



**HAWASSA UNIVERSITY**  
**COLLEGE OF LAW AND GOVERNANCE**  
**SCHOOL OF LAW**

**MINIMUM CAPITAL REQUIREMENT FOR THE ESTABLISHMENT OF  
BANKS IN ETHIOPIA**

**LLM THESIS IN COMMERCIAL LAW**

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BANKS IN ETHIOPIA**

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## **DECLARATION**

I hereby declare that the title “Minimum Capital Requirement for the Establishment of Banks in Ethiopia” is my original work and has not been presented for a degree in any other university; all sources of material used for this thesis have been duly acknowledged.

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## **ACRONYMS AND ABBREVIATION**

Art	Article
AIB	Addis International Bank
BIS	Bank for International Settlements
BCBS	Basel Committee on Banking Supervision
CBG	Central Bank Governors
CC	Commercial Code
CBK	Central Bank of Kenya
CBN	Central Bank of Nigeria
CBE	Commercial Bank of Ethiopia
DFIs	Development Finance Institutions
ETB	Ethiopian Birr
EB	Enat Bank
FDRE	Federal Democratic Republic Of Ethiopia
IMF	International Monetary Fund
ITO	International Trade Organization
ICCMCS	International Convergence on Capital Measurement and Capital Standards
MCR	Minimum Capital Requirement
NBE	National Bank of Ethiopia
NSFR	Net Stable Funding Ratio
RB	Ramis Bank
TARP	Troubled Asset Relief Program
WB	World Bank
WTO	World Trade Organization

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## **ABSTRACT**

*The banking sector plays a vital role in the development of the country, serving as the conduit for financial intermediation. Minimum capital requirements are essential for ensuring banks maintain a buffer against potential losses, thereby safeguarding depositors' funds and promoting overall financial stability. These requirements are designed to enhance the resilience of banks and prevent systemic risks that could arise from inadequate capitalization. NBE sets capital requirements for banks from time to time by updating the pre-existing capital requirements to respond to both domestic needs and international regulatory standards. The study aimed to evaluate the minimum capital requirement laws and its challenges for small banks to meet the required capital in Ethiopia. In relation to the methodology, the study used a blend of both doctrinal and non-doctrinal legal research, and in addition, the purposive sampling technique was used. The study has been conducted on the basis of qualitative research techniques to analyze minimum capital requirement laws and its challenges for small banks to meet the required capital in Ethiopia. Data were collected from different sources like laws, proclamations, and directives by NBE, books, journals, and articles related with minimum capital requirements for banks. Moreover, semi-structured interviews have also been conducted with private banks managers at the Hawassa branch and NBE policy supervision department. Finally, the data collected were analyzed through the content analysis method. Based on the findings of the thesis, it is concluded that small banks, especially those started their operations recently, faced challenges to meet the required amount of capital because of the inadequate capital held by them. Based on the findings, recommendations were forwarded. So, it is highly recommended that the NBE should regularly review and adjust the laws and policies to keep pace with the changing economic conditions and launch campaigns aimed at educating the public to join the bank industry. Lastly, the NBE must instruct small banks to have continuous training programs for their staff and to use new technology to minimize costs.*

**Keywords:** Capital, Minimum Capital Requirement, National Bank of Ethiopia, Small Banks

# CHAPTER ONE

## INTRODUCTION

This chapter presents, first, a brief background on the minimum capital requirement for banks; next, it explains the objective as well as the significance of the research. Then the methodology used and, at last, the scope and limitation of the study are presented.

## 1.1 BACKGROUND OF THE STUDY

Bank is the main instrument for the development of the economy of one country. Bank gives a variety of functions to the public as well as to the economy. Banks give the service of borrowing and lending money to their customers. The bank borrows money from some people and lends it to the public. Banks, as a borrower, accept deposits from people. So, those depositors are its creditors. Banking also implies lending deposits received in various forms to be used for productive uses in the form of loans, advances, and cash credits against approved securities. When the banks apply this, they have to take high care whether the money has to be returned back or not.<sup>1</sup> The banking sector also plays a pivotal role in the development of any country, serving as the conduit for financial intermediation, investment, and savings. Financial controllers take a number of ways to insure the financial health of banks, frequently through bylaws, rules, and directives to minimize the risks associated with banking. One of the practices that controllers use to ensure that banks work in a safe and sound manner is by establishing capital requirements. Capital requirements, also known as capital adequacy, are a significant prudential measure that banks must meet to run in a secure and good manner. It plays several significant roles, among other things. It serves as a layer of cover against risks, and in doing so; it promotes and enhances public confidence in banking institutions.<sup>2</sup>

Minimum capital requirements are crucial for maintaining the financial health of banks and the stability of the financial system. They insure that banks have a buffer to absorb losses, which helps prevent bank failures and protects depositors' funds. Additionally, these requirements promote confidence in the banking system and support economic growth by ensuring that banks can continue lending during times of financial stress. These requirements are designed to

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<sup>1</sup> Mengistu Eshete, 'The Law and The Practice Relating To The Competency of National Bank of Ethiopia in the Context of Banks Supervision.' (2009).

<sup>2</sup> Andrew P. Scott, Marc Labonte, 'Bank Capital Requirements: A Primer and Policy Issues' (2023) <Congressional Research Service Report R47447> accessed 24 October 2024.

enhance the resilience of banks and prevent systemic risks that could arise from inadequate capitalization. The concept of capital adequacy is the result of the idea of reorganizing the existing capital structure of banks to restructure the banking industry to counter widespread worry.<sup>3</sup> Capital helps banks to avoid insolvency and bankruptcy. When banks lend, sometimes the borrower fails to repay the loan, and the value of the loan, to the bank decreases. On the bank's balance sheet, when these loans default, the value of the bank's assets will decrease to reflect the new value of the loan. The bank can remain solvent because the initial loss is offset by a reduction in the value of the bank's capital.<sup>4</sup> Studying the area of minimum capital requirements is crucial for several reasons. First, minimum capital requirements insure that banks have enough capital to absorb losses, reducing the risk of bank failures and promoting overall financial stability. Understanding capital requirements helps banks comply with regulatory policies, and well-capitalized banks are better positioned to support economic growth by providing loans and financial services to businesses and individuals.<sup>5</sup>

There are different points of view on minimum capital requirements. Supporters of High Capital Requirements argue that higher capital requirements enhance the stability of the financial system by ensuring that banks have sufficient capital to absorb losses. This reduces the risk of bank failures and protects depositors.<sup>6</sup> Higher capital requirements encourage banks to adopt better risk management practices as they have more at stake. This can lead to more prudent lending and investment decisions.<sup>7</sup> Adequate capital buffers can increase market confidence in the banking sector, attracting investment and fostering a stable financial environment.<sup>8</sup>

On the other hand, opponents argue that higher capital requirements can limit the amount of money banks can lend, potentially slowing economic growth. This is particularly concerning for small and medium-sized enterprises (SMEs) that rely on bank loans for expansion. Smaller banks

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<sup>3</sup> Ayodeji Michael Obadire, Katlo Obadire, 'The Impact of Bank Regulation on Bank Performance: A Novel Analysis of the Pre-Covid Era with Cross-Country Evidence' (2023) 13 Scientific Research Publishing Inc. pp 118-139 <<https://www.scirp.org/journal/ajibm>>.

<sup>4</sup> Scott and Labonte (n 1).

<sup>5</sup> Anat R. Admati and Martin F. Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It* (Princeton University Press 2013).

<sup>6</sup> Basel Committee on Banking Supervision, 'Minimum Capital Requirements for Market Risk'.

<sup>7</sup> Michael Barr, 'Fed Vice Chair to Recommend Substantial Changes to Basel III Capital Requirements' *ABA Banking Journal* (September 2024).

<sup>8</sup> Basel Committee on Banking Supervision, 'Basel Committee Amends Capital Requirements for Non-Performing Loan Securitizations' [2020] Bank for International Settlements (BIS).

may find it challenging to meet higher capital requirements compared to their larger counterparts. This could lead to reduced competition within the banking sector, potentially leading to less favorable conditions for consumers.<sup>9</sup>

The historical development of minimum capital requirements has evolved significantly over time, reflecting changes in the global financial landscape and regulatory priorities. Before the 1980s, capital requirements were relatively informal and varied widely across countries. Banks were generally required to maintain a certain level of capital, but there were no standardized international guidelines. The Basel Committee on Banking Supervision introduced the first set of international banking regulations, known as Basel I, in 1988. This framework established a minimum capital requirement of 8% of risk-weighted assets to insure that banks held sufficient capital to cover credit risk. Basel II, introduced in 2004, aimed to create a more comprehensive and risk-sensitive framework. It introduced the three pillars: minimum capital requirements, supervisory review, and market discipline. This framework allowed banks to use internal models to calculate capital requirements, making the system more responsive to the actual risk profile of banks. In response to the 2008 financial crisis, Basel III was developed to address the shortcomings of the previous frameworks. Basel III introduced stricter capital requirements, including higher quality and quantity of capital, new liquidity requirements, and leverage ratios. The minimum capital requirement remained at 8%, but the definition of capital was refined to insure that banks held more high-quality capital.<sup>10</sup> The Basel Committee continues to refine and update the capital requirements to address emerging risks and insure the stability of the global financial system. Recent adjustments have focused on enhancing the resilience of banks to market and operational risks.<sup>11</sup>

In Ethiopia, the banking industry has undergone significant transformation for the past decades and is fueled by economic reforms and an increasing demand for financial services. The National Bank of Ethiopia (NBE) has raised the minimum paid-up capital requirement for banks from 500 million birr to 5 billion birr. This significant increase aims to strengthen the financial stability

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<sup>9</sup> Henri Fraisse, Mathias Lé, David Thesmar, 'The Real Effects of Bank Capital Requirements' [2017] Institute for Operations Research and the Management Sciences (INFORMS).

<sup>10</sup> Imon Gleeson, *Bank Capital Requirements* (Oxford University Press 2018) PP. 77-79.

<sup>11</sup> Basel Committee on Banking Supervision, 'Minimum Capital Requirements for Market Risk' (n 6).

and resilience of the banking sector.<sup>12</sup> However, banks in Ethiopia, particularly small banks, faced big challenges to meet the 5 billion minimum capital requirements.

## **1.2. STATEMENT OF THE PROBLEM**

The existence of appropriate and effective regulation which governs the banking industry of Ethiopia regarding minimum capital requirement for the establishment of banks is important under Ethiopian banking law to create financial stability and soundness in the Ethiopian banking industry. Banks in Ethiopia play a lion share in the growth of the country compared with other financial institutions.<sup>13</sup> This result comes because of the contribution of all banks, including small banks. The Ethiopian banking law is inadequate for ensuring financial stability and soundness even in comparison with other African countries.<sup>14</sup> The existing banking laws governing the minimum capital requirement for establishing banks have fallen short of fostering a robust and resilient financial system which is necessary for sustainable economic growth. In response to these, increasing the minimum capital requirement is a vital measure to bolster the stability and soundness of the Ethiopian banking industry.

These small banks currently struggle to meet the capital threshold of five billion birr due to limited financial resources and other factors. This creates a substantial negative effect on the stability of the financial sector in Ethiopia. Moreover, the recent policy shift allowing the entry of foreign banks into the Ethiopian market<sup>15</sup> exacerbates these challenges. Due to the absence of adequate capital, small domestic banks face heightened challenges to run their business and competitive pressures from well-capitalized banks. The challenge will become more evident in the future when foreign banks start their banking business in Ethiopia unless the task of enhancing domestic banks to come up with better capital is applied by the NBE at the early step. One way of addressing this challenge is to increase the pre-existing minimum capital requirements laws by applying the international Basel Accords recommended by the Basel Committee on Banking Supervision (BCBS).<sup>16</sup> The committee is known for creating the Basel

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<sup>12</sup> Samson Berhane, 'New Banks Required to Collect 5 Billion Birr within Seven Years' [2021] *The Reporter*.

