Public Disclosure Authorized

Report No: AUS0001255

Ethiopia

Ethiopia Financial Sector Development

THE PATH TO AN EFFICIENT STABLE AND INCLUSIVE FINANCIAL SECTOR

December 10, 2019

Public Disclosure Authorized

Finance Competitiveness and Innovation Global Practice

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December 18, 2019

WORLD BANK GROUP
Finance, Competitiveness & Innovation

ABBREVIATIONS AND ACRONYMSACHC

ACH	Automated Clearing House
ADB	African Development Bank
AML	Anti money laundering
ATM	Automated Teller Machine
BSD	Banking Supervision Department
B2P	Business to persons
CAR	Capital Adequacy Ratio
CAMEL	Capital, Asset quality, Management, Earnings, Liquidity
CBE	Commercial Bank of Ethiopia
CCB	Countercyclical Capital Buffer
CFT	Countering the Financing of Terrorism
CGFC	Capital Goods Finance Company
CRB	Credit Reference Bureau
CSD	Central securities depository
D-SIB	Domestic Systemic Important Banks Institutions
DBE	Development Bank of Ethiopia
EEP	Ethiopian Energy and Electric Power Corporation
EFBI	Ethiopian Federal Bureau of Investigation
ECX	Ethiopian Commodity Exchange
EATS	Ethiopian Automated Transfer System
ETB	Ethiopian Birr
ESAAMLG	Eastern and Southern Africa Anti-money Laundering Group
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FSC	Financial Stability Committee
FSD	Financial Stability Department
GOE	Government of Ethiopia
GTP	Growth Transformation Plan
G2P	Government to persons
IFC	International Finance Corporation
IFI	International Financial Institution
IHDP	Integrated Housing Development Program
IMF	International Monetary Fund
LCR	Liquidity Coverage Ratio
LTI	Loan to income
LTV	Loan to value
MER	Mutual Evaluation Report

MFI	Microfinance Institutions
MTDS	Medium-term Debt Strategy
MOF	Ministry of Finance
MOTI	Ministry of Trade and Industry
MP	Monetary Policy
MTO	Money Transfer Operator
NFA	Net Foreign Assets
NBE	National Bank of Ethiopia
NBFI	Non-banking financial institutions
NPL	Non-performing loans
NPS	National Payment System
NSFR	Net Stable Funding Ratio
OECD	Organization for Economic Co-operation and Development
OTC	Over-the-counter
PM	Prime Minister
POESSA	Private Organization Employees Social Security Agency
POS	Point of Sale
POESSA	Private Organization Employees Social Security Agency
PPP	Public Private Partnership
PSSSA	Public Servants Social Security Agency
P2G	Person to Government
P2P	Person to Person
QIS	Quantitative Impact Study
RAAS	Risk Automation Analyses System
RBS	Risk Based Supervision
RTGS	Real Time Gross Settlement
SIFI	Systemically Important Financial Institution
STP	Straight-through processing
SOE	State-owned Enterprise
SOB	State-owned Bank

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Preface

This report forms part of the World Bank Group (WBG) Technical Assistance (TA) program to the National Bank of Ethiopia (NBE) in preparing the Ethiopia Financial Sector Modernization Roadmap (Roadmap). The work was funded by the Department for International Development (DFID) and was prepared in collaboration with the Financial Sector Roadmap Committee established at the NBE. During the course of the TA, six WBG missions visited Ethiopia and prepared multiple technical and policy notes laying down strategic challenges and priority recommendations for each sector. The current report draws on the draft policy and strategy notes which were based on numerous consultations and interviews with relevant private and public agencies including financial institutions (see Annex A for the list of entities and individuals consulted).

This report will inform the preparation of the NBE Roadmap which seeks to support implementation of the Government's Second Growth and Transformation Plan (GTP II) 2016-2020 and the recently approved Homegrown Reform Agenda, advancing Ethiopia's strategic vision toward becoming a lower middle-income country by 2025. The Roadmap objective for which this report seeks to address is, to identify reforms that will, deepen the financial sector, broaden access to financial services, ensure financial stability, allocate capital in the economy more efficiently, and support the growth of the real sector. The report is structured under the 3 main Pillars of the NBE Roadmap: Pillar One, Financial Stability and Safety Net and includes; banking sector, stability & crisis management, and NBE as regulator; Pillar Two, Long-Term Finance & Monetary Framework and includes; capital markets, monetary policy, and foreign exchange management; and Pillar Three, Access to Finance and Financial Inclusion which includes; financial inclusion strategy, payment systems, fintech, AML/CFT, financial infrastructure, microfinance, and insurance.

The WBG team[1] is grateful to all counterparts and staff at the NBE, for their support and cooperation. The team would like to thank specifically; H.E. Dr. Yinager Dessie, Governor of the National Bank of Ethiopia; H.E. Ato Fikadu Digafe, Vice-Governor, Financial Stability Cluster and Chief Economist; H.E. Ato Solomon Desta, Vice Governor, Financial Institutions Supervision; H.E. Ato Eyob G/Eyesus, Vice Governor, Corporate Service; Ato Abate Mitiku, Director, Change Management, Planning & Communication Directorate and Chair of the NBE Roadmap Committee; Ato Gebreyesus Guntie, Sr. Advisor to the Governor; W/o Martha Hailemariam, Advisor to V/Governor Financial Institutions Supervision Cluster; W/o Yemehasab Tadese, Director, Foreign Exchange Monitoring and Reserve Management Directorate Ato Muluneh Ayalew, Director, Monetary and Financial Analysis Directorate; Ato Temesgen Zeleke, Head Financial Inclusion Secretariat, W/o Kibre Moges, Director, Legal Services Directorate; Ato Frezer Ayalew, Director, Micro Finance Supervision Directorate, Ato Belay Tulu, Director, Insurance Supervision Directorate, and W/o Weynshet Zeberga, Chief Research Officer.

[1] This report was prepared by the World Bank Group Finance Competitiveness and Innovation Global Practice (FCI GP) under the guidance of Niraj Verma (Practice Manager, East Africa). The report was authored by a WBG team comprised of: Randa Akeel (Senior Financial Sector Economist and report Task Team Leader); Mengistu Bessir, (Financial Sector Specialist); Jennifer Chien (Senior Financial Sector Specialist); Ezio Caruzo (Senior Financial Sector Specialist); Yara Esquivel (Senior Financial Sector Specialist); Ahmed Faragallah (Senior Financial Sector Specialist); Jonathan Gigin (Senior Financial Sector Specialist); Jose Gragnani (Senior Financial Sector Specialist); Sybille Grob (Consultant, Banking Stability); Jotework Gudeta (Financial Sector Specialist); Tanya Konidaris (Senior Financial Sector Specialist), Harish Natarajan (Lead Financial Sector Specialist); Lawrie Savage (Consultant, Insurance Sector); and Craig Thorburn (Lead Financial Sector Specialist). The team appreciates comments and inputs provided by Nataliya Mylenko (Program Leader), Miguel Martin (Senior Economist), and from the IMF; Itaru Yamamoto (Senior Financial Sector Specialist), Narayaran Raman (Senior Economist), and Marin Molosag (Technical Assistance Officer).

Executive Summary

1. **Ethiopia's financial sector has, over the past decade, been operating under a financial repression framework used by the government for managing its monetary and foreign exchange policy, and financing of large infrastructure projects and state-owned-enterprises (SOEs).** Instruments used under this framework include the central bank financing of the government, a state-dominated banking sector, mandatory financing of priority projects and directed credit, administered interest rates, a captive domestic market for government debt, high liquidity and capital requirements, and strict foreign exchange controls. Over time, the framework has led to the build-up of large macro-financial imbalances; these include a system of fiscal dominance, pressures on inflation, the overvaluation of the Birr, a chronic shortage of foreign exchange, the lack of development of the financial system, a credit allocation skewed toward the public sector, and an overall risk of malinvestment.

2. **In line with its agenda to spearhead private sector led economic growth, the Government of Ethiopia is seeking to transform its current financial system to a market driven model aligned to meet the current needs of the real economy.** The Government of Ethiopia, aware of the limitations of the previous model for the country's future trajectory, has initiated the implementation of a comprehensive structural reform program. Building on the objectives of the second national Growth Transformation Plan (GTP II), Ethiopian authorities unveiled a Homegrown Reform Agenda in September 2019 that complements the already initiated structural reforms. It aims to ease business constraints and foster private sector development with a set of sectoral and macroeconomic measures, including those targeted at de-monopolizing economic sectors and removing distortions including in the financial sector. The government's objective is to sustain the growth momentum of the past decade and to create jobs for its young and growing population, with approximately 2 million new entrants joining the labor market each year.

This report was prepared as part of a technical assistance engagement and was based on a request from the National Bank of Ethiopia (NBE) as an input to support their development of a financial sector modernization roadmap to meet the overall government reform plans. The report provides an insight on operations and challenges in Ethiopia's financial sector and proposes a framework to help open and transform the current system to meet the country's future market-oriented growth plan. The report is organized along the NBE Roadmap framework which is aligned across 3 Pillars: (i) Financial Stability and Safety Net; (ii) Long-Term Finance and Financial Markets; and (iii) Access to Finance and Financial Inclusion. Opening of the financial sector constitutes a cross-cutting theme.

Overview and Key Findings

Banking sector

3. **The financial system in Ethiopia is predominantly closed to foreign investment and is dominated by banks of which one state-owned bank holds the majority share of assets.** With

the exception of the leasing sector the sector is closed to foreign investment although recently in a positive initial step forward the government of Ethiopia passed a proclamation allowing foreign investors of Ethiopian origin to invest in banks. The banking sector is constituted of 18 banks (including two state-owned banks) and together with microfinance institutions hold 98.6 percent of total financial sector assets. The state-owned Commercial Bank of Ethiopia (CBE) holds a disproportionate share of the market with 59 percent of total banking assets and 60 percent of total deposits. The Development Bank of Ethiopia (DBE) – the second largest bank, is experiencing significant levels of non-performing loans (NPLs). The two banks are used as tools by the government for directed credit – mainly via CBE to finance large infrastructure projects, and state-owned enterprises (SOEs) and, through the DBE, subsidized financing to small and medium enterprises (SMEs) in key priority sectors.

4. **Propelled by fast-growing economic growth the Ethiopian banking sector enjoyed high growth over the past ten years.** Deposits grew at an annual rate of 28 percent, as did loans and profits which grew 31 percent and 22 percent per annum respectively. The banking expansion was led primarily by the two state-owned banks which dominate the sector. Competition is limited as shown by the high concentration ratio and spread between lending and deposit rates. The crowding out of private financing is evident by the low level of private sector credit to GDP ratio which stands at just 11 percent, half the average seen among the 20 largest African economies (22%) indicating a level of intermediation that does not meet the needs of the real economy in any significant measure.

5. **The banking sector faces several constraints impacting their liquidity and capacity to conduct effective intermediation.** Foremost is the unlevel playing field that favours state-owned banks, crowding out lending by private banks. Of significance is, the recently repealed, 27 percent rule (the 'Rule') which applied only to private banks and used to extend credit to the DBE to finance projects in priority sectors such as agriculture and manufacturing, and to purchase Government T- Bills[2]. The 'Rule' constrains banks' liquidity, increases costs, and exposes banks to interest rate mismatch as they must purchase long-term central bank bills by an amount equivalent to 27% of each new loan issued at a fixed rate using short-term savings and deposits at variable rates. As of the finalization of this paper, the government issued a statement on November 20, 2019, eliminating the 27 percent rule as part of the effort to remove distortions in the sector. Other constraints faced by banks include impact on bank asset quality due to the chronic foreign currency shortages further aggravated by the ban on foreign banks from investing in Ethiopia. In addition, competition in the sector is hampered by cumbersome bank licensing requirements, lack of capital market to raise funds, and lack of foreign investment.

[2] As of end-December 2018, the outstanding balance of NBE-bills sold to commercial banks reached Birr 79.3 billion (with private banks accounting for 99 percent of the total) but the amount transferred to DBE was Birr 52.1 billion. DBE invested about 58 percent of this borrowing from NBE on government T-bills.

6. The biggest risk to the banking system is the concentration risk of CBE. The concerns related to risks in the system are also aggravated by the lack of enforcement authority of the NBE on the state-owned banks. Consequently, risk management and internal control at both state-owned banks have not been effective while their lending practices do not always strictly follow financial rationale. The CBE is exposed to interest rate and asset liability mismatch risk as it uses short-term time-deposits and savings money to purchase bonds issued by State-Owned-Enterprises (SOEs) and to extend them loans. The practice of using the CBE to finance big infrastructure projects and SOEs has also generated extreme concentration of risk on CBE's balance sheet. Other risks facing the sector include liquidity risk where there is a systemwide liquidity shortage in all buckets between 15 days to up to 1 year, as well as system wide interest rate mismatch risk as a result of the 27 percent rule. The banking sector is also exposed to devaluation risk the bulk of which is borne by CBE as it has the highest exposure to debt in forex. Ethiopia does not have a macroprudential framework for monitoring and managing/mitigating risks to the financial sector.

