a strategy to enable them compete with the inevitable arrival of foreign banks to the Ethiopian banking market. The gradual opening of the sector to international competition is important to ensure that local banks are building up strength to the competitionas well as a limit on the number of foreign banks entering the country need to be arranged until the experience in the sector developed well.Capital requirements for foreign banks should be higher than local banks' requirements to avoid any risk of cut-and-run. Stringent control over capital fly-out is also highly optional.

The regulatory body (NBE) needs to take into consideration some useful criteria while filtering the potential candidates of foreign banks and allowing specialized foreign banks which have more knowledge in banking operation, investment banking and willing to finance the small and medium enterprises.

Subsidiary and equity acquisitions are better to generate more foreign currency for Ethiopia. Subsidiary banks are preferred since the investment it makes and the technology and knowledge transfer as well as their contribution to financial inclusion due to the bigger scope of operation, with strong regulation.As strategy to resist the influence of foreign banks, merger and acquisition and/or joint venture is advised for domestic banks. Merger enables domestic banks to form new big commercial and investment banks, for further capital consolidation and better competitive position. On the other hand, the supposition of joint venture is foreign banks can be a potential partner to work on banking business.

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