<sup>13</sup> NBE, 'National Bank of Ethiopia Annual Report 2022-2023' (2023) <<https://nbe.gov.et/wp-content/uploads/2024/08/Annual-Report-2022-2023.>>.

<sup>14</sup> National Bank of Ethiopia Banking Policy Supervision Department[2024]

<sup>15</sup> Alemayehu Gonfa, 'LIBERALIZING BANKING SECTOR FOR FOREIGN INVESTORS: IN ETHIOPIAN CASE' (2024) 13 *Oromia Law Journal* <[>https://dx.doi.org/10.4314/olj.v13i1.5</a>](https://dx.doi.org/10.4314/olj.v13i1.5).

<sup>16</sup> Basel Committee on Banking Supervision, 'Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems'.

Accords, which set out capital requirements for banks to insure they can absorb losses and maintain solvency. So, here, the NBE, to enhance domestic banks, particularly small domestic banks, capable of competing with larger banks as well as with foreign banks, and to enhance financial stability in the banking industry, must revise banking laws governing minimum capital requirements for the establishment of banks in Ethiopia.

Looking at a previously studied paper related to minimum capital requirements, the authors Tesfaye Boru and Meaza Wondimu studied, titled "The Impact of Minimum Regulatory Capital Requirements on the Performance of Banks: The Case of Ethiopian Private Commercial Banks," they investigate the effects of higher capital requirements on the performance of Ethiopian private banks from 2000 to 2020. They utilized a fixed-effects panel data model. The authors analyze how these requirements influence various performance metrics while considering internal, industry-level, and macroeconomic factors. Their findings indicate that increased minimum capital requirements have a positive and statistically significant effect on bank performance, enhancing profitability and stability.<sup>17</sup> This study was conducted from the year 2000-2020, which is before the enactment of the new directive minimum capital requirement for banks (amended) Directive No. SBB/78/2021. This study also focuses on the impact of the minimum capital requirement on the performance of banks, not about the establishment of banks. The other paper is Ragnar Gudmundsson, Kethi Ngoka-Kisinguh, and Maureen Odongo's study, titled "The Role of Capital Requirements on Bank Competition and Stability: The Case of the Kenyan Banking Industry," which examines how capital requirements affect competition and stability within Kenya's banking sector. Their findings suggest that while higher capital requirements can enhance bank stability, they may also reduce competition by increasing the cost of capital for domestic banks compared to foreign banks.<sup>18</sup> The third work is on the title of the effect of bank capital requirements on economic growth: a survey. The author is Natalya Martynovaa, who studied how higher bank capital requirements affect economic growth.<sup>19</sup> The

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<sup>17</sup> Tesfaye Boru, Meaza Wondimu, 'The Impact of Minimum Regulatory Capital Requirements on The Performance of Banks: The Case Of Ethiopian Private Commercial Banks' (2024) 12 International Journal of Economics, Commerce and Managment <<https://ijecm.co.uk/wp>>.

<sup>18</sup> Ragnar Gudmundsson, Kethi Ngoka-Kisinguh, and Maureen Odongo, 'The Role of Capital Requirements on Bank Competition and Stability: The Case of the Kenyan Banking Industry' [2013] Kenya Bankers Association (KBA) Centre for Research on Financial Markets and Policy <The Role of Capital Requirements on Bank Competition and Stability: The Case of the Kenyan Banking Industry>.

<sup>19</sup> Natalya Martynova, 'Effect of Bank Capital Requirements on Economic Growth: A Survey' [2015] De Nederlandsche Bank (DNB).

researcher concluded that banks facing higher capital requirements can reduce credit supply as well as decrease credit demand by increasing lending rates, which may discourage economic growth. However, having better capitalized banks enhances financial stability by reducing bank risk-taking incentives and increasing banks' buffers against losses. These researches did not deal with the effects of the minimum capital requirement for the establishment of banks. Therefore, the effect of minimum capital requirement for the establishment of banks in Ethiopia has not been studied in sufficient manner and the researcher of this paper focuses on the challenges of small banks and its effect on socio-economy of the country.

Thus, the core issue this thesis seeks to address is the insufficiency of current banking laws in creating a stable and sound banking industry in Ethiopia, and the challenges of banks particularly small banks to meet 5 billion minimum capital requirement thresholds for establishing banks in Ethiopia while supporting stability of banking sector in Ethiopia. The objective is to provide a critical assessment that can guide policymakers in developing a regulatory framework that not only strengthens financial stability but also promotes a diverse and inclusive banking sector capable of driving economic growth and development in Ethiopia.

Hence, it is important to critically assess the legal frameworks governing minimum capital requirement for establishing banks in Ethiopia and the challenges of banks, especially small banks, to meet the 5 billion minimum capital requirements that help to identify the gaps in Ethiopian banking laws governing minimum capital requirement for establishing banks.

### **1.3 OBJECTIVES OF THE STUDY**

#### **1.3.1 GENERAL OBJECTIVE**

The general objective of this study is to evaluate the minimum capital requirements laws and directives governing minimum capital requirements and the challenges of small banks to meet the required capital in Ethiopia.

#### **1.3.2 SPECIFIC OBJECTIVE**

- ❖ To identify the rationales of National Bank of Ethiopia behind the increment in minimum capital requirement for banks establishment

- ❖ To identify the practical challenges of small banks to meet the required capital requirement for the establishment of banks in Ethiopia
- ❖ To assess the existing legal framework governing minimum capital requirement for banks weather it sufficiently addresses the needs and interests of stakeholders involved in Ethiopia

## **1.4 RESEARCH QUESTIONS**

- ✚ What are the rationales of the National Bank of Ethiopia behind the increment in the minimum capital requirement for banks establishment?
- ✚ What are the practical challenges of small banks to meet the required capital requirement for the establishment of banks in Ethiopia?
- ✚ Does the existing legal framework governing minimum capital requirements for banks sufficiently address the needs and interests of stakeholders involved in Ethiopia?

## **1.5 METHODOLOGY AND METHOD**

### **1.5.1 METHODOLOGY**

The research utilized both doctrinal and non-doctrinal approaches to analyze the minimum capital requirements for establishing banks in Ethiopia. The doctrinal method examined legal texts such as proclamations, regulations, and directives from the National Bank of Ethiopia, providing a comprehensive understanding of the legal framework. Complementing this, the non-doctrinal approach also used to gathered empirical data from sources like books, journals, articles, and NBE reports, offering insights into the practical challenges and impacts of minimum capital requirements on the banking sector. This combination allowed for a thorough examination of both the legal context and real-world implications.

### **1.5.2 RESEARCH APPROACH**

The researcher used a qualitative approach which was essential for this research as it allowed for an in-depth exploration on regulatory frameworks and practical implications. By capturing stakeholder perspectives through interviews and integrating diverse data sources, the study

provided a comprehensive understanding of the challenges and impacts of minimum capital requirements on Ethiopian banking industry. By employing a qualitative approach, the researcher offered a holistic and contextually relevant examination of the minimum capital requirements for banks in Ethiopia. This method allowed for a thorough examination of the legal, practical, and policy dimensions of the issue, providing valuable insights that could inform the development of a balanced regulatory framework that promotes financial stability and supports the growth of a diverse and inclusive banking sector.

### **1.5.3 RESEARCH DESIGN**

This study employed a descriptive research design to analyze the minimum capital requirements for the establishment of banks in Ethiopia. The descriptive research design was chosen because it allowed for a detailed and systematic description of the current regulatory framework, its implementation, and its impacts on the banking sector. This approach was particularly useful for understanding the complexities and nuances of the legal and regulatory environment. By using a descriptive research design, the study provided a thorough examination of the minimum capital requirements for banks in Ethiopia, highlighting both the legal and practical dimensions of the issue. This approach facilitated a comprehensive understanding of the regulatory framework and its impact on the banking sector, contributing valuable insights for policymakers and stakeholders.

### **1.5.4 SAMPLING METHOD**

This research employed a purposive sampling method to select participants for the study. Purposive sampling was chosen because it allowed the researcher to intentionally select individuals who had specific knowledge and experience relevant to the research topic. It was crucial to gather insights from those directly involved in the banking sector.

The purposive sampling method ensured that the data collected was highly relevant and specific to the research objectives. This approach provided a comprehensive understanding of the practical challenges faced by small banks in meeting the new capital requirements and the perspectives of policymakers on the rationale and expected outcomes of the regulatory changes. The insights gained from these targeted interviews were valuable in informing the analysis and conclusions of the study.

### **1.5.5 POPULATION OF THE STUDY**

The study population for this research comprised key stakeholders in the Ethiopian banking sector. This included private bank managers and officials from the NBE policy supervision department. These individuals were selected due to their direct involvement and expertise in the implementation of minimum capital requirements. This paper covers all private banks now operating in Ethiopia with a minimum capital of 500 million birr but required to meet five billion birr. In addition, this study included the experiences of Nigeria, Kenya and South Africa.

### **1.5.6 COMPARATIVE STUDY: LESSONS FROM OTHER COUNTRIES**

In examining the minimum capital requirements for the establishment of banks in Ethiopia, it was valuable to draw lessons from other countries with successful banking regulation models. This comparative study focused on the experiences of Kenya, Nigeria, and South Africa these countries that have implemented significant reforms in their banking sectors.

Kenya, Nigeria and South Africa were selected for this comparative study due to their similar economic contexts and the significant impact of their banking reforms. Both countries were emerging economies in Africa, facing challenges related to financial stability and economic development. The regulatory measures implemented in Kenya, Nigeria and South Africa provides valuable insights into the potential benefits and challenges of increasing minimum capital requirements in Ethiopia. Examining the experiences of Kenya, Nigeria and South Africa helps the Ethiopian policymakers to design effective capital requirement policies that promote financial stability, and support inclusive banking sector.

### **1.5.7 SAMPLING SIZE**

The sampling size for this research was determined based on the need to gather comprehensive and relevant data from key stakeholders in the Ethiopian banking sector. From small banks which are still not meeting the five billion birr; three private banks were deliberately selected by the researcher. These banks are Ambesa international bank (AIB), Ramis bank (RB), and Enat bank (EB). The researcher collected data through interviews with these banks. The selection of

banks is based on their current capital status to represent the remaining banks of this study. In addition to the above, the researcher also collected data from the NBE policy supervision department regarding the rationale for the rising minimum capital requirement for banks.

#### **1.5.8 DATA COLLECTION TOOL**

The data collection for this research utilized a combination of document analysis and semi-structured interviews. Document analysis involved reviewing relevant legal frameworks, including banking proclamations, regulations, and directives issued by the National Bank of Ethiopia. Additionally, secondary data was gathered from books, journals, articles, and NBE reports related to minimum capital requirements for banks. This comprehensive review of documents provided a solid foundation for understanding the regulatory framework and its implications. To complement the document analysis, semi-structured interviews were conducted with private bank managers and NBE policy supervision officials. These interviews were designed to gather in-depth insights into the practical challenges faced by banks, particularly small banks, in meeting the increased capital requirements.

#### **1.5.9 SOURCE OF DATA**

The data for this research was sourced from a combination of primary and secondary sources. Primary data were collected from banking proclamations, regulations, and directives issued by the NBE and semi-structured interviews with key stakeholders, including private bank managers and officials from the National Bank of Ethiopia policy supervision department. These interviews provided first-hand insights into the practical challenges faced by banks, particularly small banks, in meeting the increased capital requirements. Secondary data was gathered from books, journals, articles, and NBE reports related to minimum capital requirements for banks. This extensive collection of secondary data provided a solid foundation for understanding the regulatory framework and its implications for the banking sector. By integrating both primary and secondary data sources, the research ensured a thorough and well-rounded analysis of the minimum capital requirements for the establishment of banks in Ethiopia.