Role of the National Bank of Ethiopia (NBE)

7. The current role and operations of the NBE will need to be updated in the context of the reforms. The NBE provides direct advances to the government to finance the budget on an annual basis. The outstanding NBE advances to the government are large and have been growing overtime. The NBE also provides indirect financing to the government by extending credit to the DBE to purchase T-bills. In addition, the NBE provides indirect financing of SOEs by granting liquidity to the Commercial Bank of Ethiopia (CBE) in the form of 5-year bonds, which amounted to Birr 27 billion in 2016/17.3.

8. De facto, it is the government and not the NBE that determines objectives and targets of Monetary Policy (MP) and foreign exchange – two areas that in most countries are delegated to the responsibility of the central bank. While there is on paper a monetary policy committee at NBE, in practice, all monetary policy decisions are taken by the macroeconomic committee at the Prime Minister's office. Empirical studies have shown correlation between independence of a central bank and better inflation trends particularly in transition economies[4]. In addition, there is abundant literature[5] that shows how independence is essential to protect the supervisory decision-making process from short term political agendas or from industry pressure.

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[3] NBE (2017). Annual Report 2016/17.

[4] Cukierman, Miller, and Neyapti (2001), Maliszewski (2000), Lybek (1999), and Loungani and Sheets (1997).

[5] Quintyn Marc and Taylor W. Michael, 'Regulatory and Supervisory Independence and Financial Stability', IMF Working Paper Series n. 02/46; Quintyn Marc, Ramirez Silvia, and Taylor W. Michael, 'The Fear of Freedom: Politicians and the Independence and accountability of Financial Sector Supervisor', IMF Working Paper Series n. 07/25 Narain Aditya, Elliot Jennifer, Toer Ian, Bologna Pierluigi, and HSU Michale, 'The Making of Good Supervision: learning to Say "No', IMF Staff Position Note, May 18, 2010; Adrian Tobias and Narain Aditya, Let Bank Supervisor do their job, IMF blog, February 2019; Angeloni Ignazio, Supervisory Independence, ECB Colloquium "Challenges for Supervisor and Central Bankers', Frankfurt am main, March 2019; Merch Yves, Central Bank independence revisited, Key note address at the "Symposium on Building the Financial System of the 21st century, An Agenda for Europe and the United Stated, Frankfurt am main, March 2017; Dalla Pellegrina L., Mascaindaro D. Pansini R.V., The central banker as prudential supervisor: does independence matter?. Journal of Financial stability, 9 (2013).

9. The NBE's MP and its implementation is thus complicated by multiple and sometimes conflicting objectives of the monetary policy framework. The MP framework comprises monetary aggregate targeting, with a ceiling on reserve money as the operating target. Pricing in the market is determined by a range of administered interest rates, which in no way reflects liquidity conditions in the money market or liquidity and risk premiums. The minimum deposit rate acts as the de facto policy rate, but it is not clear how this rate is determined. Moreover, efforts to channel resources to priority sectors and the government through artificially low interest rates, including through the NBE overdraft facility, the "27 percent rule", and regular provision of liquidity to state-owned banks have contributed to faster money growth and high inflation, complicating the achievement of monetary objectives. While there have been caps on bank lending rates in the past, currently banks have the discretion to determine the lending rate on loans and advances and could therefore pass the cost impact of the "27 per cent rule" and the mandatory minimum reserve requirement rate on to their private sector borrowers. A highly overvalued real exchange rate, poor export performance, low levels of international reserves, a widening gap with the parallel exchange rate and acute shortages of foreign exchange suggest large and growing external imbalances.

Banking supervision and safety nets

10. Supervision standard at NBE follows Basel I, which is highly outdated. There is no capital requirement for market risk, operational risk, and exchange rate risk (although NBE puts a cap on the latter of 15% of capital). The NBE's supervisory approach is laid down in a manual titled "Risk-based Supervision" (RBS) and NBE employs a CAMEL-rating approach to summarize and score performance of individual banks. A significant part of the supervisory approach still appears to be compliance-based an approach that seems counter-productive, since it does not bring the desired change in behaviour[6]. The current legal framework does not support consolidated supervision which creates grey areas in banking operations outside the scope of supervision. This is particularly important when Ethiopia opens the sector to foreign ownership. Another consequence of non-consolidated supervision is that NBE lacks the mandate to communicate with home/host supervisors and take a seat in supervisory colleges. Given the current state of the banking system, this is less pressing, however it is a prerequisite to opening the Ethiopian banking market to foreign capital. The NBE is also very constrained in terms of staffing and turnover is high. The NBE Board has initiated a review of the current salary and benefits framework.

11. A review of CBE and DBE indicate the presence of discrepancies and forbearance in their supervision exacerbated by the lack of a macroprudential oversight framework and inability of NBE to enforce remedial actions on the two banks. The NBE is properly endorsed

[6] -The NBE does conduct some preparatory dialogue with the sector such as: Quarterly prudential meetings in relation to CAMEL ratings; entrance and exit meetings both with banks' senior management and boards; quarterly stakeholder meetings to get feedback on regulatory and supervisory practices; collecting written comments and conducting meetings with CEOs before issuing new directives or revising directives; and collecting written comments before penalizing for violation of directives.

under the banking law with full authority over all banks, including the state-owned banks. Nevertheless, NBE has not been effective in enforcing prudential standards on the CBE and DBE. Macroprudential oversight is needed to address systemic risks and vulnerabilities that pile up in the system whether they are by state-owned banks or other financial institutions. In the case of Ethiopia, it is also important to note that without proper micro-prudential supervisory power towards the public institutions that hold two third of all assets in the system, building any macro-prudential (systemic) oversight function (currently absent) at the NBE becomes irrelevant.

12. There is no crisis management arrangements or safety nets related to the financial system in Ethiopia. A financial safety net includes at minimum a deposit guarantee scheme and a bank recovery and resolution framework. In addition, the lender-of-last-resort function at NBE does not work effectively, mainly because of the absence of suitable collateral. Building these arrangements will take time. It should be noted that the, NBE has recently drafted regulation for deposit insurance which will be submitted to the parliament in the fiscal year 2019/2020.[7] A properly functioning deposit insurance scheme prevents depositor runs and protects small depositors including SMEs. It shifts the cost of protecting depositors from the government to the banking industry.

Financial markets

13. Ethiopia does not have developed capital markets and the current system uses captive investors to purchase government securities at negative real rates. There is no market-based issuance of domestic government debt in Ethiopia and secondary bond markets do not exist for a number of technical and pricing reasons. Foreign investors are not allowed to participate in the capital market. Pensions (currently mandated to only purchase government T-bills) and insurance companies which could support demand for market-based issuance of government bonds are under-developed. The only non-government bond issuance is that of SOEs, which is also not market based. Market infrastructure for capital markets does not exist. Securities are issued in the form of paper-certificates, and there is no Central Securities Depository (CSD) for government securities, making transactions more difficult. It should be noted, however, that Ethiopia does have a relatively well-functioning commodity exchange, the Ethiopian Commodity Exchange (ECX), whose trading and settlement platforms could be leveraged to support market development. In addition, retail investors are already active in government infrastructure debt securities and in private share offerings and trading. They could be harnessed to develop the capital markets. The NBE has also been receiving technical assistance from the IMF and the African Development Bank (ADB) on establishment of a capital market.

14. Money market activity in Ethiopia has been negatively affected under the current government funding model. Participants trade short-term instruments with maturities of less than one year for liquidity management and investment purposes. Although a money market directive was implemented in 2003, it is still not functional and there is no regulatory framework. An

[7] The draft proposal is based on a study, funded by the WBG, and conducted by IOS Partners in 2010.

interbank repo market does not exist, although there was one in the past. There is some limited uncollateralized interbank lending, with a longer tenor (~ 6 months) in the form of Certificates of Deposit, however the general lack of liquidity in the system prevents further development. Private banks are able to access liquidity from the NBE in the case of a shortage of liquidity. They can use Bills to cover shortfalls in liquidity as well as for collateral. However, the interest rate is extremely punitive, being the maximum interest rate charged across the loan book of the bank seeking liquidity.

Financial Inclusion

15. While Ethiopia has made good progress in terms of expanding financial inclusion more effort is needed to bridge the gap with comparable countries especially in access and usage of digital financial services. According to the Findex data (2017) two-thirds of Ethiopian adults do not have a transaction account with women accounting for a disproportionate share of the unbanked; and only 35 percent of adults have an account at a formal financial institution. People rely more on informal institutions for their financial needs – although 62 percent of adults reported saving money in the past year only 26 percent had their savings in a formal financial institution. At the same time, 41 percent of Ethiopians said they borrowed money but only 11 percent borrowed from a financial institution. 'Insufficient funds' is reported as a key barrier for financial inclusion as well as distance, and lack of proper documentation. Almost all individuals pay utility bills with cash. Importantly, financial inclusion paves the way for individuals and businesses to access financing to improve skills and invest in enterprises without which private sector growth and job creation would not be feasible.

16. Payment systems in Ethiopia were radically modernized in 2011, although more work remains to be done. Government use of digital payments lacks harmonization, leadership, and consistency. The major 'government to person' (G2P) payments (salaries, pensions, suppliers, and subsidies) are not digitized or operate in a very limited way, and the same for government collections from persons (P2G) and businesses (B2G) (taxes, customs, fees). The payment systems infrastructure is owned and managed by the NBE and it includes a real-time gross settlement (RTGS) system, which provide facilities for the final settlement of payments between banks. The automated clearing house (ACH) system, to be used for the clearing of retail payments, is not yet operational. This infrastructure is a critical element to foster development of electronic payment instruments and services in Ethiopia, as it would increase the efficiency, interoperability and cost-effectiveness of payments for both the private and the public sector. The national e-payment switch, EthSwitch, was launched in 2016, with the goal of allowing interoperability of automated teller machines (ATMs), mobile money and, point of sale (POS) networks. The system is currently active for ATM switching, but the platform for mobile payments interoperability is yet to be introduced and integrated with service-providing banks. Despite progress made the NBE needs to improve oversight of payment systems and services.

17. Activities of money transfer operators (MTOs) in Ethiopia are limited and agent banking and other methods are not being utilized to improve access to financial services

including those used to deliver international remittances. MTOs can offer their services only through banks or other financial institutions licensed by the NBE, which then act as the distribution network of the MTOs. MTOs are prohibited from offering their services “directly”, through a proprietary network of agencies, or from establishing franchised services in retail stores, supermarkets, or other outlets. Hence, the distribution network is available only through commercial bank branches in main cities, and access points hardly exist in rural areas. Whilst agent banking has been introduced, few banks have used it to develop their footprint in other parts of the country. Micro finance institutions are well placed to serve the population of Ethiopia with 885 branches, predominately in rural areas however, they are currently only permitted to participate in the remittances market, as a sub agent of a banking partner. In addition, despite the good progress, Ethiopia faces many challenges in implementing an effective AML/CFT regime, especially in the areas of domestic coordination supervision and enforcement.

18. The Ethiopian Fintech market is nascent, and fintech companies are mainly providing digital payment services. The lack of traction within the mobile money market is in part due to the bank-led approach to licensing service providers and low coverage and penetration of mobile services in the country. Fintech companies are typically licensed by the Ministry of Trade and Ministry of Innovation and Technology which implies a license for a technology provider not a financial service provider. Consequently, the NBE tends to outsource the due diligence of those providers to commercial banks who work directly with those providers. This approach leaves the fintech companies in an ambiguous position and creates a gap in understanding the risks introduced by those providers. In addition, despite efforts by EthioTelecom, penetration rate for mobile services remains low, and access to data services and smart phones is still very rare. The plans for EthioTelecom privatization and introduction of further mobile network operators to the market will fill a significant gap in access to basic internet and data services.

19. The microfinance sector in Ethiopia plays an important role in financial inclusion and is characterized by a heterogenous mix of institutions. However, currently many MFIs do not operate efficiently and have limited outreach. The dominance of government-affiliated MFIs, which do not operate on a fully commercial basis, has distorted overall growth in the sector. The unintended negative consequences are, government-affiliated MFIs access concessionary funds to fund their loan portfolios and are less motivated to mobilize retail deposits or innovate in product design or service delivery. The MFIs that do operate on a commercial basis, end up facing higher relative funding costs requiring them to charge higher rates. In addition, there is a widespread perception among the public that all MFIs are government-affiliated entities which are credit-focused and not fully commercialized. More commercialization of the MFI sector is necessary for the sector to advance in sophistication, expand outreach efficiently, and reach its potential of contributing to inclusive growth in Ethiopia.

20. Despite progress in combating money laundering and financing of terrorism ((ML/TF) there are still many important challenges facing the country. In addition, given Ethiopia’s financial and economic isolation authorities have limited experience when it comes to international cooperation on anti-money laundering and combating terrorism financing.