#### **1.5.10 DATA ANALYSIS**

The researcher employed a content analysis method to systematically examine the collected data. Content analysis was chosen because it is suitable for analyzing the detailed information obtained from semi-structured interviews and document reviews.

In addition, this study used both descriptive and analytical methods to interpret this study. These methods are important to this study, which describe the concepts and evaluate the existing law in application.

## **1.6 SIGNIFICANCE OF THE STUDY**

This study on the minimum capital requirements for the establishment of banks in Ethiopia held significant importance for several reasons. Firstly, it provided a comprehensive understanding of the regulatory framework governing the banking sector, highlighting the implications of increased capital requirements on financial stability and resilience. By examining the challenges faced by small banks in meeting these requirements, the study shed light on policymakers aiming to foster a diverse and competitive banking environment. Secondly, the research offered valuable insights into the practical impacts of regulation on domestic banks, particularly for smaller banks to create financial stability in the banking industry. By incorporating perspectives from private bank managers and National Bank of Ethiopia officials, the study captured the real-world challenges and benefits associated with minimum capital requirements. This information was essential for developing policies that support the stability of the banking sector in Ethiopia. Furthermore, this study might be used as feedback for policymakers as well as the legislature to improve their areas of weakness. It is also used as a reference for anybody who is interested in undertaking research in the same area and is useful to knowledge.

## **1.7 SCOPE OF THE STUDY**

The scope of this study encompassed the examination of minimum capital requirements for the establishment of banks in Ethiopia. It focused on the regulatory frameworks governing minimum capital requirements for banks. The study investigated the challenges of small banks that started their operations with a minimum capital of 500 million ETB and were required to meet five billion dollars in a specified period. The research included a detailed analysis of relevant legal frameworks, such as the CC, banking proclamations, regulations, and directives issued by the NBE. Additionally, it incorporated empirical data collected through interviews from private bank managers and NBE policy supervision officials to gain insights into the practical challenges. The

study was limited to the Ethiopian private commercial banking sector which are licensed by the National Bank of Ethiopia whose paid-up capital is below 5 billion birr but required to raise its paid-up capital to 5 billion birr by June 30, 2026, and banks under formation and in the process of share subscription during the effective date of the same directive and which permitted to get banking business license with a minimum of 500 million birr but required to raise its paid-up capital to 5 billion birr within 7 years after commencement of banking operation. This study excludes banks that meet five billion birr.

### **1.8 LIMITATION OF THE STUDY**

One of the problems that limit the researcher in studying this research is the absence of enough similar prior study in Ethiopia. Most research is studied in developed countries and the factors applied by those countries may not be same with developing countries including Ethiopia. In addition to this, domestic laws do not define the term minimum capital requirement in a clear way; this is also another limitation. However, the researcher was tried to overcome these challenges by exhaustively analyzing available materials.

### **1.9 ORGANIZATION OF THE STUDY**

This paper organized into five chapters. The first Chapter is the introductory part which includes introduction, background of the study, objectives, research question, and scope of the study, significance of the study and limitation of the study. The second chapter reveals the general overviews and concepts on minimum capital requirement for the establishment of banks. It focuses on the meaning and importance of minimum capital requirement for banks, historical development of minimum capital requirement for banks, development of international Basel Accords, nature of banking business, and capital requirements for banks in Ethiopia. Chapter three also discussed on policy and legal frameworks governing minimum capital requirement for bank establishment in Ethiopia and the experiences of Nigeria, Kenya, and South Africa. The fourth chapter deals with the presentation and analysis of data. The last chapter presents the conclusion of the study and forward recommendations.

## CHAPTER TWO

### GENERAL OVERVIEWS ON MINIMUM CAPITAL REQUIREMENT FOR THE ESTABLISHMENT OF BANKS

#### INTRODUCTION

In this chapter, the general overviews of the concept and importance of the minimum capital requirement for the establishment of banks are discussed. This chapter also discusses the international Basel Accord development to strengthen the banking sector that safeguards banks not to fail during economic crises and creates financial stability on the banking industry. Further, the chapter reveals the nature of banking business in Ethiopia and discusses in detail the development of the minimum capital requirement in Ethiopia.

#### 2.1 MEANINGS AND IMPORTANCE OF MINIMUM CAPITAL REQUIREMENT FOR BANKS

Capital reform in the banking industry is a common phenomenon across the globe, and the financial environment, Ethiopia is not an exception. In financial regulation, the imposition of capital requirements stands as a pivotal mechanism designed to insure the stability and resilience of banking institutions. This is particularly significant for small banks, which often operate under a different set of economic dynamics compared to their larger counterparts. The minimum capital requirement is the minimum amount of capital that banks and DFIs (Development Finance Institutions) must maintain as per the Basel II framework.<sup>20</sup> The essence of capital requirements is to mandate banks to hold a certain level of capital reserves relative to their risk-weighted assets. This serves as a buffer against the possibility of losses, safeguarding depositors and maintaining the integrity of the financial system.<sup>21</sup> A crucial part of bank regulation is to make sure that banks hold enough capital to insure the durability of a safe and effective market and are suitable to survive unforeseeable problems.<sup>22</sup> The question of banks' capital adequacy became a renewed focal point for lawmakers after the 2007–08 financial crisis embarked. How much capital should a bank hold to manage their risks? Are statutory regulations necessary and

<sup>20</sup> State Bank of Pakistan, 'Minimum Capital Requirements For Banks & DFIs'.

<sup>21</sup> 'Capital Requirement: The Impact of Capital Requirements on Small Banks' (*FasterCapital*) <<https://fastercapital.com/content/Capital-Requirement--The-Impact-of-Capital-Requirements-on-Small-Banks.html>> accessed 8 August 2024.

<sup>22</sup> David P. Stowell, *Investment Banks, Hedge Funds, and Private Equity (Third Edition)* (2018).

sufficient? Why does the approach to governing bank capital differ in other jurisdictions? These questions are clearly not new, and a lot of work has been devoted to chancing answers.<sup>23</sup>

The accurate definition of ‘capital’ varies between countries. Indeed, in the first Basel Accord of 1988, there was an alone agreement on what is termed tier one capital, whereas the description of tier two capital is allowed to vary between jurisdictions. Financial controllers at the state and federal levels take a number of steps to insure the financial health of banks, generally through what is referred to as prudential (or safety and soundness) rules, regulations, and principles put in place to mitigate risks associated with banking activity. One-way regulators insure that banks work in a secure and sound manner is by establishing capital requirements that banks must meet.<sup>24</sup> A capital requirement (also known as regulatory capital or capital adequacy) is the amount of capital a bank or other financial institution has to have as needed by its financial regulator.<sup>25</sup> Capital requirements may reduce the casualty of a financial institution’s failure. In theory, the further capital that an institution has, the better it may withstand a run. While capital requirements serve a necessary function vis-à-vis certain exogenous correlation risks affecting the industry generally, contagious runs are probable to overwhelm any presumptive capital requirement, due to the stunning losses that inescapably follow from asset fire sales.<sup>26</sup> In the banking sector, where the governed entities operate in a principal capacity and are leveraged institutes, capital requirements are correctly designed with the consummate aim of enhancing safeness and stability, both for individual banks and for the banking system as a whole. Bank capital requirements serve as an important cushion against unanticipated losses. They incentivize banks to run in a prudent form by putting the bank owners’ equity at risk in the occurrence of a failure. In its simplest form, bank capital serves several purposes. First, there is the need to have a capital cushion as earnings may change; this makes it possible to manage losses. Second, deposit-taking institutions require capital as an assurance to depositors that they will be refunded.

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<sup>23</sup> Åsa Malmström Rognes, ‘The Evolution of Capital Adequacy Rules – the Contrasting Cases of Sweden and Britain’ (2022) 70 *Scandinavian Economic History Review* 19.

<sup>24</sup> Andrew P. Scott, Marc Labonte (n 2).

<sup>25</sup> Carol Woods, ‘Capital Requirements: Definition & Explanation - Lesson’ (*study.com*, n.d.) <<https://study.com/academy/lesson/capital-requirements-definition-lesson-quiz.html>> accessed 24 June 2024.

<sup>26</sup> Hal S Scott, ‘14. Capital Requirements: Basel III Framework’ [2020] MIT Press on COVID-19 <<https://covid-19.mitpress.mit.edu/pub/a8zvrr6j/release/1>> accessed 25 June 2024.

Third, capital assures the overall people that the bank is solvent and will stay in business. They serve, in little, to reduce risk and defend against failure.<sup>27</sup>

## **2.2 BASEL ACCORD INTERNATIONAL CAPITAL REQUIREMENTS**

The evolution of minimum capital requirements has been a significant aspect of banking regulation over the past few decades.

Before the establishment of the Basel Committee on Banking Supervision (BCBS) in 1974, minimum capital requirements for banks were not standardized internationally. Each country had its own regulatory framework, and the requirements varied significantly. Generally, the focus was on ensuring that banks had enough capital to cover potential losses, but the methods and criteria for determining these requirements were not uniform.

In the United States, for example, the Bank Holding Company Act of 1956<sup>28</sup> required bank holding companies to maintain a certain level of capital. However, the specifics of these requirements were less rigorous compared to the later Basel Accords. The lack of international standards often led to inconsistencies and competitive imbalances among banks operating in different countries. The establishment of the Basel Committee and the subsequent Basel Accords aimed to address these issues by creating a more cohesive and robust regulatory framework for banks worldwide. Modern capital requirements can appear to be overly complicated, but they reflect centuries of practical experience, compromises between different controllers, and legal and financial systems that developed over time.<sup>29</sup>

### **2.2.1 Early Developments**

In 1974, the Basel Committee on Banking Supervision (BCBS) was formed by central bank governors from the Group of Ten (G10) countries. This establishment aimed to improve financial stability worldwide by enhancing the supervision and regulation of banks. The committee was created in response to the need for more effective banking oversight and to foster international cooperation among its member countries, ensuring the banking sector's resilience against

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<sup>27</sup> Daniel M. Gallagher, 'The Philosophies of Capital Requirements' [2014] U.S. Securities and Exchange Commission (SEC) <<https://www.sec.gov/news/speech/2014-spch011514dmg>> accessed 25 June 2024.

<sup>28</sup> Bank Holding Company Act of 1956 1956.

<sup>29</sup> Joseph G Haubrich, 'A Brief History of Bank Capital Requirements in the United States' [2020] Economic Commentary <<https://www.clevelandfed.org/publications/economic-commentary/2020/ec-202005-evolution-bank-capital-requirements>> accessed 10 September 2024.

financial crises and systemic risks.<sup>30</sup> In 1988, the Basel I Accord was introduced, setting the first international minimum capital requirements for banks.

The Basel Committee-primarily named the Committee on Banking Regulations and Supervisory Practices- was established by the central bank Governors of the Group of Ten countries at the end of 1974 in the face of serious disturbances in transnational currency and banking markets (specially the failure of Bankhaus Herstatt in West Germany). The Committee, headquartered at the Bank for International Settlements in Basel, was established to help financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular collaboration between its member countries on banking supervisory matters. The Committee's first meeting took place in February 1975, and meetings have been held regularly three or four times a year. Since its commencement, the Basel Committee has developed its membership from the G10 to 45 institutions from 28 jurisdictions. Starting with the Basel Concordat, first issued in 1975 and modified several times, the Committee has established a series of transnational standards for bank regulation, most specially its landmark publications of the accords on capital adequacy which are generally known as Basel I, Basel II and, Basel III.<sup>31</sup>

### **2.2.2 Basel I Accord: The Basel Capital Accord**

The Basel Capital Accord, launched in 1988 by the Basel Committee on Banking Supervision (BCBS), was the pioneering international regulatory framework designed to standardize minimum capital requirements for banks globally. Its main objective was to bolster the stability and resilience of the banking sector by ensuring banks held enough capital to absorb potential losses. Basel I introduced the concept of risk-weighted assets, categorizing them into five risk levels, from 0% for low-risk assets like government securities to 100% for high-risk assets like corporate debt. Banks were mandated to maintain capital equivalent to at least 8% of their risk-weighted assets. This framework marked a significant milestone in harmonizing global banking regulations and set the stage for future frameworks like Basel II and Basel III, which aimed to refine and enhance these regulations. Despite its advantages, Basel I was criticized for its oversimplified risk-weighting system that failed to distinguish adequately between different levels of risk within asset categories. Nevertheless, it laid a critical foundation for improving

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<sup>30</sup> Bank for International Settlements (BIS), History of the Basel Committee[2017] <<https://www.bis.org/bcbs/historyhtm>> accessed 22 March 2024

<sup>31</sup> Bank for International Settlements (BIS), 'History of the Basel Committee' <<https://www.bis.org/bcbs/history.htm>> accessed 22 March 2024.

bank capital adequacy and fostering international financial stability. In Basel I, discuss the three problems related to applying the leverage ratio alone by requiring too much capital against assets of higher perceived credit risk, by applying it to off-balance sheet activities as well as assets, and by adapting and applying the requirements to all countries with a BIS membership and to the many others without a BIS membership who adopt them as well.<sup>32</sup>

### **2.2.3 Basel II Accord: The New Capital Framework**

Basel II was created to replace Basel I with several variations that were issued in 2004, along with additional updated rules published in 2005. Basel II contained three pillars that depended on each other to be most effective. In June 1999, the Committee published a proposal for a new capital adequacy framework to substitute the 1988 Accord. This led to the release of a modified capital framework in June 2004. The modified framework consisted of three pillars. The first pillar was Minimum capital requirements, which sought to develop and expand the standardized rules set out in the 1988 Accord. The second pillar is the supervision of an institution's capital adequacy and internal assessment processes. And the final pillar is the effective use of disclosure as a lever to strengthen market discipline and encourage sound banking practices.<sup>33</sup>

### **2.2.4 Basel III Accord: Responding to the 2007-09 financial crises**

Basel III, developed by the Basel Committee on Banking Supervision (BCBS) in response to the financial crisis of 2007-2009, is an international regulatory framework aimed at significantly enhancing the regulation, supervision, and risk management of the global banking sector to insure financial stability and resilience. This framework introduced more stringent capital requirements than its predecessors, mandating higher minimum capital ratios to insure banks have sufficient capital buffers to absorb financial shocks. Furthermore, Basel III established new liquidity standards, such as the Liquidity Coverage Ratio (LCR), which requires banks to hold an adequate amount of high-quality liquid assets to cover net cash outflows for a 30-day stress period. The Net Stable Funding Ratio (NSFR) was also introduced to promote longer-term stability by ensuring that banks maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities.<sup>34</sup>

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<sup>32</sup> Allen N. Berger, Raluca A. Roman, *TARP and Other Bank Bailouts and Bail-Ins around the World: Connecting Wall Street, Main Street, and the Financial System* (Elsevier Science 2020).

<sup>33</sup> *ibid.*

<sup>34</sup> Basel Committee on Banking Supervision (BCBS), 'Basel III: International Regulatory Framework for Banks'.

In addition to capital and liquidity requirements, Basel III introduced the leverage ratio, a non-risk-based metric that acts as a backstop to the risk-weighted capital requirements. The aim is to constrain the build-up of excessive leverage in the banking sector, thus reducing the likelihood of financial crises. Basel III builds on the foundations of Basel I and Basel II, addressing the weaknesses and gaps exposed by the global financial crisis. By setting higher standards and implementing more rigorous regulatory measures, Basel III strives to create a more resilient banking system capable of withstanding economic and financial stress, ultimately promoting a safer and more robust global financial environment.<sup>35</sup>

Indeed, before Lehman Brothers collapsed in September 2008, the need for a basic strengthening of the Basel II framework had become apparent. The banking sector entered the financial crisis with too much leverage and insufficient liquidity buffers. These weaknesses were accompanied by poor governance and risk management, as well as incorrect encouragement structures. The hazardous combination of these factors was demonstrated by the mispricing of credit and liquidity threats, and surplus credit growth. Responding to these risk factors, the Basel Committee published Principles for valid liquidity risk management and supervision in the same month that Lehman Brothers failed. In July 2009, the Committee published an additional package of documents to strengthen the Basel II capital framework, especially regarding the treatment of some complicate securitization positions, off-balance sheet vehicles and trading book exposures. These advancements were part of a wide effort to strengthen the regulation and supervision of internationally active banks, in the light of weaknesses exposed by the financial market crisis.<sup>36</sup>

#### **2.2.5 Basel IV Accord**

Basel IV also referred to as Basel 3.1, represents an evolution of the international banking regulatory frameworks established by Basel I, II, and III initiated in response to the ongoing need for financial stability following the 2007-2009 financial crises. Basel IV aims to address the shortcomings of its predecessors and further reinforce the global banking system. Officially beginning implementation on January 1, 2023, these reforms introduce more precise methodologies for calculating risk-weighted assets (RWAs), ensuring that banks hold sufficient

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<sup>35</sup> Basel Committee on Banking Supervision, 'Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems' (n 16).

<sup>36</sup> 'History of the Basel Committee' <<https://www.bis.org/bcbs/history.htm>> accessed 12 September 2024.

capital to cover their risk exposure accurately. The reforms also mandate higher capital requirements to enhance the financial buffers available to banks during economic downturns. Additionally, Basel IV sets forth stringent standards for liquidity and leverage, compelling banks to maintain robust levels of liquid assets and limiting excessive leverage practices. By seeking to harmonize these regulations across different countries, Basel IV endeavors to create a more resilient and stable banking environment, reducing the likelihood of future financial crises and promoting global economic stability.<sup>37</sup>

### **2.3 NATURE OF THE BANKING BUSINESS**

Banks mainly act as financial intermediary in the monetary system. Financial intermediaries are link between the borrowing individuals and firms. The lenders or surplus income units possess assets in the form of bank deposit, insurance deposits, insurance policies, pensions etc. The financial intermediaries transfer the saving of surplus income units to the spending units by purchasing primary securities. They bring borrowers and lender together. By doing such activities, they promote savings and investment habits among ordinary people by putting funds to profitable and productive use and by providing credit loans to the consumer. They also encourage the growth of the business sector by providing facilities for investment in plant, equipment, etc... through loans, mortgages, purchase of bonds, shares etc.<sup>38</sup>

Banks are vital to a nation's economy as they facilitate financial intimidation, enabling the effective distribution of resources and encourage both investment and consumption. Lawmakers can enhance financial stability in the banking sector by enhancing regulatory measures that promote responsible lending practices, insure sufficient capital reserves, and improve transparency. Furthermore, establishing central banks can help to manage monetary policy and serve as lenders of last resort during financial emergencies. Collectively, these strategies foster a robust banking environment that supports sustainable economic progress and safeguards consumers.<sup>39</sup>

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<sup>37</sup> Greg Daugherty, 'What Basel IV Means for U.S. Banks' [2023] Investopedia <What Basel IV Means for U.S. Banks - Investopedia.>.

<sup>38</sup> Eshete (n 1).

<sup>39</sup> David R. Hennessey, 'The Theory of Banking', [2019]

## **2.4 THE ETHIOPIAN BANKING SECTOR**

Nowadays, banks operating different activities after the new reform have been done in the private sector, especially the banking sector. The number of the banking sector has started to expand from time to time after the development of the first private bank Awash bank S.C. in 1994. Banks play a certain role in the sustainable economic development of a country through delivering the needed financial services to the economy. Commercial banks, particularly, can be taken as a lung for every business activity. Hence, well-arranged, and structured commercial bank services are needed to have better business activity and sustainable economic development. According to the National Bank of Ethiopia website, the total number of banks operating in Ethiopia reached 41. The other 13 new banks in the process of share subscription (selling shares to the public) during the new directive released failed because they were unable to meet the new minimal establishment paid-up capital threshold within the allocated time.<sup>40</sup>

## **2.5 DEVELOPMENT OF MINIMUM CAPITAL REQUIREMENT FOR BANKS IN ETHIOPIA**

Like other countries of the world, the banking sector in Ethiopia has been subject to regulations through proclamations and directives. The Banking Business Proclamation No. 84 of 1994 unlocked the doors of the Ethiopian banking sector to the private sector banks. The banking sector has gradually caught up a central place in the economic growth and development of Ethiopia. This needed a further comprehensive banking legal framework that could insure the security, stability, and soundness of the banking system in the country. Accordingly, the government of Ethiopia came up with a new Banking Business Proclamation No. 592/2008 in 2008, repealing the previous Proclamation No. 84 of 1994. Later, the 2008 proclamation was amended by Proclamation 1159 of 2019. The foregoing implies that reforms are an integral part of the Ethiopian banking sector.<sup>41</sup>

Nowadays, the banking business proclamation 592 of 2008, the amended proclamation 1159 of 2019, and the NBE establishment proclamation 591 of 2008 are the leading legislation that constitutes the banking supervisory framework of Ethiopia. Indeed, a set of directives issued by the banking sector controller are the subordinate legislation that forms the banking regulatory

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<sup>40</sup> Misrak Abate and Ratinder Kaur, 'BANKING SECTOR IN ETHIOPIA: ORIGIN AND PRESENT STATE' (2023) 9 EPH - International Journal of Business & Management Science 1.

<sup>41</sup> *ibid.*

framework of Ethiopia. These include, among others, directives for the minimal establishment capital requirement, reserve requirement, liquidity requirement, restriction on investment of banks, and single borrower loan limit. The proclamations, concurrently with a suite of directives, govern all banking business activities in the country. To improve the safety, soundness, and stability of the banking system, the current banking legislations (proclamations and central bank's directives) have brought rigorous preventative regulations like requirements for capital adequacy, restrictions on the kinds of businesses that banks may involve, requirements for statutory reserves and liquidity, restrictions on entry into the banking business through licensing and entry capital base, and imposition of extents on the credit to be extended to a single borrower.<sup>42</sup>

The key role of a bank as an institution is to mobilize resources and distribute its idle resources to potentially productive sectors with the aim of raising the level of economic development. In modern times, the role of commercial banks is found important. Since the coming to power of the Derg in 1974 and during its stay till 1991, Ethiopia had been under the central planning economic system through which macro incentives such as interest rates, exchange rates, and prices of major commodities were administratively fixed with no management autonomy. The economy would be without the private sector if there was a predetermined capital ceiling not exceeding a quarter of a million birr. As a result, the policies of the government resulted in a sluggish performance of the economy and macroeconomic imbalances. Following the change of government in May 1991, the then new government, EPRDF, took various policy measures with the aim of adjusting the macroeconomic imbalance and fostering sustainable economic growth, and declared a market-oriented capitalist mode of economic policy. The government at that time was faced with the twin tasks of reconstructing the economy and embarking on the transition to a market economy. As part of this process, state banks have been recognized, the role of the private sector in the financing system has been expanded, interest rate controls have been liberalized, and the central bank has been given new powers on financial supervision.<sup>43</sup>

Currently, the major financial institutions operating in Ethiopia are banks, insurance companies, and microfinance institutions. To establish banks in Ethiopia, the banking sector should keep up

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<sup>42</sup> *ibid.*

<sup>43</sup> Tony Addison & Alemayehu Geda, 'Ethiopia's New Financial Sector and Its Regulation'.

a minimum paid-up capital needed by the National Bank of Ethiopia directive for banks. The sustainability and increment of the banking business operation requires keeping up a level of capital proportionate with the amount of their business operation to resist adverse operational results and hence raise profitability. To extend the stability and soundness of banks, NBE modified its directive from time to time. Thus, the National Banks of Ethiopia issued the Minimum Capital Requirement for Banks Directive No. SBB/ 50/2011. As per this directive, the National Bank of Ethiopia raised the minimum capital requirement for banks from Birr 75 million to Birr 500 million to all banks operating in the country to meet the new requirement by 2016.<sup>44</sup> Currently, banks in Ethiopia are ruled by the Minimum Capital requirement Directive No. SBB/ 78/2021. This directive further raised the former capital tenfold. It bears banks to operate their business in Ethiopia; they must meet the minimum paid-up capital of 5 billion birr.<sup>45</sup> This ten-fold increase is a strategic move aimed at bolstering the financial stability and resilience of Ethiopia's banking sector. The new requirement aligns with international standards, ensuring that banks possess the necessary capital buffers to absorb potential financial shocks and manage risks effectively. This regulatory change is expected to enhance the banks' capacity to provide larger loans, support extensive operations, and contribute more robustly to the country's economic growth.<sup>46</sup>

To facilitate a smooth transition, the NBE has granted existing banks a five-year period to comply with the new capital requirement, while new banks have been given a seven-year window. This phased approach allows banks to gradually build up their capital reserves without causing immediate financial strain. The expectation is that this increase will lead to greater consolidation within the sector, with smaller banks potentially merging or seeking additional capital to meet the stringent requirements. This move is intended to create a more robust and competitive banking environment that can better support Ethiopia's ambitious economic development goals.<sup>47</sup> Overall, the substantial increase in the minimum capital requirement reflects the NBE's commitment to fostering a stable and resilient financial system capable of withstanding economic fluctuations and contributing to sustained economic growth.