21. Ethiopia's credit markets are relatively underdeveloped compared to other neighboring countries. This is a result of several binding constraints, including lack of appropriate collateral that MSMEs can pledge for loans, underdeveloped credit infrastructure systems such as a modern collateral registry, secured transactions framework, and credit reporting system. Ethiopia also lacks specialized financial institutions such as investment banks, housing/ mortgage banks and others to meet the economy's diverse financing needs. The NBE Credit Reference Bureau (CRB) (the credit reporting system in Ethiopia) is still nascent; even though it has registered key progress since it was first established in 2012. The CRB is still understaffed and under resourced and will require substantial investments in technology and expertise for service provision to diverse lenders and to develop value added services and products that could cater to lenders' needs. In a significant move the Prime Minister in February 2019 instructed the NBE to integrate the microfinance and leasing sectors into the CRB requiring extensive collaborative effort among the relevant stakeholders (NBE, MFIs, leasing companies and service providers). By April of the same year 2.8 million borrowers from 20 MFIs were uploaded to the NBE CRB. Together with those registered at banks they represent 5.2 percent of the adult population.

22. The legal and regulatory framework for leasing (capital goods and leasing business) is undergoing reforms to progressively help the sector to grow from its current US$153.7 million and improve access to finance. The NBE is currently revising the existing Proclamation for leasing and capital goods business in partnership with the Ministry of Trade and Industry, and with technical support from the WBG. In January 2019, major policy shifts and changes in the prudential guidelines for capital goods and leasing business were approved by NBE related to the lifting of the interest rate cap; access to foreign borrowing; allowance to include big ticket leases within portfolios; increase of the single borrower's limit; and lifting of restrictions on the number of branches and operations required in the country. Following these reforms, the NBE in July 2019 licensed the first foreign owned independent leasing company in Ethiopia. Nevertheless, there are high market/stakeholders, expectations for additional reforms in the sector. For example, local borrowing is still not allowed for foreign owned leasing companies operating in Ethiopia a key element for foreign investors considering investment in Ethiopia.

23. The insurance industry in Ethiopia is moribund with premiums amounting to less than half of one percent of GDP. There are 17 insurers active in the Ethiopian market of which 9 are composite companies. The largest single insurer is the state-owned Ethiopian Insurance Company (EIC). In addition to compulsory 3rd party Motor Liability insurance there are a number of other types of coverage for businesses and investment that are virtually compulsory (e.g. Liability coverage). Ethiopia ranks 96th in the world in terms of insurance premium volume by country with a premium volume of approximately US$300 million. Foreign branch insurers are not permitted to be licensed in the country and foreign shareholdings in Ethiopian insurance companies are not allowed. In addition, the presence of composite insurers is hindering development of a more vibrant life insurance industry in the country. Given the small size of the industry, supervision at the NBE has been tepid and long overdue policy reforms have not been

implemented impacting the growth and development of the sector with implications on development of long-term finance in the country.

The Way Forward

24. Financial sector reform in Ethiopia if done gradually, alongside a strong consolidated monetary and fiscal framework, and lower inflation should lead to an increase in financial depth and improve financial intermediation and allocation of resources to productive sectors. Reforms should be accompanied with issuance of government securities at market-prices and development of the capital market in addition to the removal of the 27 percent rule, to allow an alternative source of funding for the public sector, and support creation of liquid market instruments needed to modernize the monetary framework and meet monetary objectives more efficiently; removal of directed credit; restructuring (including changes to governance) as well as eventual privatization of key public institutions and state-owned enterprises (SOEs) including state-owned banks (when feasible); and improvement in the business environment. In parallel the government of Ethiopia and the NBE should work with international donors and development organizations on building capacity of the relevant public and private market players (including reform in the role as well as capacity of the NBE) to manage transition and management of a modernized and open financial system.

25. Comprehensive reforms are needed to modernize the monetary policy framework and manage foreign exchange management. The NBE should gradually phase out its reliance on direct instruments and develop indirect MP instruments which will focus on overnight rates as the trigger for effective monetary policy transition and the pricing of other financial market instruments and to establish the basis for further financial market development. The NBE should design a basic, transparent liquidity management framework, including regular Open Market Operations and Standing Facilities. The gradual adoption of the common international practice of averaging on reserve requirements would allow banks to meet the reserve requirements on average over the maintenance period. In order to transit to a price-based monetary policy implementation framework the NBE should formalize its monetary policy rate and use market operations to allow transmission to market rates. Development of a monetary policy communication strategy is also needed to increase the effectiveness of policy transmission. While reforms to boost exports and FDI and inflows from the diaspora will help increase FX supply, this needs to be coupled with NBE policies to address the overvaluation in a durable manner. A gradual alignment with market fundamentals and eventual increase in flexibility should be accompanied by the appropriate macro policy settings to achieve inflation targets and explained to the public with careful communication and education efforts. In addition, the NBE should start a review of all FX regulation to support the process of gradual liberalization of the FX market.

26. The GOE should strengthen NBE's independence both in monetary policy and in supervisory functions. This includes a review of distortions in the law that render the NBE de facto non-independent and putting in place a governance structure aligned with international best practice. Independence should be prescribed clearly by law and should include entrusting NBE

with effective fit and proper test and removal power of Board members (including at the CBE and DBE). The NBE should also function under no ambiguities to be able to enforce supervisory decisions whenever CBE and DBE breach prudential requirements. The public enterprise holding agency (PEHA), as representative of the government, should act as the main shareholder, maintain an arms' length oversight with regards to the banks' management and practices, and ensure that the governance structure and functions of state-owned financial institutions adhere to regulations and standards applied by the regulator and its supervision department. NBE independence should be accompanied by a proper conflict resolution mechanism to ensure adequate checks and balances are in place.

27. The GOE and the NBE must work together to institutionalize by law adherence to proper governance and operations that would put state-owned banks on an even level with other banks. The government has recently taken the decision to remove the 27 percent rule that had been applicable to private banks only. This is already a positive step forward however, the effect of this removal on intermediation by private banks should be monitored to ensure the banks are effectively increasing their lending (within regular prudential requirements). Along with the elimination of the 27 percent rule private bank's ability to provide loans to the private sector is expected to increase as will their ability to invest in market-based debt issuance on a voluntary basis.

28. Closer inspection and review of risks on CBE and DBE's books is needed to prepare an appropriate restructuring plan. An effort to strengthen intermediation capacity of the two state-owned banks is necessary, for the CBE, given its large size and currently concentrated exposures, and the DBE, given the role a well-structured and performing development bank could play in a context such as Ethiopia's where financial intermediation levels are very limited, and the range of products and services is basic and narrow. The government should perform an independent comprehensive risk assessment and review of the balance sheets of the two state owned banks to help identify corrective actions and a reform path, including possibly capitalisation, to make it 'fit for purpose'. The banks' governance arrangements should also be revisited, and reforms aimed at strengthening the collective suitability of Board members and effectiveness of internal control mechanisms in each institution should be undertaken.

29. NBE's supervision standards need to be enhanced to enable the central bank to conduct proper oversight in accordance to the new market-model including supervision of state-owned banks. The NBE should start monitoring interest rate mismatch from supervised institutions and require banks to furnish their data on interest rate mismatch as well as providing mitigation actions. The NBE with support from the IMF-EastAfriTAC is working to move to Basel II as soon as possible. However, considering the risk characteristics of the system, introduction of some features of Basel III should be considered, to be able to address the main systemic vulnerabilities in the system. The high concentration risk can be mitigated by an additional capital surcharge for domestic systemic important banks (D-SIBs). Inflated balance sheets of state-owned banks which are lending to SOEs under a government guarantee against a risk weight of zero percent, will find a limit with a leverage ratio. The gradual introduction of the Liquidity Coverage

Ratio (LCR) and Net stable Funding Ratio (NSFR) can help restore liquidity in the system. Given the high concentration risk from CBE and to monitor and address systemic risks and vulnerabilities that pile up in the system the NBE needs to build a macro prudential oversight function, starting by establishing (through law) a macroprudential authority with hard powers at the NBE. The NBE should begin to take immediate steps to gather the necessary data to gain insight into the vulnerabilities and risks affecting the system.

30. The NBE should also strengthen its approach to risk-based supervision which is currently more compliance-based and align it with the CAMEL methodology. The NBE should also set up an Enforcement and Sanction Unit, entrusted to independently assess violations and banks response to supervisory findings. Transparency of the criteria and methodology would greatly help foster acceptance and provide a good starting point for dialogue. Transparency can easily be achieved by providing the relevant information for the criteria on the NBE-website. Increasing transparency however does not absolve the NBE from having to consider the unwanted and harmful side effects of regulation beforehand. Hence the NBE should consider using the Qualitative Impact Studies (QIS) to engage with the sector before issuing important new regulation. Finally, with the increasing number of new banks seeking to get a license and the need for high level skills in finance and banking, the NBE should review its framework for salary and benefits including incentives, with the objective of attracting talent and increasing retention rates. NBE should also consider introducing a cooling-off period for staff moving to private banks.

31. In order to support real sector-growth the NBE needs to ease restrictions on banks to extend foreign currency loans but design the regulation carefully (alongside an appropriate macro fiscal and FX management framework) to avoid future dollarization of the financial system. The NBE should enforce the cap on open exchange rate positions of 15 percent of regulatory capital vigorously, and force CBE to close this position. While there is no clear regulatory framework NBE should start considering the impact of climate change on financial stability and climate related risks should be considered in stress-test methodology.

32. In preparation for opening the sector to foreign ownership and competition the NBE needs to change the banking business law and adopt a comprehensive strategy to build capacity in supervision of foreign owned banks. Changes in the regulation for opening the sector includes easing of restrictions in transfer of significant ownership and eliminating or mitigating limitations on acquisition of bank shares (currently no person, other than the government, may hold more than 5 percent of a bank's total shares either alone or jointly with his/her spouse[8]). To ensure appropriate supervision the Banking Proclamation and legal framework should be changed introducing supervision on a consolidated basis and endorsing the NBE with the mandate to take seat in supervisory colleges. To ensure competition in the sector, the NBE should put in place a strategy for measuring and monitoring competition in the banking sector and ease entry and exit of banks and non-bank financial institutions (NBFIs). This should be done through appropriate regulatory frameworks, including development of an appropriate resolution procedures for banks.

[8] Proclamation No. 592/2008.

33. A proper crisis management framework and safety nets are integral components for the stability of the system and protection of consumers. The NBE should develop a crisis management framework, composed of recovery plans submitted by banks providing a realistic view of their recovery capacity in crisis conditions and resolution plans prepared by the NBE. Recovery plans should be used in the context of supervisory dialogue with credit institutions. It is equally important to put in place proper arrangements that help orderly resolve or restructure of non-viable banks, identifying for each credit institutions the preferred resolution approach and the resolution tool (insolvency, bail-in, sale of business, bridge bank). Since CBE is state owned, the MOF will have to play a role to come to a viable solution; however, any action should be coordinated, involving both the supervisor (NBE) and MOF. This cooperation could provide MOF and NBE with valuable experience in working side-by-side in a crisis-situation, which can be used at a later stage as input for the design of a well-functioning crisis-management framework[9]. The lender-of- last-resort function at NBE should also be modernized.

34. In developing a deposit insurance scheme, the NBE should take into consideration the core principles of effective Deposit Insurance Systems (2014). These include among other: regulation mandate, compulsory membership, governance, coverage, funding, legal protection and reimbursement.

35. With respect to capital markets the creation of a market-based government debt market is the first step and should take into account fiscal constraints and the funding needs of SOEs and the DBE. A government bond market will set the ground for broader development of capital markets, particularly the pricing of corporate bonds, and provide safer and relatively liquid investments to a broad array of investors. In addition to the regulatory framework for the Capital Market as well as the Money Market, measures to increase the investor base are important namely participation of banks on a voluntary basis (elimination of the 27 percent rule being key in this case), attracting foreign investors, and strengthening the investment fund industry (pensions, insurance), the latter an important segment to develop retail investors. Market infrastructure requirements should include a review of the legal and regulatory framework, dematerialization of securities and developing a CSD, setting up a secondary market trading platform, and developing market intermediaries. Licensed market intermediaries do not exist and would need to be licensed by the NBE to facilitate development of both the primary and secondary government securities market. To create the conditions to start capital market activities in Ethiopia, close coordination and cooperation of the key stakeholders will be essential including between MOF, NBE, MOTI (Ministry responsible for the ECX), and the ECX.

36. Despite recent positive developments in the supply of financial services, there is a need for greater diversity of financial products to enhance financial inclusion especially for

[9] A full-fledged crisis situation can only be solved when the central bank and the Ministry of Finance cooperate. While the central bank is essential for giving liquidity support, it may only do so for solvent, but illiquid institutions. Any capital support for an insolvent too-big-to-fail-institution therefore needs to come from the budget. It is essential that both central bank and Ministry of Finance know beforehand their role, have established information sharing arrangement and have worked out a contingency workplan.

underserved segments of the society. A Sound financial consumer protection framework and a dispute resolution mechanism are fundamental to maintaining transparency and trust in the system while increasing financial access. Related are digital financial services which are important for enhancing financial inclusion.