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<sup>44</sup> tesfaye Boru Lelissa, 'The Impact of Industry Concentration on Performance, Exploring A Comprehensive Bank Performance Model: The Case of the Ethiopian Banking Sector' (University Of South Africa 2017) p, 4.

<sup>45</sup> Minimum Capital Requirement for Banks (Amended) Directive No. SBB/78/2021

<sup>46</sup> *ibid*

<sup>47</sup> The response of National Bank of Ethiopia Policy Supervision Department, [2024]

## **CHAPTER THREE**

### **POLICY AND LEGAL FRAMEWORK**

#### **INTRODUCTION**

In this chapter, the legal frameworks and policies governing the minimum capital requirement for establishing banks in Ethiopia are discussed in detail. The legal frameworks and policies raised under this chapter are the FDRE Constitution, the new commercial code of Ethiopia proclamation No. 1243/2021, the NBE establishment proclamation No. 591/2008, the amended minimum capital requirement for banks directive, and their weakness to create financial stability in the Ethiopian banking industry. This part of the discussion also included the experiences of Nigeria and Kenya as a lesson.

#### **3.1 POLICY AND LEGAL FRAMEWORK ON MINIMUM CAPITAL REQUIREMENT FOR THE ESTABLISHMENT OF BANKS IN ETHIOPIA**

This part of the research focuses on analyzing laws, policies, and institutional frameworks related to bank regulation. Ethiopian government, starting from the constitution, formulated different proclamations, regulations, and directives for the implementation of bank policy to address bank problems to protect banks' financial stability and soundness.

#### **3.2 The FDRE Constitution of Ethiopia**

The FDRE constitution provides principles for all legislative frameworks in the country. Although the term minimum capital requirement is not provided in the constitution directly, it provides by articles that stipulate the rights of people to participate in economic activities.

The concept of freedom of association is enshrined in Article 31 of the FDRE Constitution, which stipulates that "every person has the right to freedom of association for any cause or purpose." This fundamental right allows individuals to form and join groups, including financial institutions like banks, thereby fostering a collaborative economic environment. Article 41(1) and (2) of the Constitution outline the economic rights of citizens. According to Article 41(1), every Ethiopian has the right to engage freely in economic activities and pursue a livelihood of their choice anywhere within the national territory.<sup>48</sup> This provision empowers individuals and businesses to operate without undue restrictions, promoting economic inclusion and diversity.

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<sup>48</sup> Art 41(1) and (2) of the Federal Democratic Republic of Ethiopia Constitution

Moreover, Article 89(1) identifies economic objectives, stating, "Government shall have the duty to formulate policies which insure that all Ethiopians can benefit from the country's legacy of intellectual and material resources."<sup>49</sup> In the context of enhancing financial stability and promoting competition within the banking sector, these constitutional provisions play a crucial role. By guaranteeing the right to freedom of association and economic activity, the Constitution supports the establishment and growth of banks. These banks are essential in creating a more competitive banking environment, and creating financial stability in the country.

To achieve this competitive balance, it is imperative that banks, regardless of their size, maintain sufficient capital reserves. Adequate capitalization ensures that banks can absorb financial shocks, lend more effectively, and sustain operations during economic downturns. By aligning constitutional rights with sound economic policies, Ethiopia can foster a robust banking sector that supports economic growth, promotes financial inclusion, and ensures stability. The synergy between legal frameworks and financial regulations is pivotal in creating a more resilient and competitive financial system.

### **3.3 THE NATIONAL BANK OF ETHIOPIA ESTABLISHMENT PROCLAMATION No. 591/2008**

The National Bank of Ethiopia Establishment Proclamation No. 591/2008 provides a comprehensive framework for the establishment and regulation of the National Bank of Ethiopia. The preamble of the proclamation emphasizes the importance of maintaining financial stability, promoting economic growth, and ensuring the efficient functioning of the financial system.<sup>50</sup> This proclamation sets the stage for the NBE to implement policies and regulations that support these objectives. Regarding minimum capital requirements, the proclamation outlines the need for banks to maintain adequate capital reserves to insure financial stability and solvency. The NBE has the authority to set and adjust these requirements based on economic conditions and the evolving needs of the banking sector. The recent increase in minimum capital requirements from 500 million Birr to 5 billion Birr is a reflection of this regulatory approach, aimed at strengthening the financial system and enabling banks to better manage risks and support economic activities.

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<sup>49</sup> Art 89(1) of the Federal Democratic Republic of Ethiopia Constitution

<sup>50</sup> The National Bank of Ethiopia Establishment Proclamation No. 591/2008

Article 4 of this proclamation further delineates the purpose of the NBE as maintaining stable rates of price and exchange, fostering a robust financial system, and undertaking activities conducive to Ethiopia's rapid economic advancement. Based on this legal framework, the rationale behind the NBE's recent increase in the minimum paid-up capital requirement for banks is clearly aligned with these foundational goals. By raising the capital threshold, the NBE aims to enhance the resilience and stability of financial institutions, ensuring they possess sufficient buffers to absorb potential losses and manage risks effectively.

### **3.4 THE BANKING BUSINESS PROCLAMATION NO. 592/2008**

The preamble of the Banking Business Proclamation No. 592/2008 underscores the critical need for comprehensive legislation to insure the safety, soundness, and stability of the banking system. It warns that mismanagement within banks holds the potential to trigger macroeconomic instability. Based on this principle, the National Bank of Ethiopia's decision to increase minimum paid-up capital requirements is a strategic move to safeguard the financial system. By mandating higher capital thresholds, the NBE aims to fortify banks against financial shocks, thereby maintaining confidence among depositors and investors. This proactive measure is designed to avert systemic risks and insure that banks are resilient enough to support sustainable economic growth. Ultimately, these regulations are pivotal in preventing the adverse effects of mismanaged banking operations on the broader economy and promoting a stable and robust financial environment.

### **3.5 THE NEW COMMERCIAL CODE OF ETHIOPIA**

The new Commercial Code of Ethiopia, Proclamation No. 1243/2021, has introduced several reforms that mark significant improvements over the old code. These reforms are particularly appreciable as they incorporate modern business practices, address issues like e-commerce and digital transactions, and align with international trade standards.

The current economic environment and the complexities of banking operations necessitate a higher capital base to create financial stability in the country. Adequate capitalization is critical for banks to absorb financial shocks, lend effectively, and sustain operations during economic downturns. The new Commercial Code, while progressive in many respects, should align its capital requirements for banks with these practical needs to insure a stable and competitive banking sector.

By setting a more realistic minimum capital requirement for banks, the new Commercial Code can help to create a more robust financial system. This adjustment would enable small banks to operate on a level playing field with larger banks, fostering a competitive environment that benefits consumers through better services and innovation. It is essential for the legal framework to reflect the financial realities of the banking sector to promote sustainable economic growth and financial stability in Ethiopia. The new Commercial Code of Ethiopia can complement the NBE's efforts by providing a legal framework that supports modern business practices and financial operations.

### **3.6 MINIMUM CAPITAL REQUIREMENT FOR BANKS (AMENDED) DIRECTIVE NO SBB/78/2021**

By referring to the preamble of the minimum capital requirement for banks directive No. SBB/78/2021(hereinafter the directive) we understand the rationale of NBE behind increasing capital requirements. According to the preamble of this directive, raising the minimum paid-up capital for banks is essential to insure their resilience against financial shocks. The preamble under paragraph one says that “whereas it has become necessary to raise the minimum paid-up capital required for banks’ and further improve financial resilience and soundness of banks and banking system”.<sup>51</sup> According to the directive, increasing capital requirements act as a safeguard to reduce the likelihood of bank failures and promote overall financial stability. Banks must maintain enough capital buffers to resist potential losses.

From the definition and scope of application part of this directive, we can also understand that this directive governs existing banks, a bank under formation and a bank in the process of share subscription. Existing bank refers to a bank licensed by the National Bank before the effective date of this directive. A bank under formation means a banking share company under formation which fulfills its capital that has been fully subscribed, collected in cash from its founding shareholders a minimum capital of birr 500 million birr and deposited in an existing bank(s) in the name and to the account of the bank under formation, as per the commercial code and relevant laws of the country held its subscribers meeting, elected board of directors and approved memorandum of association and submitted final application for banking business to the National Bank. A bank in the process of share subscription means a banking sharing company that is in

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<sup>51</sup> The Preamble of Minimum Capital Requirement for Banks Directive No. SBB/78/2021.

the process of selling shares to the public as per the approval obtained from the National Bank and has not conducted its subscribers meeting as of the effective date of this directive.<sup>52</sup>

Article 4 of this directive says... “The minimum paid-up capital required to obtain a banking business license shall be birr 5 billion (Five Billion Birr), which shall be fully paid in cash and deposited in a bank(s) in the name and to the account of bank under formation”. However, there is a transitory provision under article 5 of the same directive which is an exception to article 4. As per article 5 of this provision notwithstanding the provision of article 4, an existing bank, a bank under formation and in the process of share subscription whose paid-up capital is below birr 5 billion shall raise its paid-up capital to the said amount by June 30, 2026, and seven years after commencement of banking operation respectively.<sup>53</sup> Under article 6 there is sanction. If a licensed bank fails to comply with the minimum paid up capital requirement, the National Bank may put the bank under receivership and appoint a receiver or require the appointed receiver to dissolve the bank through merger with another bank or take any other measures that it considers fit. A licensed bank upon the event of seeing difficulty in meeting the minimum paid-up capital as required in this directive may undertake voluntary merger or acquisition transactions with another bank before to elapse the stated period under this directive.<sup>54</sup>

### **3.7 THE EXPERIENCES OF OTHER COUNTRIES AS A LESSON**

#### **3.7.1 MINIMUM CAPITAL REQUIREMENT FOR THE ESTABLISHMENT OF BANKS IN NIGERIA**

The history of minimum capital requirements for banks in Nigeria have seen several significant changes aimed at strengthening the financial system and promoting economic stability. In 2004, the Central Bank of Nigeria (CBN) implemented a significant reform by raising the minimum capital requirement for banks from N2 billion to N25 billion. This decisive action spurred a wave of consolidation within the banking sector, prompting numerous banks to merge to comply with the new financial threshold. The primary goal of this reform was to establish a more robust and resilient banking system, better equipped to support and drive economic growth. This move not only strengthened the financial stability of banks but also enhanced their capacity to manage risks and foster a more competitive and dynamic banking environment. Numerous smaller banks

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<sup>52</sup> Art 2 and 3 of the Minimum Capital Requirement For Banks (Amended) Directive No SBB/78/2021

<sup>53</sup> Art 4 and 5 of the Minimum Capital Requirement For Banks (Amended) Directive No SBB/78/2021

<sup>54</sup> Art 6 of the Minimum Capital Requirement For Banks (Amended) Directive No SBB/78/2021

have struggled to meet the new capital requirements, prompting a series of mergers and acquisitions. This consolidation process has reduced the number of banks but has created stronger, more resilient institutions capable of handling larger-scale operations and investments.<sup>55</sup> The new minimum capital levels for Nigerian banks with international authorization are now less stringent than they were in 2009, when the requirement was \$671 million. The minimum capital includes only paid-up capital and share premiums, excluding retained earnings reserves and other forms of capital. This approach contrasts with other markets, such as Ghana and Egypt, which have raised their banks' capital requirements in recent years.<sup>56</sup>

In 2010, the CBN reevaluated the capital requirements for banks, making adjustments to align with the evolving economic conditions and the necessity for banks to strengthen their capital bases. This review was designed to enhance banks' ability to manage risks more effectively and support the expanding economy.<sup>57</sup> In 2024, the CBN implemented another substantial increase in minimum capital requirements. Now, commercial banks with international authorization must maintain a minimum capital of N500 billion, those with national authorization need N200 billion, and regional banks are required to have N50 billion. This adjustment is part of the CBN's continuous efforts to bolster financial stability and insure that banks are adequately prepared to handle economic disruptions. This process greatly improved the reputation of Nigerian banks.<sup>58</sup>

The Nigerian legal framework and policies regarding minimum capital requirements for banks have undergone significant reforms to enhance financial stability and resilience. The CBN has periodically reviewed and increased these requirements to insure that banks maintain adequate capital buffers to absorb potential losses and support economic growth. For example, in 2004, the CBN raised the minimum capital requirement from N2 billion to N25 billion, leading to a wave of bank mergers and acquisitions. More recently, in 2024, the CBN announced another substantial increase in minimum capital requirements, with commercial banks now required to have up to N500 billion in minimum share capital. These reforms have been crucial in strengthening the Nigerian banking sector, promoting financial stability, and fostering investor

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<sup>55</sup> PA PUNUKA Attorneys & Solicitors, 'The New Banking Sector Recapitalization Programme 2024 - What You Need To Know' [2024] Mondaq <The New Banking Sector Recapitalization Programme 2024 - Mondaq>.

<sup>56</sup> Neil Ford, 'What Higher Capitalisation Levels Mean for Nigerian and Kenyan Banks' [2024] African Banker.

<sup>57</sup> Pavestones Legal, 'Regulatory Update: Review of the Minimum Capital Requirement for Banks by the Central Bank of Nigeria'.

<sup>58</sup> *ibid.*

confidence. The CBN's Banking Sector Recapitalization program ensures that banks maintain capital levels appropriate for their risk profiles, scale, and scope of operations. This approach has created a more robust and competitive banking environment, enabling banks to better manage risks and support economic activities.<sup>59</sup>

This wave of consolidation has significant implications for the banking landscape. On the positive side, it has led to the creation of larger, more robust banks with enhanced capacity to support substantial investments and undertake larger-scale operations. These newly consolidated banks are better positioned to compete in a globalized financial market, offering greater financial stability and instilling confidence among investors and depositors. However, the reduction in the number of banks can also lead to decreased competition, potentially impacting customer choice and innovation in the sector.

In the context of Ethiopia, these insights can inform strategies to strengthen the banking sector. By learning from the experiences of countries like Nigeria, Ethiopia can adopt policies that promote financial stability while supporting the growth and competitiveness of smaller banks. Ensuring that all banks, regardless of size, have the opportunity to thrive is essential for fostering a resilient and dynamic financial system that contributes to sustainable economic growth.

### **3.7.2 MINIMUM CAPITAL REQUIREMENT FOR THE ESTABLISHMENT OF BANKS IN KENYA**

Kenya's experience with raising the minimum capital requirements for banks provides valuable insights into the implications of such reforms. In 2012, the Central Bank of Kenya (CBK) increased the minimum core capital requirement from 250 million KES to 1 billion KES (approximately USD 12 million). This adjustment aimed to bolster the financial stability and resilience of the banking sector by ensuring that banks maintained sufficient capital buffers to absorb losses and manage risks effectively. The reform led to significant consolidation within the banking sector, as smaller banks either merged with larger institutions or faced closure. This consolidation resulted in stronger, more competitive banks capable of supporting larger-scale projects and contributing to economic growth.<sup>60</sup>

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<sup>59</sup> Natalya Martynova, 'Effect of Bank Capital Requirements on Economic Growth: A Survey' [2015] SSRN Electronic Journal <<http://www.ssrn.com/abstract=2577701>> accessed 7 February 2024.

<sup>60</sup> Fitch Solution Association, Kenya's Proposed Capital Requirements to Support Financial Stability, [2024]

However, the increase in capital requirements also raised concerns about market concentration, as a few large banks began to dominate the sector. Despite these challenges, the CBK's efforts to strengthen the banking sector have been largely successful, with banks maintaining capital adequacy and liquidity ratios well above the minimum requirements.<sup>61</sup> Kenya's experience demonstrates that while increasing capital requirements can lead to consolidation and stronger banks, it is crucial to balance these reforms with measures that insure a competitive and inclusive banking environment.

The Kenyan banking sector is poised for further consolidation following a significant policy announcement by the Central Bank of Kenya. The CBK revealed plans to raise capital requirements for commercial banks, a move driven by the increasing risks associated with climate change and advancements in the IT sector. This decision is timely, given the alarming rise in non-performing loans, which constituted 15.5% of all loans as of February. Historically, Kenyan banks were mandated to maintain a minimum capital of KSh1 billion (\$7.8 million), a relatively modest amount compared to the capital requirements in Nigeria. This threshold, which has been in place since 2012, has now been significantly elevated to KSh10 billion. It is worth noting that an earlier attempt in 2015 to raise the minimum capital requirement to KSh5 billion was rejected by the Kenyan parliament. The recent increase represents a decisive step towards ensuring the stability and resilience of Kenya's banking sector in the face of evolving economic and environmental challenges. This policy change is expected to prompt mergers and acquisitions among smaller banks, leading to a more consolidated and robust banking industry capable of supporting larger-scale operations and investments.<sup>62</sup>

The CBK Governor Kamau Thugge said: “The capital requirements for banks need to be increased. We have seen increased risks, whether from climate change or cyber-security. So we need very strong banks. We need strong banks that can not only operate in Kenya, but also operate in the region.” Banks are currently required to maintain 10.5% core capital to total risk-weighted assets and 14.5% total capital to risk-weighted assets.<sup>63</sup>

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<sup>61</sup> Kenya Bankers Association, The role of capital requirements on bank completion and stability: the case of the Kenyan banking industry,[2013]

<sup>62</sup> Neil Ford (n 56).

<sup>63</sup> The speech of Central Bank of Kenya (CBK) Governor Kamau Thugge may,[2024]

### **3.7.3 MINIMUM CAPITAL REQUIREMENT FOR THE ESTABLISHMENT OF BANKS IN SOUTH AFRICA**

The evolution of minimum capital requirements for banks in South Africa has been a significant journey marked by various regulatory milestones and adjustments aimed at enhancing financial stability. The Basel Accords have played a critical role in shaping these requirements. Basel I, implemented in 1994, laid the foundation for capital adequacy standards by introducing a basic framework for minimum capital requirements. This initial accord focused on credit risk and mandated banks to maintain capital equivalent to at least 8% of their risk-weighted assets. This marked a crucial step in ensuring that banks had sufficient capital buffers to absorb potential losses.<sup>64</sup>

In 2008, Basel II was introduced, bringing more sophistication to the regulatory framework. Basel II expanded the focus beyond credit risk to include operational and market risks. It introduced advanced risk-weighted assets calculations and capital buffers, which aimed to align regulatory capital requirements more closely with the actual risk profiles of banks. Basel II also emphasized the need for banks to have robust risk management practices, internal controls, and transparency in their operations. This framework has helped South African banks to better manage risks and maintain stability during periods of economic volatility.<sup>65</sup> The most recent and comprehensive framework, Basel III, was implemented in South Africa in 2013. Basel III further strengthened capital requirements by introducing additional buffers such as the countercyclical capital buffer and the capital conservation buffer. The countercyclical buffer is designed to build up capital during periods of economic growth to be used during downturns, while the capital conservation buffer ensures that banks maintain extra capital to absorb losses during periods of financial stress. Basel III also introduced the leverage ratio, which acts as a backstop to the risk-weighted capital requirements and liquidity requirements such as the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR).<sup>66</sup>

These regulatory changes have had a profound impact on the South African banking sector. By increasing the minimum capital requirements, banks have been compelled to maintain higher levels of capital, which has enhanced their resilience to financial shocks. This resilience is

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<sup>64</sup> South African Reserve Bank ,Capital Framework for South Africa based on the Basel III framework, [2021]

<sup>65</sup> South African Reserve Bank, The impact of Basel III implementation on bank lending in South Africa,[ 2024]

<sup>66</sup> ibid

particularly important in a volatile economic environment, where banks need to be prepared for potential downturns. The implementation of Basel III, for instance, has been associated with little evidence of reduced bank credit supply, indicating that well-capitalized banks can continue to lend while maintaining stability. This has helped insure that banks remain a source of funding for businesses and consumers, even during periods of economic uncertainty.<sup>67</sup>

Moreover, the higher capital requirements have led to improved risk management practices among banks. Banks are now more cautious in their lending practices, which has contributed to a reduction in non-performing loans and overall risk in the financial system. This cautious approach has been crucial in maintaining financial stability and fostering investor confidence in the South African banking sector. The proactive measures taken by banks to manage risks effectively have also helped maintain the stability and soundness of the financial system, even during periods of global financial turbulence.<sup>68</sup> The South African Reserve Bank (SARB) has played a pivotal role in implementing these regulatory frameworks and ensuring compliance among banks. The SARB's proactive approach has been instrumental in maintaining the stability of the country's financial system. The SARB has provided guidance and oversight to banks, helping them navigate the complexities of the Basel Accords and adapt to the evolving regulatory landscape. This has been a key to ensuring that banks maintain adequate capital buffers and continue to support economic growth.<sup>69</sup>

In summary, Ethiopia's current lower minimum capital requirement for bank establishment offers a unique opportunity to learn from the successful experiences of Nigeria, Kenya, and South Africa. By considering the implementation of higher capital requirements, Ethiopia can foster greater financial stability and resilience within its banking sector. Furthermore, encouraging the consolidation of financial institutions can lead to improving the overall stability of the banking system.

In addition, by adopting robust regulatory frameworks similar to those in Kenya and South Africa, Ethiopia can enhance the strength and reliability of its banking sector. These regulatory measures can help maintain strong capital adequacy and liquidity ratios, ensuring that banks are

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<sup>67</sup> South Africa Reserve Bank, Financial Stability Review,[2023]

<sup>68</sup> *ibid*

<sup>69</sup> South African Reserve Bank ,Capital Framework for South Africa based on the Basel III framework, [2021]

well-prepared to withstand economic shocks and protect depositors' interests. By integrating these best practices from these countries, Ethiopia can maximize its capital requirement. This approach will promote financial stability, protect depositors, and support economic growth, ensuring a robust and competitive banking sector that can withstand economic challenges.