37. The market is seeking a leadership role from the NBE in promoting digital service providers. Fundamental steps are required to bridge the gaps to a digital economy in Ethiopia, this includes developing regulations and allowing non-bank payment service providers to issue e-money and provide intermediary services like bill payment and merchant aggregation. In addition, the NBE should consider, opening participation of foreign investors in the sector, and implement changes for agent regulations. For development of the EthSwitch, the NBE should envision the institution as a hub and a connector for other service providers performing its role as an interoperability platform to access cards, mobile and bank accounts, and also, connecting it to other bill aggregators, payment gateways, government portal (Derash), and any eKYC or digital ID infrastructure. Finally, to achieve the objective of modernizing and automating government payments and collection processes the Ministry of Finance and Ministry of Revenue should work closely with the NBE and other government stakeholders to modernize the financial management information system (FMIS).

38. A new approach to supervising the insurance sector should be considered as well as other options to establishment of the credit bureau. A Public Private Partnership (PPP) option for a credit bureau which the NBE has agreed to consider, could present a viable solution for NBE. In terms of developing the insurance sector stakeholders have recommended that, an independent agency, not part of the formal public service, be given the mandate, structure, and funding to be the supervisor, delivering a more focused level of policy development and industry oversight. In addition, the insurance industry should be opened to foreign participation as this will inject new knowledge and experience into the marketplace, to the benefit of Ethiopian insurance consumers. Given, that natural disasters in Ethiopia are expected to increase in magnitude and severity due to climate change, straining government's response cost in a significant way; it pays dividends for Ethiopia to start to develop and implement financial protection strategies that help smooth fiscal shocks and avoid disruption of longer-term economic growth due to climate shocks. Various disaster risk financial instruments are at Government of Ethiopian (GOE) disposal; however, there is a need to select the suitable tool depending on the layer of risk and policy objectives.

39. The following table provides the recommended high level reforms the Ethiopian government and the NBE would need to do under the financial sector modernization roadmap. The recommendations were discussed with stakeholders in the public and private sector as well as with NBE staff. The remainder of the report provides detailed background and comprehensive reform recommendations grouped under the three Pillars of; financial stability and safety net, long-term finance/financial markets, and financial inclusion and digital financial services.

Table 1: Strategic objectives for each Pillar

PILLAR I: Financial stability and safety net	Priority
GOE (PM, MOF, NBE, PEHA) Review the legal and regulatory frameworks to strengthen NBE independence in managing monetary policy and removing ambiguities preventing NBE's full enforcement-power towards the government-owned banks whenever they breach prudential requirements. Should include entrusting NBE with effective fit and proper test and removal power of CBE and DBE Board members appointed by the government. NBE independence should include proper accountability, a conflict resolution mechanism, and a transparency framework to ensure adequate checks and balances are in place.	High
GOE (PM, MOF, PEHA and the NBE) to revisit State-own banks governance arrangements and perform a comprehensive review of their balance sheet with a view to enhance the information available on the condition of the banks, implement necessary corrective action and develop a business plan to address key weaknesses and strengthen the banks based on the outcome of the review.	High
Remove the 27% rule since it is highly distortive and creates additional risks to the system.	High
Ease restrictions on banks to extend foreign currency (alongside an appropriate macro fiscal and FX management framework).	High
NBE to require banks to submit data on interest rate mismatch and require mitigation measures by banks whose earning base decline below a pre-defined threshold and enable banks to attract longer term deposits.	High
NBE to enforce vigorously the cap on open exchange rate positions of 15% of regulatory capital especially the CBE.	High
Move to Basel II standardized approach and introduce some features of Basel III related to inherent risks resulting from structure of Ethiopia's banking system – capital surcharge for SIFIs, leverage ratio next to CAR and LCN/NSFR.	High
Move to full risk-based supervision framework aligning risk assessment with CAMEL methodology. Also consider using the Qualitative Impact Studies before issuing any new regulation.	High
Empower NBE to do Macro-prudential supervision with hard powers and proper tools including NBE endorsement to establish a Financial Stability Committee and a Financial Stability Dept. that will feed the Financial Stability Committee with analyses and policy recommendations. The necessary information by the MOF, other NBE depts. and relevant agencies should provide the banking supervision dept. with the necessary related information.	High
Strengthen bank resolution, crisis preparedness, contingency planning and revamp NBE lender of last resort function.	Medium/High
Open banking market to all foreign ownership by amending the Banking Business law on transfer of significant ownership and limitations on acquisition of bank shares; and adopt a capacity building strategy at NBE for supervision of foreign owned banks – first introduce through law (Banking Proclamation) supervision on a consolidated basis and give NBE mandate to take seat in supervisory colleges.	Medium
NBE to start measuring 'green' and 'brown' activities of financial institutions and issue guidance on appropriate governance, strategy and risk management of climate and related environmental risks including applying capital measures and including climate related risks in stress tests.	Medium
NBE to review its framework for salary and benefits including incentives with the objective of retaining talent.	Medium/High
GOE and NBE to Set up a Deposit Insurance scheme in the medium term.	Medium
PILLAR II: Long term finance/financial markets	
Develop regulatory framework and instruments for the money market, introduce GMRA or SBB to allow for collateralized lending and develop money market lending instrument and reference rate. NBE liquidity window to be established at market-based rate with a moderate haircut to develop the money market.	Medium/High
Move to market-based issuance of Government Debt, establish legal framework and trading platform for the securities market, develop licensing framework for intermediaries, and phase out NBE advances.	High
NBE and MOF to engage with broader investor base in design and NBE and MOF to adopt and enforce transparency to avoid collusion, improve market connectivity and quality of information,	Medium/High

Market infrastructure and supervision and regulatory framework for capital markets to be developed (primary and secondary markets, CSD development and bond dematerialization). Improve market connectivity among all market players and securities market regulator to require notice of OTC issuances.	High/Medium
Broaden and diversify the investor base, develop tax legal & regulatory framework for investors, broaden distribution channels and review institutional investor limits.	Medium/High
Establish the equity and corporate debt market based on a feasibility study.	Medium
PILLAR III: Access to Finance and Financial Inclusion	
Refresh the Financial Inclusion Strategy factoring in Digital Financial Services and mobile money.	High
Issue a Financial Consumer Protection Law.	High
Launch a National Financial Capability Strategy.	High
Implement tiered account opening.	Medium
MOF and NBE, to spearhead the development of the housing finance system.	Medium
Develop legal and regulatory framework for digital payments.	High
Adopt a strategy to accept and distribute digital payments for all government services.	Medium
Create policy/directives that favor electronic payments limiting use of cash/checks.	Medium
Open the sector to non-bank payment service providers.	Medium/High
Develop regulations and practices to enhance the remittances market.	Medium
Create incentives for banks to provide internet banking and mobile banking services and adopt new technology to expand usage of DFS.	Medium
Develop a modernized national payment system oversight framework and a risk management framework for different payments systems and services.	Medium/High
Apply effective implementation of the AML/CFT framework: NBE and the GOE to bolster their legal framework, improve risk-based supervision of financial institutions and DNFBPs, and the use of financial intelligence in an effort to progress combating corruption, tax evasion and other illicit flows.	Medium
Improve governance and increase independence of government affiliated MFIs by including shareholders and board members from the private sector.	High
Open micro finance sector to foreign investment.	Medium
Strengthen MFIs accounting standards.	Medium
Support improvement of technology and increase capacity-building and training at MFIs.	Medium
Strengthen regulatory and supervisory framework for MFIs.	Medium
Consider an Apex for MFIs.	Medium
Implement a PPP for the credit reporting industry – design a roadmap/strategy based on requirements established in the PPP proclamation and best practice.	High
Improve policies and procedures, operations and portfolio management of regional leasing companies.	High
Review/amend legal framework for CGFB and develop a manual for offsite surveillance of CBGF activities.	High
Implement National Leasing Sustainability strategy and establishment of a national leasing association.	Medium
Revise insurance supervisory system to be administered by an independent agency based on best practice.	High
Adopt policy to phase out Composite insurers.	Medium
Open insurance industry to foreign participation.	Medium
GOE to conduct a fiscal assessment of climate risks and prepare a disaster risk finance strategy to address different layers of risk.	Medium
NBE to work with the sector to develop new financial products in insurance including through new role for DBE to support growth of the sector and facilitate improved intermediation.	Medium

I. Country Context

Background

1. **Ethiopia, a growing economy with a population of over 100 million is located in the conflict-affected Horn of Africa region.** Since the appointment of the current Prime Minister following the 2018 elections the country has witnessed unprecedented political and economic change most notably the peace brokered with Eritrea. The government also started to implement a range of economic reforms designed to revitalize the Ethiopian economy by expanding the role of the private sector which given Ethiopia's size and location, has far reaching geo political and socio-economic implications in the Horn of Africa and across the entire continent.

2. **Despite significant progress on the Millennium Development Goals, Ethiopia continues to face serious human development challenges.** Ethiopia hosts close to one million refugees, primarily from Somalia, Sudan, South Sudan, and Eritrea, and the number of internally displaced persons (IDPs) is estimated to have reached 2.2 million, of which 1.6 million were conflict-related as of June 2019. The poverty rate declined from 38.7 percent in 2005 to 23.5 percent in 2016.[10] During 2005-2018, the under-five mortality rate per 1,000 live births was reduced from 123 to 55, while primary enrollment doubled, and secondary enrollment increased tenfold. Life expectancy increased from 55 to 65 years and is now higher than the averages for both Sub-Saharan Africa (SSA) and low-income countries worldwide, however maternal and child mortality rates remain high, as does the rate of stunting. Gender disparities are profound, and a combination of cultural norms and socioeconomic inequality greatly increases the risks faced by women. Although poverty rates have converged over time across regions, there are significant intra-regional and inter-woreda disparities, and ethnic tensions are widespread. Finally, income inequality has increased, with the GINI index rising from 0.30 in 2005 to 0.33 in 2016.

3. **Ethiopia's strong economic growth over the past 15 years was driven by large-scale public infrastructure investment contributing to strong growth in agriculture and services.** According to official data, GDP growth averaged 10.4 percent in 2004-2018, making Ethiopia one of the world's fastest-growing economies. This has resulted in a dramatic increase in GNI per capita, from US$140 in 2004 to US$790 in 2018.[11] Public investment has been financed by tapping external financing, keeping government consumption low, and deploying heterodox mechanisms such as controlled interest rates and financial repression. As a result, during this period, the share of the population with access to electricity tripled, the share with access to water doubled, and the length of all-weather roads almost quadrupled.

4. **Foreign Direct Investment inflows to Ethiopia have surged in recent years.** FDI to Ethiopia increased from an average of US$ 0.4 billion in 2010-12 to US$ 3.7 billion in 2016-18, with the country overtaking Kenya, Tanzania and Uganda in annual inflows. This has been

[10] Official national headcount index.
[11] GNI per capita in current US$, according to the Atlas Method. World Development Indicators.

facilitated by an industrial policy that favored FDI in export led sectors, resulting in some large investments such as the establishment of a Hyundai assembly plant in Addis Ababa.

Macroeconomic context

5. **Despite substantial investments in infrastructure to support future growth, the limitations of the state-led development model have become evident, as external competitiveness has eroded and imbalances have increased.** Recently, GDP growth slowed from 10.1 percent in FY17 to 7.7 percent in FY18,[12] and merchandise exports dominated by commodities such as coffee and oil seeds dropped from 8.6 percent of GDP in FY11 to 3.4 percent in FY18, due to falling commodity prices and an overvalued currency. Poor export performance coupled with an ambitious public infrastructure investment agenda have placed the economy at high risk of debt distress. In addition, State-owned enterprises (SOEs) have increasingly crowded out the private sector, with the share of SOE credit in total outstanding domestic credit surging from 14 percent in 2007 to 54 percent in 2018. Some SOEs are not servicing their debt, thus exacerbating financial sector vulnerabilities. Finally, inflation is hitting double digits, and entrepreneurs are reporting persistent foreign exchange shortages, with businesses needing to wait more than a year to obtain foreign currency.

6. **Inflation is projected to remain in double digits in FY20, prior to easing in the medium term as more effective monetary policy tightening is deployed.** The NBE is expected to continue to strengthen its control on the growth of base money. Given that the relationship between base money and broader monetary aggregates has weakened with the ongoing financial deepening, the NBE is committed to prudently managing all direct monetary instruments (including direct advances to the budget) and adhering strictly to its annual financial programming to avoid deviations such as those in the past. The NBE is also working toward reforming available monetary policy instruments and adopting more indirect instruments of monetary control in the context of overall financial system reform and modernization. Tighter monetary policy, including through reducing NBE's direct advances to the government, would be appropriate even at the cost of slowing growth in the near future.