## CHAPTER FOUR

### **DATA COLLECTION AND ANALYSIS ON MINIMUM CAPITAL REQUIREMENT FOR THE ESTABLISHMENT OF BANKS IN ETHIOPIA**

#### **INTRODUCTION**

This chapter is organized in terms of the objectives of the study. It also presents and describes the rationales of NBE behind the increments of minimum capital requirement for establishing banks based on the data collected from the laws and NBE officials in the policy supervision department. This chapter also reveals the challenges of small banks to meet five billion ETB based on the data collected from the managers of private banks and other related literature. Finally, this part analyzes the existing legal frameworks and policies regarding its insufficiency to address the needs and interests of stakeholders involved in Ethiopia and to create financial stability in the banking industry based on the data collected from both NBE and private bank managers. This chapter also used the experiences of Nigeria and Kenya as a lesson to reform the existing frameworks.

#### **4.1 THE RATIONALES OF NATIONAL BANK OF ETHIOPIA TO INCREASE MINIMUM PAID-UP CAPITAL REQUIREMENT FOR BANKS ESTABLISHMENT**

When the National Bank of Ethiopia issued a directive in April 2021 required the country's commercial banks to increase their minimum paid-up capital, it was to insure ongoing financial resilience within the banking sector. Higher capital levels also promote responsible banking practices and reduces the risk of bank runs, as depositors are more likely to trust financially sound institutions.<sup>70</sup> Ultimately, banks with robust capital reserves can continue to provide credit during economic distress, supporting businesses and consumers and facilitating quicker recoveries. Therefore, enhancing minimum capital requirements is critical for ensuring the long-term health of the banking sector and the broader economy. This move is designed to instill greater confidence among investors and depositors,<sup>71</sup> ultimately contributing to a more stable and robust banking sector. Moreover, stronger capital bases enable banks to support larger-scale operations and investments, driving economic growth and development. In essence, the NBE's

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<sup>70</sup> *ibid*

<sup>71</sup> Basel Committee on Banking Supervision, 'Minimum Capital Requirements for Market Risk' (n 6).

actions are focused on creating a more secure and competitive financial environment that can sustain Ethiopia's ambitious economic trajectory and safeguard the nation's financial system against future shocks.

Recently, the decision to liberalize or allow foreign banks to enter the banking sector was made by the Ethiopian Council of Ministers on September 3, 2022. The preparation of laws, guidelines, and necessary consultative sessions with banks and other stakeholders is undergoing.<sup>72</sup> So, increasing pre-existing capital is appreciable in order to make domestic banks capable of competing with foreign banks.

Regarding this, the respondent says that, “the purchasing power of money tends to diminish over time, which presents a significant challenge for the operation of banks on older capital; as a result, these banks struggle to maintain their functionality. This situation has led to an increase in capital requirements, primarily because banks are responsible for managing and safeguarding the funds deposited by individuals. In alignment with this responsibility, the National Bank of Ethiopia, as outlined in Article 4 of its establishment proclamation, aims to provide robust protection for depositors due to the inherent risks associated with banking operations. By enacting strong capital requirements, the NBE not only seeks to protect individual depositors but also plays a crucial role in maintaining price stability within the economy, thereby contributing to further sound financial environment for all stakeholders involved”.<sup>73</sup> He also said, when we see Ethiopian banks, particularly in comparison with international, Africa, and east African levels, it becomes evident that even the largest bank in Ethiopia, the Commercial Bank of Ethiopia (CBE), is found small in terms of capital adequacy. As highlighted by the 2023 African bank rankings, where the Commercial Bank of Ethiopia is positioned at 32<sup>nd</sup> place<sup>74</sup>, it underscores the significant capital requirements needed to compete effectively with international banks. Furthermore, to protect banks from potential religious and political influences and to insure that their operations remain focused solely on commercial objectives, implementing stricter capital requirements is essential. This measure would help to mitigate the risk of political

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<sup>72</sup> Aklilu Wubet Lemma, Worku Negash Motbainor and Shumey Berhie Teshome, ‘ISSN: 1520-5509 Pennsylvania Western University, Clarion, Pennsylvania’.

<sup>73</sup> ‘Interview with Ato Efrem, Policy Supervision Expert at National Bank of Ethiopia in May 27 2024’ (27 May 2024).

<sup>74</sup> Tom Minney, ‘Africa’s Top 100 Banks in 2023’ (*African Business*, 4 October 2023)

<<https://african.business/2023/10/finance-services/africas-top-100-banks-in-2023>> accessed 8 August 2024.

interference in banking operations, as some politicians may seek to leverage banks for their own agendas, as expressed by Efreem. The other respondent additionally said that the NBE takes a measure to minimize challenges. Previously, collateral requirements were stringent; however, recent reforms have introduced more flexible regulations. These changes allow borrowers to use movable assets, such as crops and other goods, as collateral. In addition, Directive No SBB/73/2020 that allowed foreign nationals of Ethiopian origin or the Diaspora community to invest in the Ethiopian Banking industry in Ethiopia. This directive allowed banks to raise their paid-up capital by selling to the Diaspora communities new banks that were selling share like Amhara Bank, have taken advantage of the directive.<sup>75</sup> He also strongly support that increasing of the preexisted minimum capital to achieve NBE's purpose and to enhance financial stability in banking industry.

International guidelines on minimum capital requirements, particularly those set by the Basel Committee on Banking Supervision (BCBS) in the Basel III framework, encourage increasing minimum capital for banks to enhance their resilience against financial shocks and promote stability in the banking system. Specifically, Basel III introduced higher capital ratios and established a leverage ratio to insure that banks maintain sufficient capital buffers. And holding higher capital requirements for banks enhances their ability to absorb losses and reduce the risk of systemic crises.<sup>76</sup> Aligning national regulations with international standards, such as those set by the Basel Accords, mitigates regulatory arbitrage and ensures consistent safety measures across borders.

When concluding, the rationales of the NBE, as the response of NBE's policy supervision expert, the reason for increasing the past capital requirement is because of the purchasing power of money diminishes over time, often due to inflation and other macroeconomic factors. This decline in purchasing power poses a significant challenge for banks that operate with older capital; it affects their ability to maintain operational viability and competitiveness in the financial market. As the purchasing power erodes, banks are confronted with the need to adapt to changing economic conditions. The directive likely aims to address these challenges by

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<sup>75</sup> Interview made with Temesgen Menza, Policy Supervision department at National Bank of Ethiopia in May 27 2024')

<sup>76</sup> 'Basel Committee on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking System'.

increasing capital requirements for banks. As stated above, this increase is essential for ensuring that banks can effectively manage and safeguard the funds deposited by individuals because the huge amount of money deposited is the money of depositors (customers). So, this is to maintain public trust and financial stability. The NBE policy supervision expert's response indicates that the directive serves multiple purposes: First, strength bank resilience. By raising capital requirements, the directive seeks to enhance the resilience of banks against economic fluctuations. Second, this directive aims to protect depositors. Higher capital reserves insure that banks meet their obligations to depositors, which is crucial for maintaining confidence in the banking system. Thirdly, it encourages financial stability. A more robust capital base contributes to overall financial stability, reducing the risk of bank failures and systemic crises. Additionally, the NBE is committed to shielding banks from potential religious and political influences. Such influences can divert banks from their primary commercial objectives, leading to inefficiencies and instability. By setting strong capital requirement, the NBE can ensure that banks operate based on commercial objectives, and free from external pressures.

Through these efforts, the NBE aims to create a resilient banking sector that can support sustainable economic growth. By promoting financial stability, protecting individual deposits, and ensuring banks remain focused on their commercial goals, the NBE contributes to a robust and trustworthy banking environment in Ethiopia. This, in turn, supports broader economic development and prosperity for the country.

The financial sector also continued to be dominated by the banking sector, whose total assets accounted for 96.3 percent of total financial sector assets at end-June 2023 (slightly less than a year before because of a stronger growth of the microfinance sector). This implies that the stability of the Ethiopian financial system/sector largely depends on the health and stability of the banking sector.<sup>77</sup>

#### **4.2 THE PRACTICAL CHALLENGES OF SMALL BANKS TO MEET THE REQUIRED CAPITAL REQUIREMENT FOR THE ESTABLISHMENT OF BANKS IN ETHIOPIA**

The Ethiopian banking sector has undergone significant transformation in recent years, driven by regulatory reforms and economic growth. However, smaller banks face formidable challenges in

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<sup>77</sup> The National Bank of Ethiopia Report 2022-2023'[2023]

meeting the mandated minimum capital requirements, particularly the 5 billion thresholds set by NBE. The reforms by NBE aimed at raising the minimum capital requirement for banks can be seen as a double-edged sword. On the one hand, increasing capital requirements is intended to strengthen the financial stability of banks, ensuring they have a robust buffer to absorb potential losses. This can ultimately lead to greater confidence among depositors and investors. However, for small banks, these reforms can pose significant challenges. Higher capital requirements restrict their ability to operate effectively and compete with larger institutions. Regarding the challenges of small banks to meet the required capital, the respondent says that the bank is grappling with significant challenges that threaten their growth and sustainability, primarily in raising the required capital, of 5 billion birr and competing against larger banking institutions. The difficulty to meet this capital comes from several socio-economic factors, such as high existing debt levels, political instability that undermines investor confidence, and a general lack of public awareness about the benefits of investing in banks. Additionally, many individuals face financial constraints that limit their ability to invest. These and other factors create a challenge for this bank not to compete with big banks because which banks benefit from greater resources, strong brand recognition, and gain strong customer bases previously.<sup>78</sup> This disparity makes it hard for small banks to address these intertwined challenges. The final point raised by him is a collaborative effort from various stakeholders is essential, including government initiatives to enhancing financial literacy, stabilizing the political environment, and improving the competitive standing of small banks. Without such support, the future of small banks remains uncertain in an increasingly competitive financial landscape.

The researcher also included Islamic bank, a special bank and new in Ethiopian banking history that engaged in a fully-fledged bank operation. The interviewee gives its response to the researcher about the challenges of its bank to meet the required capital. There was a hot discussion with the respondent of Ramis bank (RB) manager; the summary of the interview will be as follows: “In Ethiopia, the banking law does not differentiate between Islamic banks and commercial banks; both are governed by the same regulation. This uniformity presents unique challenges for RB, which operates under an Islamic banking model. It means this bank does not seek profit as a primary goal like other commercial banks do. The new directive on the

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<sup>78</sup> Interview made with Addis International Bank Manager at Hawassa branch (3 June 2024).

establishment of a minimum capital requirement of 5 billion Ethiopian birr is a binding law that applies to all banks, regardless of their operational capacity. This is a bank founded by individuals who are not interested in profit, which limits their ability to attract investment. Many of the shareholders have not extensive experience in the banking sector and have a minimal understanding of share. As a result, mobilizing the necessary funds to meet the mandated capital requirement is a significant hurdle. As a result, fully-fledged banks require differentiated regulations.<sup>79</sup> In addition, this bank is a new bank, and competing with a huge bank is difficult, which poses additional challenges for this bank. This stringent capital requirement compels shareholders and customers to explore alternative banking options, this potentially diminish the bank's market presence. This shift could have long-term consequences not only for the viability of Ramis Bank but also for the diversity of the banking sector in Ethiopia. Additionally, the current directive has implications for shareholders' rights, particularly concerning dividends. As the bank strives to meet its capital requirements, its ability to distribute profits may be significantly hindered. This situation could lead to dissatisfaction among shareholders, complicating efforts to maintain investor confidence and support.<sup>80</sup> In summary, RB has the potential to contribute to the growth of the banking system in Ethiopia. So, by considering these issues and to expand the domestic banks, especially those which have such kind of objectives, a separate directive is needed.