7. **While new sources of foreign exchange are expected to help rebuild reserves, the management of foreign exchange will remain a key challenge in the coming years.** While the tightening of fiscal and monetary policies will help reduce macroeconomic imbalances, the foreign exchange position will remain fragile and will require the full vigilance of policymakers. Short-term solutions such as one-off foreign exchange earnings from privatization might help improve the foreign exchange situation temporarily. Exports are expected recover in the medium term as the export base expands and large supportive investment projects become fully operational. The Addis Ababa–Djibouti Railway, which will improve trade logistics and reduce transportation costs for imports and exports, is partially operational and is expected to be completed within the next two years. The addition of two industrial parks in FY19, Adama and Jimma is also expected to help underpin manufacturing export performance. The power lines linking to neighboring Kenya

[12] Ethiopia's fiscal year runs from July to June.

are expected to be ready to export electricity by April 2020. As a result, Ethiopia's external financing requirements are projected to stabilize, allowing for a gradual build-up of foreign exchange reserves. However, fully addressing shortages and overvaluation would come from gradually moving to market determined foreign exchange management and a more flexible exchange rate regime. Continued scarcity of foreign exchange and persistent commercial arrears from SOEs to foreign business partners is likely to hamper foreign direct investment prospects.

8. Recognizing the shortcomings of the previous development model, the Government has initiated the implementation of a comprehensive structural reform program. Building on the objectives of the second Growth Transformation Plan (GTP II), Ethiopian authorities unveiled a Homegrown Reform Agenda in September 2019 that complements the already initiated structural reforms. It aims to ease business constraints and foster private sector development with a set of sectoral and macroeconomic measures, including those targeted at de-monopolizing economic sectors and removing distortions. The government's objective is to sustain the growth momentum of the past decade to create jobs for its young and growing population, with approximately 2 million new entrants joining the labor market each year.

9. This report provides an insight on operations and challenges in Ethiopia's financial sector and proposes a framework to help open and transform the current system to meet the country's future market-oriented growth plan. The report is formulated as an input for the Roadmap and thus organized along 3 Pillars identified by the NBE: (i) Financial Stability and Safety Net; (ii) Long-Term Finance and Monetary Policy; and (iii) Access to Finance and Financial Inclusion. Opening of the financial sector constitutes a cross-cutting theme.

II. Pillar I: Financial Stability and Safety Net

A. Ethiopian banking sector

1. **The Ethiopian financial system is shallow and less developed than those of its peer countries in the region.** For example, relative to GDP, Kenya's financial sector is almost twice the size of that of Ethiopia. This difference is mainly due to the virtual absence of non-bank financial institutions in Ethiopia (see table 2). Also, the role of government in the banking sector is completely different. While in Kenya less than 5 percent of all banking assets are controlled by government-ownership, in Ethiopia State-owned banks comprise 2/3 of the banking system total assets. Comparisons with other countries of the same region also suggest a lot of potential for the local banking system. For instance, money-to-GDP ratio (roughly similar to deposit-to-GDP but somewhat broader) is 33 percent in Ethiopia versus Africa average of 37 percent and South Africa of 72 percent.

Table 2: Comparison of Financial Sector between Ethiopia and Kenya

	Ethiopia		Kenya	
	assets (% GDP)	# institutions	assets (% GDP)	# institutions
Banks	59.0	18	58.3	46
- government controlled	38.5	2	2.7	4
- private	20.6	16	55.6	42
MFI	3.1	38	5.7	11
Insurance	0.6	17	7.5	52
Pension Funds	0.2	3	14.0	n.a.
subtotal	**62.9**		**85.5**	
Capital market licensees*	0	0	32.5	n.a.
total	**62.9**		**118.0**	
pro memory				
# inhabitants (million)	105		50	
GDP per capita (curr. US$)	768		1,595	

Sources: National Bank of Ethiopia, Kenya Financial Stability Report, Nr.9 (2018), World Bank Database; IMF Financial Soundness Indicators.

2. **Ethiopia's financial system is dominated by banks.** The banking sector is comprised of 18 banks including the two state-owned Commercial Bank of Ethiopia (CBE) and Development Bank of Ethiopia (DBE). Together with Microfinance Institutions (n. 38 MFIs) banks hold 98.6 percent of all sector assets. The banking sector has been closed to foreign investors, who are prohibited from acquiring shares of Ethiopian banks (Art. 9 of Banking Business Proclamation n. 592/2008). However, through amendments to the Banking Proclamation[13] ratified by Parliament on July 31, 2019 the government of Ethiopia (GOE) took recent steps towards opening the sector

[13] Proclamation Nr. 592/2008.

which now allows 'foreigners of Ethiopian origin' (diaspora) to purchase shares in Ethiopian banks. The new proclamation also allowed interest-free lending to support development of Islamic financing.

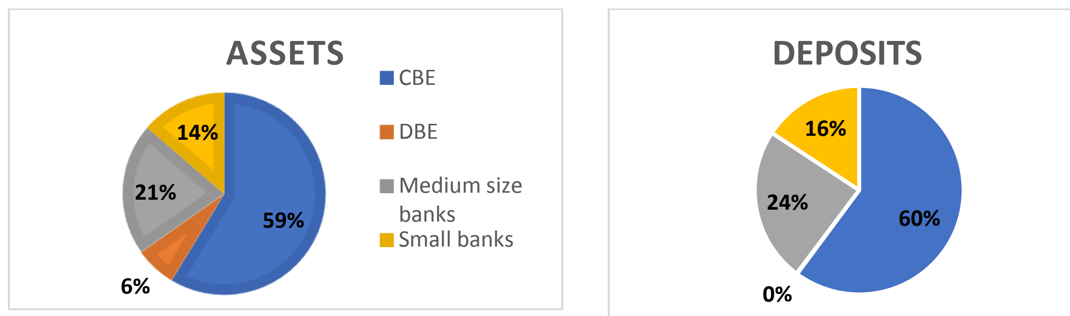
3. **Propelled by fast-growing economic growth the Ethiopian banking sector enjoyed high growth over the past ten years.** Deposits grew at an annual rate of 28 percent, as did loans and profits which grew 31 percent and 22 percent per annum respectively. The banking expansion was led primarily by the two state-owned banks which dominate the sector and are exempt from certain levies imposed on private banks. The crowding out of private financing is evident by the low level of private sector credit to GDP ratio which stands at just 11 percent, half the average seen among the 20 largest African economies (22%).

4. **Competition[14] is limited, as shown by the high concentration ratio, spread between lending and deposit rates, barriers to entry and exit, and lack of a non-banking financial sector.** The spread of 7.4 percent between the average lending rates (11.9%) and the average deposit rates (4.5%)[15] is significant. From a regulatory perspective, the domestic financial system is insulated from the benefits of foreign competition (services, transfer technology and know-how). Furthermore, barriers to market entry (minimum capital was increased in 2011 and in 2015) and exit (lack of a crisis management framework) prevents new entrants from challenging incumbents, resulting in lack of incentives for innovation by commercial banks. Finally, competition from non-banking financial institutions is non-existent, given the nascent stage of this sector.

State-owned banks – CBE and DBE

5. **The Ethiopian banking system is highly concentrated and dominated by the two government-owned banks: CBE and DBE.** The CBE has a particularly dominant market position, with its share of 59 percent of assets and 60 percent of deposits (Figure 1). It is followed by the DBE with 7 percent of all assets[16].

Figure 1: Concentration in the Ethiopian banking system – distribution of balance sheets



Source: NBE

[14] On competition see: https://www.worldbank.org/en/publication/gfdr/gfdr-2016/background/banking-competition; http://documents.worldbank.org/curated/en/673071468314707800/pdf/wps4656.pdf

[15] Interest rate on lending are freely determined by banks, whereas NBE determines the minimum interest rate on deposits. Despite a minimum 7 percent interest rate that banks must pay on saving deposits, the effective deposit rate is 4.5 percent, thanks to banks' ability to attract non-interest paying account (checking deposits).

[16] DBE does not take deposits and a set of different requirements for solvency and liquidity is applied to it.

6. Both State-own banks have been used by the government as vehicles to finance large infrastructure projects, and SOEs (in the case of CBE), and subsidized financing to SMEs in key priority sectors by the DBE. CBE loans to SOEs – as part of overall government directives and development finance policy for state owned banks – diverts finance from productive private investments to public enterprises most of which are loss-making. The directed and abundant flow of credit disincentivizes – or at the least lowers the practice of market discipline for SOEs to strengthen their governance and restructure their business model. The DBE acts both as a conduit for (largely donor-funded) lending to SMEs and as a funding vehicle for large projects in the manufacturing, agriculture and textiles sectors. While DBE's SME-focused credit programs have demonstrated success, its project financing activities resulted in abnormal levels of non-performing loans (NPLs ratio 34% as per official reporting to the NBE, June 2019), posing substantial quasi-fiscal risk (NBE credit to DBE is 2.4 percent of GDP).

7. Risk management and internal control at both CBE and DBE have not been effective, while lending practices do not always strictly follow financial rationale. To protect the national budget and avoid distorting competition, government-owned banks should be subject to the same prudential quantitative and qualitative requirements as private banks, including effective governance arrangements and robust risk management standards particularly when it comes to credit risk. Furthermore, the supervisor should be perceived as credible and be able to enforce decisions against state-owned banks.

8. Recent steps have been taken by the GOE to diversify the Boards of CBE and DBE however, Board members continue to be political appointees and hence further effort is needed to bring governance of CBE and DBE in line with international best practice. Sound corporate governance supports efficient, productive and profitable institutions, embodies fit and proper management, contributes to prudent risk-taking, while ensuring accountability for performance. In the case of state-owned financial enterprises (SOFIs) effective governance arrangements are particularly important for reducing risks to public finances.

B. Constraints to the banking sector

9. The unlevel playing field between private and government-owned banks is a fundamental obstacle to efficient financial intermediation and development of the overall Ethiopian banking sector. Due to their sheer size and (implicit) government guarantee of their debt, the CBE and DBE can offer subsidized funding (DBE lending rate is 9%, CBE is around 11% - 12%, whilst private banks average between 14% - 18%).

10. In addition, emblematic of the distorted competition is the recently removed requirement known as the 27 percent-rule that was introduced in April 2011. The 'Rule' which did not apply to the state-owned banks, required private banks to purchase 5-year NBE Bonds (known in the market as NB Bills) by an amount equivalent to 27 percent of each new loan disbursed. As banks' liabilities are based on the minimum mandated savings deposit rate of 7 percent, the interest paid by NB Bills (currently 5 percent) is below both inflation and deposit rates. To minimize their purchases of NB Bills, banks began to skew their loan books towards longer

term loans, taking more credit risk and increasing asset-liability mismatches, as short-term deposits are their predominant source of funding. In response the NBE issued a directive requiring that 40 percent of the loan book of private banks is in short term loans (<1 year). Private banks also have a 5 percent mandatory reserve requirement to be deposited with NBE. During periods of tight liquidity, the 27 percent rule had the effect of significantly worsening liquidity constraints for private banks. Therefore, the strategy has both reduced the capacity of private banks to provide loans to the private sector and resulted in higher interest rates to customers. As of publication of this paper, the government took the step of eliminating the 27 percent rule (November 20, 2019). While this is a positive move the effect of eliminating the Rule should be monitored in terms of interest rate margins and level of credit extended to the private sector by private banks.

11. The majority of the proceeds from the NB-Bills sold through the 27 percent rule were on-lent to DBE with the intention for it to fund priority sector projects; however, the policy objective was really been met. The balance sheet of DBE suggests that the amount is above what the bank was able to finance in suitable opportunities, thus the DBE bought 364-day NBE treasury bills (at 5% interest) with the excess funds. As of June 30, 2019, DBE had 35 percent of total assets invested in NBE treasury bills, against 56 percent in loans. Therefore, the 27 percent rule provided liquidity to the NBE, via DBE purchases of NBE treasury bills (and indirectly from the private banks). The quality of lending that does happen, is also very poor, as evidenced by DBE's very high levels of NPLs.

12. Cumbersome bank licensing requirements, lack of capital markets and lack of foreign investment in the sector hamper entry of new banks into the market. There are currently seven[17] new banks that have applied for a license to operate in Ethiopia. Article 5.1 of the Banking Business Proclamation (n. 592/2008) states that 'NBE shall decide on a banking business licence within 90 days from the last date of receipt of all information'. Despite this timeline, it can take a much longer time to get a license[18]. The actual licencing procedure starts only after the minimum statutory capital amount has been collected and deposited in a blocked dedicated account at a commercial bank. The biggest obstacle cited by banks is raising the statutory minimum capital[19]. With the restriction on foreign investment all prospective banks compete in raising funds from the same pool of domestic investors. Allowing foreign investors into the financial system would therefore help speed up the licensing process, as well as introduce innovative products, thereby fostering competition, and lowering cost of capital, contributing to increased financial inclusion.

13. The chronic foreign currency shortage due to decrease in exports over recent years is constraining real sector growth and competitiveness of financial markets; it also affects bank's asset quality The Banking Proclamation that restricts foreign banks from investing in

[17] Four Islamic banks, 1 mortgage finance bank, and 2 commercial banks have applied for a license.

[18] Directive Nr. SBB/56/2013.

[19] In 2011 the amount for pre-paid capital for new banks was raised from ETB75 million (USD 7.5 million) to ETB 500 million (USD 31.05 million), with existing commercial banks being given until June 2016 to meet this requirement. In September 2015, the NBE advised commercial banks to increase paid-in capital to ETB 2 billion (USD 94.78 million) by June 2020. All 7 applicants to a new banking license are in the stage of collecting the required amount of capital. The first started in December 2018.

Ethiopia aggravates shortages of forex. Forex shortage has driven the NBE to ration foreign currency allocation (see Box 1). While this rule prevented dollarization of the system in the past, the flipside is that it unnecessarily hampers investment projects that need to be paid in foreign currency. According to the NBE, between mid-May 2018 and January 2019, banks have received foreign exchange requests worth US$7.4 billion. However, they were only able to meet 31 percent of this demand. Foreign exchange allocations are based on a wait-list system and as a result the queue for foreign exchange increased by US$5.1 billion in less than eight months. The NBE allocates net foreign assets (NFA) prioritizing foreign exchange needs of the government, SOEs, and CBE and DBE with the remaining balance made available to private banks. Furthermore, based on the meetings held with DBE, one of the key drivers of NPLs is the shortage of foreign currencies to support projects' development. Almost all projects funded by the DBE require foreign currency for purchase of raw material and machinery. Many of these ambitious projects have been forced to slow down, with borrowers entering default status. Box 1 lists the various mechanisms used by the NBE to manage foreign currency in the financial system.

Box 1: NBE directives to manage foreign currency in the system

No person residing in Ethiopia (Ethiopian national residing in Ethiopia and resident foreigners) can hold foreign currency for more than 30 days[20], while Non-resident Ethiopians and non-resident foreign nationals of Ethiopian origin are allowed to establish and operate foreign currency accounts.[21]

Authorized banks can open foreign exchange retention accounts for eligible exporters of goods and services and recipients of inward remittances. However, exporters and remittance recipients must surrender 70 percent of their account balances and convert them into Birrs after 28 days (30 percent can be kept for an indefinite period)[22].
Banks have to surrender an equivalent of 30% of their FX inflows to the NBE FX reserve account (at the buying rate) and the daily overall open foreign currency position of each bank cannot exceed 15 percent of its total capital.[23] Recently the NBE has proposed changing the rate to between the buying and selling rate.
Banks are required to prioritize a list of import items and payments in their allocation of foreign currency in addition to other FX allocation restrictions. The remainder can then be sold to the bank's other customers on a first come first served basis[24].

All private external loans and supplier credits (and their repayments) are subject to NBE prior approval. While Public external borrowings are subjected to MOF authorization, including from SOEs.
External loans and supplier's credit conditions are subject to interest rate ceilings set by the NBE.

C. Risk assessment of the Ethiopian banking system

14. The banking sector's exposure to the concentration risk posed by CBE overshadows all other risks and can undermine any financial sector reform program Ethiopia is seeking to pursue. The CBE's assets equal 35 percent while its deposits are equivalent to 25 percent of GDP respectively. The bank is exposed to interest rate and asset liability mismatch risk as it uses short-term time-deposits and savings money to purchase bonds issued by SOEs and to extend them

[20] Directive No. FXD/49/2017.
[21] Directive No. FXD/55/2018.
[22] Directives No. FXD/11/1998 and No. FXD/48/2017.
[23] Directive No. SBB/23/97, amended by Directive No. SBB 27/2001.
[24] Directive No. FXD/45/2016.

loans. The practice of using the CBE to finance big infrastructural projects and SOEs has generated extreme concentration of risk on CBE's balance sheet: the ten biggest borrowers account for 83 percent of CBE's total credit portfolio. The exposure to the Ethiopian Energy and Electric Power Corporation (EEPCO) is the biggest and amounts to six times CBE's own capital, significantly above the NBE required limits on concentration risk (which is 25% of total capital)[25]. The majority of SOEs, including EEPCO, are not fully servicing their contracts to CBE with both parties relying on the government to cover the gap. The financial health of CBE is of crucial importance for the stability of the whole system and the sustainability of the government budget. A comprehensive review of its balance sheet and diagnostics should be conducted in order to, develop a credible financing and debt restructuring plan for the CBE with a view to modernize and strengthen the institution to gradually and progressively serve more, the real economy in the private sector.

Table 3: Solvency and credit risk in the Ethiopian banking sector (June 30, 2019)

	CBE	DBE	Other banks	Total system	
Loan portfolio (Billion Birr)	196.9	47.6	258.3	502.8	
Bond portfolio (Billion Birr)	379.7	2.0	45.0	426.7	
Reported NPL (Billion Birr)	3.5	16.1	7.1	26.7	
Reported NPL (% of loan portfolio)	**1.8**	**33.9**	**2.7**	**5.3**	
Capital (Billion Birr)	49.8	7.7	44.0	101.5	
Total RWA (Billion Birr)	143.6	56.5	328.2	528.2	
Total Assets (Billion Birr)	762.5	85.1	452.6	1300.2	
CAR* (in%)	**34.7**	**13.6**	**13.4**	**19.2**	
Leverage Ratio	**6.5**	**9.0**	**9.7**	**7.8**	

Source: NBE data and WBG team calculations

15. **Relative to the size of the local economy, CBE is 'too big to fail', and introduces a moral hazard issue.** Therefore, good governance arrangements, effective internal control systems, robust risk management, sound and prudent lending practices and vigorous and independent supervision are crucial. The DBE is also sizable and important but unlike the CBE it does not attract deposits and is significantly smaller[26]. Nevertheless, given its sizeable level of NPLs the DBE should also undertake an asset quality review (AQR) and a comprehensive diagnostic and restructuring of its governance, financing, and operations to transform it into a self-sustaining development bank.

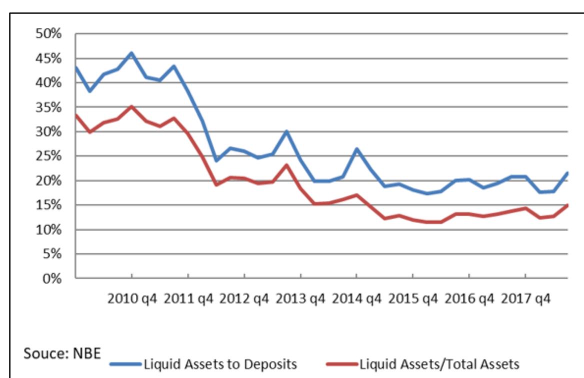
16. **Total Capital Adequacy Ratio (CAR) of the system is reported to be around 19 percent - a comfortable level that is nevertheless heavily influenced by CBE's CAR (34.7%).** However, CBE's CAR is driven by low risk weighted assets benefitting from government guarantees covering bonds and loans to SOEs that are reported to be underperforming. Since CBE reflects only non-guaranteed loans in its calculations of NPLs, the bank reports a very low NPL ratio (below 2%) - lower than the average NPL of 2.6 percent and significantly lower than the DBE

[25] SBB 53/12 set an additional limit of 15% of own funds for exposure towards 'related parties'.
[26] Whether DBE is actually too big to fail would require further analyses of interdependencies and possible impact of failure on the rest of the system and the economy.

NPL ratio of 33.9 percent. However, loans and bonds, even when guaranteed by government, can be risky, with the ultimate risk level resting on the credit quality of the government, i.e. the sustainability of the government debt. The recent sovereign crisis in the Eurozone demonstrated again that there is no risk-free asset. The concerns are aggravated by the lack of enforcement authority of the supervisor towards the CBE and DBE. The Public Enterprise Holding Agency (PEHA), acting as shareholder on behalf of the MOF, is substantially assuming the supervisory role for DBE and CBE.

17. Liquidity in the system was on a downward trend for years and has stabilized at a low level since 2015 (figure 2). Supervisory figures for liquidity gap analyses show that in June 2019, there was a systemwide liquidity shortage in all buckets between 15 days to up to 1 year. This systemwide squeeze in liquidity is probably also an unintended side-effect of the '27 percent rule'.

Figure 2: Banking sector liquidity ratios in Ethiopia



Source: NBE

18. In addition to liquidity problems, the 27 percent rule also creates a systemwide interest rate mismatch. Exact figures are currently not known since banks do not report their interest rate mismatch to the supervisor. Figure 3 shows the development of bond holdings in the Ethiopian system: almost all are NBE bonds. Approximately 37 percent of all assets in the system are currently bonds. Those bonds have a maturity of 5 years and yield a fixed interest rate, while they are typically funded on the basis of variable interest rates. This mismatch makes the system vulnerable to a rise in interest rates. If the cost of funding were to increase for whatever reason (monetary policy or increase by NBE of the minimum deposit rate), banks could react by increasing interest only on 63 percent of their assets, since the interest rate is fixed on the remaining 37 percent. In other words, the 27 percent rule exposes banks to material repricing risk, since in the event of sudden and unexpected change in interest rates, assets and liabilities will be repriced at a different amount. This can squeeze profitability considerably and pose a threat to the banks' capital base. Back-of-the-envelope calculations show that a rise in interest rate by 1 percentage-point could cost approximately 16 percent of systemwide operating income (before tax)[27].

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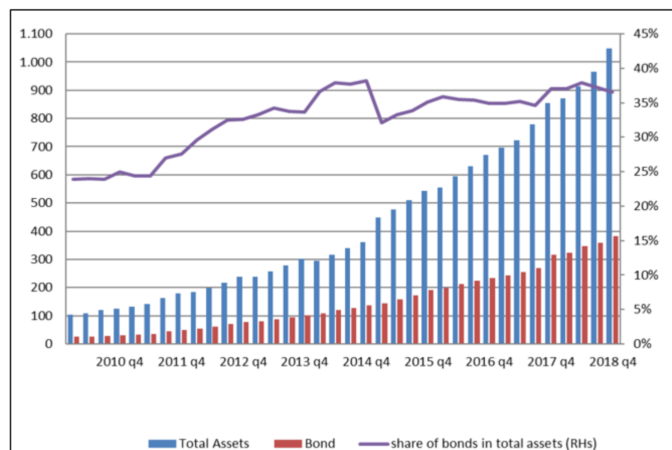
[27] For this calculation it is assumed that all liabilities have variable interest rates as well as 63% (= 100 – 37) of all assets. An interest rate increase, of 1% translates in lesser profit equal to 1% of 37% of total assets, equaling roughly

Figure 3: Bond holdings in Ethiopian banking system



Source: NBE

19. The sector is also exposed to foreign currency devaluation risk. In June 2019, the total banking system had a short position of foreign currency equivalent to ETB 68.8 billion. The Birr is currently overvalued[28] and its devaluation will help improve Ethiopia's competitive advantage in exports and allow injection of additional FX into the country; however, exchange rate adjustments need to take into account the increase in cost of capital (imports) and debt burden[29] which might generate pressures and trigger new NPLs. The latter will impact key sectors such as manufacturing and construction that rely on imported machinery, increasing their costs and narrowing returns, making it difficult for borrowers to service their debt obligations. DBE and CBE (already facing FX shortages) will be particularly affected, as DBE is the biggest lender to the manufacturing industry, and CBE is exposed to SOEs – some of them are exposed to foreign currency debt. Banks will also face increased deposit mobilization costs as they tackle rising operating costs. Foreign exchange risk needs to be managed carefully through regulation applying lessons from other countries.

20. CBE's net short position in foreign currency accounts for the bulk share of the total system position. As of June 2019, CBE's net short position in FX amounted to ETB 60.8 billion. This means that CBE is extremely vulnerable to changes in the exchange rate. The magnitude of the foreign exchange risk raises concerns about risk management systems and internal control, and the bank's governance, particularly on effectiveness of Board oversight over business lines and speculative behaviour. Since it is a short position in foreign currency, losses will occur in case the Birr devaluates vis a vis the foreign exchange, which is not an entirely unlikely scenario. Stress tests using June 30, 2019 data from NBE show that a devaluation of the Birr by 30 percent would

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4,8 billion Birr. All banks reported per June 2019 an operating income before taxes for the fiscal year 2018/2019 of 30,4 billion Birr.

[28] The IMF estimated that as of September 2018 the Birr was overvalued by 12-18% (Art IV, 2018).

[29] The Exchange Rate, *why it matters for structural transformation and growth in Ethiopia*, Policy Research Working Paper 8868, World Bank, May 2019. http://documents.worldbank.org/curated/en/898821559134798352/pdf/The-Exchange-Rate-Why-It-Matters-for-Structural-Transformation-and-Growth-in-Ethiopia.pdf

amount into losses for CBE of approximately ETB 18.2 billion (equivalent to 36% of CBE's capital).

21. Physical and transition risks stemming from climate change could affect the economy and financial stability of the Ethiopian banking system. Ethiopia is vulnerable to the adverse impacts of climate change[30] due to its low adaptive capacity, limited livelihood options for most of the population, climate sensitive sectors (such as agriculture and energy), and land prone to degradation and desertification. Rainfall is highly erratic and typically falls in the form of intensive convective storms. Over the past three decades, Ethiopia has experienced innumerable localized drought events and seven major droughts, five of which were associated with famines. Future climate variability and change are expected to accelerate already high levels of land degradation and soil erosion, increase vulnerability to droughts and floods, and negatively impact agricultural productivity.