The response given by the Enat bank (EB) manager, he said that the increasing measure taken by the National Bank on previous capital is appreciable and also expectable, but the amount of capital released by NBE created shocks among banks. To meet the required capital, EB works as per its ability, and now although the banks do not meet the required capital, the bank is in a good position. To know the time when this bank meets this capital? It is a matter of time; it will be known in the future. In addition to the above, the interviewee said that as the Prime Minister of Ethiopia, Dr. Abiy Ahmed warned the Ethiopian domestic bank to prepare them to be ready in capital and to compete with foreign banks.<sup>81</sup>

Small banks typically face numerous challenges during their startup phase. Like these banks, they must navigate regulatory frameworks established by financial authorities, which can be

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<sup>79</sup> Interview made with Ramis Bank Manager at Hawassa branch, (4 June 2024).

<sup>80</sup> *ibid.*

<sup>81</sup> 'Interview with Enat Bank Manager at Hawassa Branch' (9 June 2024).

burdensome and costly to comply with. After the initial setup, banks must continue to maintain capital ratios that comply with regulatory standards, which can be challenging as they grow. So, securing this capital can be difficult, especially for new entrants without established reputations.

Competing against established financial institutions with greater resources and a customer base can pose a challenge. The banking sector is highly competitive, with numerous established players. Larger banks often offer a wide range of products and services, which can be appealing to consumers. To attract customers, small banks may need to offer higher interest rates on deposits or lower rates on loans, which can squeeze profit margins. Attracting and retaining customers in a saturated market requires effective marketing strategies and unique value propositions. Attracting customers is one of the most significant challenges for new banks. Implementing robust risk management and meeting capital adequacy can be specifically challenging for small banks due to limited capitals.<sup>82</sup>

#### **4.3 DOES THE EXISTED LEGAL FRAMEWORKS GOVERNING CAPITAL REQUIREMENT FOR BANKS ESTABLISHMENT SUFFICIENTLY ADDRESS THE NEEDS AND INTERESTS OF STAKEHOLDERS INVOLVED IN ETHIOPIA?**

The stability of the banking sector is vital for the economic health of any nation, and capital requirements serve as a fundamental pillar in safeguarding this stability. In Ethiopia, the legal framework governing capital requirements for banks is primarily overseen by the NBE, which aims to insure that financial institutions maintain adequate capital buffers against potential risks. This analysis explores the strengths and weaknesses of Ethiopia's legal framework on capital requirements, examining how it aligns with international standards and addresses the diverse interests of stakeholders (for this paper the stakeholders covered under this study are small banks, customers and shareholders) in the banking sector. By doing so, we can better understand the implications for financial stability and economic growth in Ethiopia. Capitalization decisions are important to the success of modern institutions. Banks are expected to follow rigorous international and national standards in this connection. As said previously, the aim of bank capital requirements is to insure the stability and solvency of the banking system in any country.

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<sup>82</sup> 'Capital Requirement: The Impact of Capital Requirements on Small Banks' (n 21).

By implementing several Basel Accords, regulators change capital requirements according to economic situations and adjust capital requirements by taking mergers.<sup>83</sup>

The other legal framework that dealt with the minimum capital requirement is the new commercial code of Ethiopia. The coming up of the new commercial code by repealing the old code has different justifications. The few justifications are changes taking place in the rest of the world, especially those occurring in investor countries; they need to be reflected in the new code. The other justification is the need to be internationally competitive and perceived as modern in the eyes of investors.

However, when we look the new code, it is inadequate and not comprehensive enough to create financial stability. The code as a general law governing companies (it includes banks), must consider the current market realities. The new commercial code by incorporating the best practices of the countries mentioned above and aligning with the Basel accords can promote the stability of financial sector in Ethiopia. Because the Ethiopian economy is characterized by high inflation rates, fluctuating currency values, and a rapidly changing market environment.

The existing legal framework in Ethiopia is inadequate for achieving financial stability and addressing the diverse needs and interests of stakeholders. Shareholders express dissatisfaction due to unsatisfactory dividend payments, while customers are unhappy with the services provided by the smaller banks<sup>84</sup>. These issues stem from the insufficient capital held by these banks, which hinders their ability to function effectively.

The primary reason behind these challenges is the inadequate capital requirements, which limit the banks' capacity to offer comprehensive services, generate substantial profits, and maintain overall financial health. This insufficiency in capital impacts the banks' ability to meet the expectations of their stakeholders, leading to dissatisfaction among shareholders and customers alike.

To resolve these issues, it's essential to implement more stringent capital requirements and enhance the regulatory framework. Doing so would enable banks to operate more efficiently, offering better services and higher dividend payouts. Consequently, this would lead to increased

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<sup>83</sup> Dr. K. S. Adeyemi, “Banking Sector Consolidation in Nigeria: Issues and Challenges” (2014).

<sup>84</sup> Interview made with Ramis bank manager at Hawassa branch (Jun,2024)

satisfaction among stakeholders and contribute to the stability and resilience of Ethiopia's financial sector. By bolstering the capital requirements and regulatory measures, Ethiopia can ensure that its banking sector is capable of meeting the demands and expectations of its stakeholders, thus fostering a more robust economic environment. It is also essential to gain insights and learn from the best practices of these countries mentioned under chapter three of this paper. By addressing these areas, the Ethiopia banking law can address the needs and interests of stakeholders involved in the country.

## **CHAPTER FIVE**

### **CONCLUSIONS AND RECOMMENDATIONS**

#### **INTRODUCTION**

This study, after the careful examination of the challenges of small banks to meet 5 billion birr and the legal framework on minimum capital requirements, analysis was made based on the data obtained through interviews from private bank managers and NBE bank policy supervision. Based on the analysis, conclusions, and recommendations of the study are presented in this chapter.

#### **5.1 CONCLUSION**

This paper identified the challenges of small banks to meet the required capital, identifying the rationale of NBE behind the new directive and assesses the existing legal frameworks that either adequately addresses the need and interests of stakeholders involved in Ethiopia. After the data analysis and interpretation, the following major findings were obtained. From this study, it is found that small banks, especially licensed recently, faced practical challenges to meet 5 billion birr due to inadequate capital held. As identified from the preambles of the NBE establishment proclamation No. 591/2008, and Directive No. SBB/78/2021 and the response to the interview given by the National Bank of Ethiopia banking policy supervision, the rationale of the National Bank is to create strong, capable, and well capitalized banks in Ethiopia. The other rationale of the bank to increase the minimum capital requirement for banks is the newly established bank to operate and compare successfully with existing banks. The big bank in Ethiopia, the Commercial Bank of Ethiopia, compares with African banks, it ranked 32nd. This shows that the domestic bank must obtain a huge amount of capital to compete with international banks. From this study, it is found that for small banks to compete with big domestic banks as well as with international banks, these banks must hold adequate capital to create the long term financial stability in Ethiopia.

Regarding the new directive, the measure taken by the National Bank is appreciable, but when the NBE before taking the measure of merger or acquisition, must take into account the existence of diverse financial services in the country. Unless the NBE follows this, the existence of very few banks may have an opportunity to create monopolistic banks. This affects competition

among banks. The new commercial code compares with the old one; it is more sophisticated and includes different articles that are not raised under the old commercial code. However, this code is not adequate and comprehensive enough to create financial stability in the country.

## **5.2 RECOMMENDATIONS**

Based on the conclusion of this paper, the following recommendations are forwarded to different concerned organs. These are:

- ❖ The lawmaker should revise the new commercial code of Ethiopia in aligning with the international Basel Accords and by incorporating the best practices of other countries. The code, as a general law governing companies, which includes banks, must consider the current market environment and enable domestic banks to compete with foreign banks.
- ❖ The NBE should regularly review and adjust the minimum capital requirements and related policies to keep pace with changing economic conditions and the evolving needs of the banking sector. Because currently, Ethiopia has allowed the entrance of foreign banks in Ethiopia. If the NBE not revises the existing directive governing minimum capital requirement for bank establishment, including big banks may also face challenges to compete with foreign banks. This dynamic approach will help maintain financial stability and support sustainable growth.
- ❖ The NBE should launch campaigns aimed at educating the public, enabling potential investors to acquire the knowledge and confidence necessary for making informed financial decisions. By becoming well-versed in the benefits and risks associated with banking investments, individuals are more likely to support and actively engage in the banking sector. This increased engagement can contribute to a more stable and robust financial environment.
- ❖ Banks must give continuous training programs for staff, which are important for enhancing employee performance, customer service, and operational effectiveness. The active role of staff and creating awareness create more opportunities for small banks to attract new customer base and to increase their capital.
- ❖ The NBE must encourage these banks to take a measure of merger with other banks or acquisition to increase their paid-up capital to minimize these challenges. The NBE put a

duty on small banks to use new technology in the banking industry by promoting the growth of digital banking services and financial technologies. Embracing digital banking can significantly improve financial inclusion, making banking services accessible to a broader population. Additionally, these technological advancements can create new revenue streams for banks, aiding them in meeting capital requirements with greater ease.

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## **APPENDICES**

### **1. INTERVIEW PREPARED FOR NBE POLICY SUPERVISION DEPARTMENT**

The objective of this study is to find out the rationale of National Bank of Ethiopia behind the new capital requirement directive.

This requires your genuine response for the research questions. It is worthwhile to confirm that any information you give me is maintained confidential and your contribution is highly appreciated.

1 What are the rationale behind the new directive, and how the National Bank seen the new directive with article 5(8) of NBE establishment proclamation No. 591/2008?

1 When the new directive No. SBB/78/2021 was issued; it did not take in to account various factors, such as size, time, and capital profiles of each bank. And this decision will not create an obstacle for new or recently established banks to compete with large banks?

2 What is their fate if they do not meet five billion birr?

3 How many banks are there in Ethiopia? How many of these have reached five billion birr? And how did you see regarding access to financial institutions?

4 Do you think that currently operating banks in Ethiopia meet the needs of citizens sufficiently?

5 How you will see the rights of shareholders regarding right to dividend? Does it not limit this right?

If there anything that you want to add with the issue you are welcome!

Thank you!!!

### **2. INTERVIEW QUESTIONS PREPARED FOR PRIVATE BANK MANAGERS**

The objective of this study is to find out the challenges of small banks to meet the new capital requirement. For this study the selected banks are Anbesa international bank, Enat bank and Ramis bank.

This requires your genuine response for the research questions. It is worthwhile to confirm that any information you give me is maintained confidential and your contribution is highly appreciated.

1. What is your name? And your status?
2. What are the practical challenges did you faced to meet this minimum capital requirement?
3. What factors hinder you not to meet this capital requirement?
4. What measures taken by you to overcome these challenges?
5. What is your suggestion for the possible solution to correct this problem?
6. How do you think the increment of this capital requirement in light of the new reform taken by the prime Minster of Ethiopia to permit the entry of foreign banks in the country?

## THE 2023 PAID-UP CAPITAL OF BANKS IN ETHIOPIA

<u>Banks</u>	<u>paid-up capital</u>
- Awash international bank	14,651.05
- Dashen bank	9,472.86
- Cooperative bank of Oromia	10,024.75
- Abyssinia bank	11,904.41
- Hibret bank	4,790.42
- Wegagen bank	4,039.88
- Nib International bank	6,001.22
- Oromia International bank	5,379.71
- Anbesa bank	2,675.98
- Birhan bank	3,366.28
- Buna International bank	4,294.98
- Zemen bank	5,000.91
- Abay bank	4,768.69
- Addis International bank	1,825.36
- Debub Global bank	2,032.53
- Enat bank	2,538.25
- Amhara bank	5,842.23
- Omo bank	918.41
- Hijra bank	1,274.81
- Zamzam	1,699.14
- Sinqe bank	7,891.61
- Sidama bank	590.27
- Goh Betoeh bank	1,320.68
- Shabelle bank	594.93
- Gadda bank	890.15
- Ahadu bank	672.63
- Tsehay bank	1,087.77
- Tsedey bank	9,828.00
- Ramis bank	636.08