Recommendations banking sector

22. The 27 percent rule recently eliminated by the government should increase private bank's ability to provide loans to the private sector, reduce the cost of such loans[31], and allow banks room to invest in market-based debt issuance on a voluntary basis. As proceeds from the 27 percent rule have been used in large part to fund the DBE and the GOE, the government should analyze financing alternatives as part of the DBE's overall restructuring and gradual move to market-based sources of finance. To manage government bond market issuance at market prices and the 27 percent elimination process, the NBE could in the very short term amend any remaining Rule requirements, to be applied on the total outstanding loan balance of each bank (as opposed to loan flows on a cumulative basis). This would permit banks to expand loans without concerns regarding the term/period, but more aligned to business and market needs.

23. The effect of removal of the 27 percent rule on intermediation should be monitored. There is the risk that banks may not pass the benefits regained with the elimination of the Rule, to consumers as such, and instead retain the gain for their shareholders in the form of higher margins and increased profitability. Healthy competition in the banking market is therefore essential to mitigate this risk. Competition can also bring new instruments, more technology, new distribution channels and consequently, expand and diversify the investor base. The results will be presented in the growth of credit loans and lower average interest rates thereby enhancing financial inclusion. The NBE should therefore put in place a strategy for measuring and monitoring competition in the banking sector and ease entry and exit of banks and NBFIs (including foreign owned) through appropriate regulatory framework, including appropriate resolution procedures for banks.

[30] *Exploring Carbon pricing in developing countries, A macroeconomic analysis in Ethiopia,* Policy Research Working Paper 8860, World Bank Group, May 2019.

[31] Because 40% of loans must be short-term (below 1y), the rule which is calculated based on the flow of loans requires an annual increment in deposits. So, if a bank lends 100 units 1y-loan and rollover 5 times, it needs to buy 27 units each year. If the stock of deposit does not grow, the bank needs to increase substantially the interest rate of the new loans to compensate the additional deposit and increased participation of NB bills in the asset composition.

24. Closer inspection and review of CBE's books is needed to properly quantify CBE's asset quality and the concentration of risk whose reduction requires preparation of an appropriate restructuring plan. The opaqueness and potential amount of losses make it paramount to get clarity on the quality of the balance sheet of the most important bank in the system. This is a pre-requisite to building a macroprudential framework and opening the sector to external investors. The government should perform an independent comprehensive assessment and a comprehensive review of the balance sheets of CBE as well as the DBE to enhance the quality of information available on the conditions of the banks, identify problem assets and implement necessary corrective actions. The banks' governance arrangements should also be revisited, and reforms aimed at strengthening the collective suitability of Board members and effectiveness of internal control mechanisms in each institution should be undertaken.

25. In order to support real sector-growth the NBE needs to ease restrictions on banks to extend foreign currency loans but design the regulation carefully (alongside an appropriate macro fiscal and FX management framework) to avoid future dollarization of the financial system. The NBE should enforce the cap on open exchange rate positions of 15 percent of regulatory capital vigorously, and force CBE to close this position.

26. The NBE should start monitoring interest rate mismatch from supervised institutions. During, their quarterly CAMEL rating or periodic on-site examination, the NBE reviews banks interest rate risk assessment reports and they check whether the bank is monitoring its assets and liability reprising gap and taking action accordingly. The NBE should continue to monitor those positions closely and to require banks to furnish their data on interest rate mismatch and provide mitigation actions, whose economic value or earning base decline by more than a predefined threshold (15-20%) as a result of sudden and unexpected change in interest rates (outlier banks)[32]. To facilitate banks to close their interest rate mismatch positions the NBE can enable them to attract longer term deposits.

27. In preparation of foreign ownership of domestic banks, the NBE will need to take several steps, including building capacity. This includes change in the regulation in transfer of significant ownership, eliminating or mitigating the limitations on acquisition of bank shares (at present, private banks cannot have any single shareholder holding more than 5 percent of a bank's share)[33] and setup of a prudential framework for consolidated supervision (see next section on supervision).

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[32] See Basel Committee for Banking Supervision interest rate risk in banking (April 2016) https://www.bis.org/bcbs/publ/d368.pdf

[33] Art. 11.1 of banking business Proclamation Act.

Box 2: Foreign banks in emerging market economies

The entry of foreign banks brings large benefits to host countries' financial systems, but at the same time, raises some concerns that need to be taken into account. Benefits stem from efficiency gains brought about by new technologies, products and management techniques as well as from increased competition stimulated by new entrants. Moreover, foreign banks may have more stable funding, thanks to greater access to resources from abroad, and a more geographically diversified credit portfolio.

However, foreign institutions might expose host economies to events taking place in other countries where the parent companies operate. Also, since international banks have access to more investment alternatives, they could quickly cut their investments if they are not performing as expected. Hence, to reduce volatility and protect the local banking system, host supervisor should be able to ring fence the subsidiaries' capital and liquidity in time of stress. Furthermore, international banks might engage in regulatory arbitrage seizing differences in regulations around the world. It is therefore critical to align local standards to international best practices.

Eastern Europe and Central America are two examples of banking systems with the significant presence of subsidiaries of multinational banks. The dominance of foreign banks in both regions has often been the result of banking crises and/or privatization and has, in most cases, contributed to these economies' overall development and rapid growth. Some banking systems in Eastern Europe went through a transformation process from a state-owned mono-bank system towards a privately-owned market-based financial system and this was key to achieving macroeconomic stability. However, most of those subsidiaries of international banks are of systemic importance in the host country, but in many cases are not material for the parent bank and thus for the home country supervisory and resolution authority. This asymmetry should be reduced by stipulating Memoranda of Understanding (MoU), to facilitate the flow of information on a continuous rather than ad hoc basis, and by an active participation in supervisory and resolution colleges.

Source: WBG team

28. While there is no clear regulatory framework, NBE should start considering the impact of climate change on financial stability and adopt a regulatory framework accordingly. For example, NBE can measure 'green' and 'brown' activities of financial institutions, issue guidance on appropriate governance, strategy, and risk management of climate and related environmental risks, setting out expectations for bank's disclosures and consider applying capital measures. Climate related risk should be also considered in stress test methodology.

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Table 4: List of recommendations grouped by priority – banking sector

Nr.	Recommendations Pillar I – banking sector	Timeframe
Precondition to the next step in the program		
	Perform independent comprehensive assessment and an asset quality review on the balance sheets of CBE and DBE, to enhance the quality of information available on the condition of banks, identify problems, and implement necessary corrective actions. Implement reforms of CBE and DBE based on the outcome of these diagnostics.	Immediate,
	Revisit governance arrangements of the two State-own banks (CBE and DBE) and implement reforms aimed at strengthening the collective suitability of their Boards and enhancing the effectiveness of the internal control mechanisms.	Within 1 year.
High Priority – Short-term according to priority		
1	GOE to phase out/remove the 27 percent rule as it is highly distortive and creates additional risks in the system.	Already repealed
2	Ease restrictions on banks to extend foreign currency loans but design the regulation carefully (alongside an appropriate macro fiscal and FX management framework) to avoid future dollarization of the financial system.	Within 1 year
3	NBE to require data on interest rate mismatch from supervised institutions. NBE should monitor those positions closely and require mitigation actions to banks, whose economic value or earning base decline by more than a predefined threshold (15-20%) as a result of sudden and unexpected change in interest rates (outlier banks). Facilitate banks to close their interest rate mismatch positions by enabling them to attract longer term deposits.	Within 1 year
4	NBE should enforce the cap on open exchange rate positions of 15% of regulatory capital vigorously, and force CBE to close this position.	Within 1 year
Medium-term according to priority		
5.	In preparation of opening the banking sector to foreign ownership the GOE and the NBE should work to amend the Banking Business proclamation easing the regulation on transfer of significant ownership and eliminating or mitigating limitations on on acquisition of bank shares.	2 years
5.	NBE should start measuring 'green' and 'brown' activities of financial institutions, issue guidance on appropriate governance, strategy and risk management of climate and related environmental risks, set out expectations for bank's disclosures and consider applying capital measures. Climate related risk should be also considered in stress test methodology.	Within 3 years

A. Role and structure of the NBE

NBE-governance and legal framework

29. De facto it is the government and not the NBE that determines objectives and targets of Monetary Policy (MP) and foreign exchange – two areas that in most countries are delegated to the responsibility of the central bank. While there is on paper a monetary policy committee at NBE, in practice, all monetary policy decisions are taken by the macro-economic committee at the Prime Minister’s office. Empirical studies have shown correlation between

independence of a central bank and better inflation trends particularly in transition economies[34]. In addition, there is abundant literature[35] that shows how independence is essential to protect the supervisory decision-making process from short term political interference or from industry pressure. Both monetary policy and supervisory decisions should be delegated to an institution which is sufficiently detached from the political election cycle, in view of the 'public good' associated with financial stability. Decision makers who are subject to political election cycles tend to act in a short-sighted manner. This might lead to a weakening of monetary policy decision, as well as regulatory or supervisory arrangements. Government's interference can take many forms and can indeed be very subtle. Often it leads to granting forbearance and not enforcing sanctions. This causes higher longer-term resolution costs for taxpayers in cases of bank failure and creates moral hazard. Furthermore, if supervision is not perceived as credible and stable, potential investors might defer investment decisions and development of financial markets will be hampered. A perception of weak supervision, combined with other factors (flows in AML/CFT regime, lack of profitability), might also cause de-risking. This is the reason why Basle Core Principle for Effective Banking Supervision (2012) prescribes that Supervisor should be independent (Principle 2).

NBE as supervisor

Organization of the Banking Supervision Directorate (BSD) at the NBE

30. In 2016, the BSD underwent a reorganization, with two major outcomes: a change in structure and a gradual increase in staff. The reorganization became necessary due to the growth of the banking system over the past decade, particularly in terms of assets. The work pressure resulting from this growth created serious backlogs in supervisory activity[36].

31. A Deputy Director was added to oversee the Analyses, Licencing, and Credit Reference Bureau sections. The on-site supervisory teams remain directly under the Director. The number of inspection teams increased from 2 to 3, with each team responsible for 6 banks. Figure 4 depicts the new organisational structure of the BSD. The numbers in the boxes describe the capacity as projected in 2020, whereas the numbers at the bottom of the graph show the actual

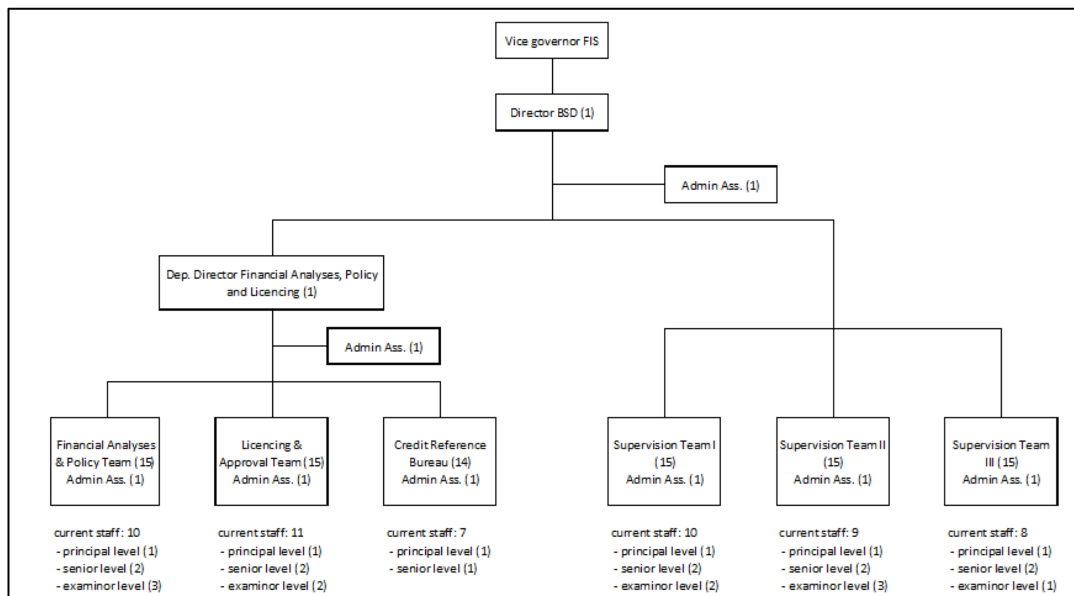
[34] Cukierman, Miller, and Neyapti (2001), Maliszewski (2000), Lybek (1999), and Loungani and Sheets (1997).

[35] Quintyn Marc and Taylor W. Michael, 'Regulatory and Supervisory Independence and Financial Stability', IMF Working Paper Series n. 02/46; Quintyn Marc, Ramirez Silvia, and Taylor W. Michael, 'The Fear of Freedom: Politicians and the Independence and accountability of Financial Sector Supervisor', IMF Working Paper Series n. 07/25 Narain Aditya, Elliot Jennifer, Toer Ian, Bologna Pierluigi, and HSU Michale, 'The Making of Good Supervision: learning to Say "No', IMF Staff Position Note, May 18, 2010; Adrian Tobias and Narain Aditya, Let Bank Supervisor do their job, IMF blog, February 2019; Angeloni Ignazio, Supervisory Independence, ECB Colloquium "Challenges for Supervisor and Central Bankers', Frankfurt am main, March 2019; Merch Yves, Central Bank independence revisited, Key note address at the "Symposium on Building the Financial System of the 21st century, An Agenda for Europe and the United Stated, Frankfurt am main, March 2017; Dalla Pellegrina L., Mascaindaro D. Pansini R.V., The central banker as prudential supervisor: does independence matter?. Journal of Financial stability, 9 (2013).

[36] For example, as per the NBE *Final Structure & Manning of the Banking Supervision Department,* November 2016 (internal document), in 2015, only half of the planned on-site inspections could be carried out due to capacity problems. National Bank of Ethiopia.

capacity. However, given the fact that another 7 banks are currently applying for a banking licence, the currently planned increase might not suffice for the future.

Figure 4: Organogram of the banking supervision department at the NBE



Source: NBE

32. Capacity at the BSD is set to increase. A substantial increase in capacity was already realized between 2017 and 2019 (growing from 39 staff to a current count of 60) and this trend is expected to continue with a target of 98 staff in 2020. A main challenge is providing all these new recruits with proper training, especially as they tend to be hired right after university (all have bachelor's degree in accounting, management or economics) and lack working experience. The NBE is investing in staff training. Every new employee follows an extensive introduction program; first, they are sent for a 1-2 months on-the-job training at a commercial bank, after that, they get a one-week in-house training on the regulatory framework at NBE; and last, they are paired with a senior staffer for a substantive period of additional on-the-job training.

33. Despite a slight increase in secondary benefits for NBE staff, turnover is expected to remain high. Employment and management at NBE are administered in accordance with regulation adopted by the Council of Minister (Art 24 of NBE Establishment)[37] and the salary scale is not aligned with the market. On average, 20-30 percent of junior staff leave NBE for a job at a commercial bank after gaining one or two years of experience at NBE. For example, while the salary scale for a banking examiner at NBE starts at ETB 3,000 (for a junior) and goes up to ETB 15,000 a month (for a principal, with 10 years of experience), the compensation for a comparable position at a commercial bank is 2.5 times higher (ranging between ETB 7,000 – ETB 40,000). An internal reform committee at the NBE is reviewing the current salary scale.

34. Movement of supervisory staff into employment with banks can enrich the supervisory culture, but it could also lead to conflict of interest ('revolving door') which may

[37] Proclamation n. 591/2008.

damage supervisory credibility. To mitigate this risk, policies implementing a cooling-off period, as well as measures regulating rotation of staff assigned to the supervision of credit institutions are crucial.

Supervisory standard and approach

35. The NBE supervisory standard follows Basel I, which is highly outdated. Consequently, there is no capital requirement for market risk, operational risk, and exchange rate risk (although NBE puts a cap on the latter of 15% of capital). The NBE with support from the IMF-EastAfriTAC is working to move to Basel II as soon as possible. Given the current state of development of the banking system, the standardized approach seems most appropriate for now. However, considering the risk characteristics of the system, introduction of some features of Basel III should be considered, to be able to address the main systemic vulnerabilities in the system. The high concentration risk can be mitigated by an additional capital surcharge for domestic systemic important banks (D-SIBs). Inflated balance sheets of state-owned banks which are lending to state-owned enterprises (SOEs) under a government guarantee against a risk weight of 0%, will find a limit with a leverage ratio. The gradual introduction of the Liquidity Coverage Ratio (LCR) and Net stable Funding Ratio (NSFR) can help restore liquidity in the system.

36. Currently the NBE is not adequately equipped to supervise foreign owned banks. The current legal framework does not support consolidated supervision which creates grey areas in banking operations outside the scope of supervision. In addition, the NBE lacks the mandate to communicate with home/host supervisors and take a seat in supervisory colleges. The two elements (consolidated supervision and seat on supervisory colleges) are preconditions to opening the market to foreign capital. The lack of consolidated supervision creates opportunities for regulatory arbitrage, since providers of financial services can operate outside the scope of supervision. One example would be the Commercial Nominees (a company owned by CBE), another example would be a subsidiary of the Ethiopian Postal Service.

37. The NBE's supervisory approach is laid down in a manual titled "Risk-based Supervision" (RBS)[38]; however, the NBE acknowledges that its RBS still needs further strengthening[39]. In addition, not a negligible part of the supervisory approach still appears to be compliance-based and could therefore gain effectiveness by further moving towards a more risk-based approach. Due to the compliance-based nature of supervision both, on and off-site supervisors are strictly focussed on finding violations of regulation. According to NBE Directive SSB 35/2004, 'Any bank that fails to comply with the requirements of any of the Directives of the National Bank of Ethiopia shall be subject to a penalty of ETB 10,000 for each violation'. Banks cannot appeal to Court Small and big violations are treated the same way. This approach seams counter-productive, since it does not bring the desired change in behaviour. Moreover, it precludes any dialogue with the sector. NBE does acknowledge that the penalty directive needs improvement and has already started to revise it. In this context the NBE should also set up an Enforcement and Sanction Unit, entrusted to independently assess violations and banks response to supervisory findings.

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[38] NBE, Banking Institutions Risk Based Supervision Framework, Revised Draft, Volume 6b1, August 2015, Internal Document.

[39] IMF's EastAfriTAC has planned Technical Assistance to NBE in developing guidelines for Basel II, notably the supervisory review process to be integrated in the risk-based supervision framework.

38. The NBE employs a CAMEL-rating approach to summarize and score performance of individual banks. While risk-based assessment is currently based on 4 profiles (credit market, operational and liquidity) assessed as either high, medium, or low, CAMEL rating looks at 6 profiles (scored from 1 to 5). There is therefore an opportunity to harmonize risk assessment with the CAMEL methodology. CAMEL scores are eventually shared with the individual banks. Interviews with banks showed that they are sensitive to the CAMEL rating they receive, especially the sub-rating for management quality. Transparency of the criteria and methodology would greatly help foster acceptance and provide a good starting point for dialogue. Transparency can easily be achieved by providing the relevant information for the criteria on the NBE-website.

39. Avoiding unwanted and harmful side-effects will make regulation more effective and efficient. The NBE should be more aware of standing and potential distortions and unwanted side-effects of regulation. The issue will be partly addressed by the macro-prudential oversight function, to be built at NBE in the future. However, NBE should also try to gauge the impact of important new regulation on individual banks and the sector beforehand in cooperation and dialogue with the sector. One way is to introduce the Basel III Qualitative Impact Studies (QIS). In such an approach, the supervisor issues a questionnaire to the supervised institutions beforehand to ask their calculations of the consequences on their balance sheet by the proposed new regulation. In the next step, the supervisor can gauge the effect on individual institutions and on the whole sector. In this way, the supervisor can make a better-informed decision and fine-tune parameters of the new regulation, time paths, transitional arrangements, agreements and so on.

Supervision of State-owned banks

40. While the overall, on-site and off-site supervisory processes of commercial banks at the NBE are relatively sound (see also Annex I section A) the case is not the same however, with state-owned banks. A review of the CBE and DBE indicate the presence of discrepancies and forbearance in their supervision. The NBE is properly endorsed under the banking law with full authority over all banks, including the state-owned banks. Nevertheless, NBE has not been effective in enforcing prudential standards on the CBE and DBE. The NBE performs the full cycle of on- and off-site inspections on CBE and DBE similar to other banks and issues them fines for violations, however fines are paid without any subsequent corrective measures taken. From July 2015 to date, CBE was fined 5 times, for a total number of 117 violations at ETB 10,000 each, totalling around ETB 1.2 Million. During the same timeframe, DBE was fined on 4 occasions for a total number of 25 violations, also at ETB 10,000 per violation (total of ETB 250,000). A consequence of this lack of enforceability by the NBE is, the CBE is now exposed to material sovereign risk, foreign exchange risk and liquidity risk; while DBE's asset quality deteriorated so significantly requiring an almost full restructuring of the bank's structure and operations.

41. Submitting state-owned banks to the same regulations and requirements as other banks is in the interest of stability and efficiency, and international best practice. It holds true along the whole spectrum of effective corporate governance arrangements, sound financial risk management, robust internal control framework, independent external control and supervision,

prudent and free of conflict of interest lending practices, and Board composition and functioning[40]. When stakeholders (such as Board members, senior management, and government) do not have clarity or alignment regarding whom the bank is accountable to, the bank's ability to adhere to sound management and prudential standards is weakened, its financial position might become vulnerable, and in the case of large banks, can jeopardize the entire system.

42. According to the banking law, Board members for all banks must pass NBE's fit & proper test but, in the case of CBE and DBE it is unclear whether there is an adequate 'fit and proper' vetting process that ensures that candidates have the necessary expertise, and time commitment for the role[41]. Government appointed Board members are subject to political cycle/changes, it also opens the space for conflict of interest. The size and the role played by those banks provides a strong rationale to make fit and proper requirements for their board members very stringent. Support to crucial economic sectors should not be done through directed lending by financial institutions but be pursued by means of other tools (such as fiscal policy, tax regime etc.).

B. Macro-prudential oversight and financial safety net

43. There is no macro-prudential oversight function in Ethiopia. Macro-prudential supervision emerged as a lesson from the 2008 global financial crisis and became a new international best practice. Macro prudential oversight needs to be built on sound micro-prudential supervision and is needed to address systemic risks and vulnerabilities that pile up in the system. Experience has shown that systemic risks can be neglected by supervisors when looking only at individual banks. In the case of Ethiopia, it is important to note that without proper micro-prudential supervisory power towards the public institutions that hold 2/3 of all assets in the system, building any macro-prudential (systemic) oversight function at the NBE becomes irrelevant.

44. A proper macro-prudential framework is never a one-size-fits-all and needs to be tailored to the situation in each country. However, every macro-prudential framework has four defining features: objective, scope, instruments, and mandate. The objective relates to enhancing financial stability and / or limit systemic risk. The proper scope covers the entire financial system, including all financial institutions (public and private), financial markets, and financial infrastructure. Thus, macro-prudential oversight is an overarching function, standing on the pillars of sound micro-prudential supervision of banks, MFIs, insurers, pension funds, and others.

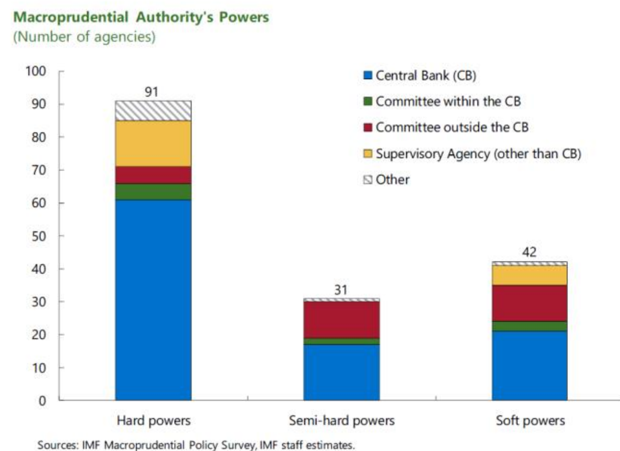
45. A macro prudential framework needs to have instruments. Many of those instruments already exist at NBE (such as reserve requirements, and supervisory caps on certain positions). Some new instruments might come with a targeted adoption of some features of Basel III (for example, the capital surcharge on SIFI's,). Also instruments like loan to income (LTI) and loan to

[40] Fit and proper criteria for banks Board member are well spelled out by the Bank Business Proclamation (Art 14) and the NBE Circular SBB n. 54/2012. Also, the Board role is well described in the Bank risk management guidance http://nbe.gov.et/pdf/bankrisk/Rm%20Guideline%20revised.pdf – the issue is lack of capacity by NBE to enforce corrective measures on state-owned banks.

[41] Fit and proper criteria for banks Board member are spelled out by the Bank Business Proclamation (Art 14) and the NBE Circular SBB n. 54/2012.

value (LTV) ratios or caps on certain types of exposures have already proven their value to mitigate excessive risk taking, preventing the pile-up of vulnerabilities in the system. Finally, a designed authority should be responsible for the function and its policies i.e. be given the mandate to implement. That mandate can be explicit or implicit and the strength of power can vary. In case the macro-prudential authority has direct control over (most of) the instruments, the powers are hard. When it only has the power to give recommendations, the power is soft (see figure 5).

Figure 5: Overview of a Macro-prudential authority institutional set up, 2016-2017



Source: IMF's Macro Prudential Policy Survey 2018

46. In most countries, the central bank or a committee within the central bank is endorsed with being the macro-prudential authority, possessing hard powers. In Ethiopia, NBE would be the natural candidate, since NBE, as supervisor of the financial sector (banks, MFIs, and insurers) already possesses important parts of the necessary expertise and instruments, thereby making it best suited for this role.

47. The new role and mandate will imply organizational changes for NBE whereby a Financial Stability Committee (FSC) and a Financial Stability Department (FSD) would be established. The FSC should be chaired by the NBE Governor. It will function as the most important policy-coordination and decision-making mechanism for macro-prudential policy, bringing together all relevant expertise: banking supervision (including MFIs), insurance supervision, monetary policy, foreign exchange policy, and payment systems. The FSC will be fed with analyses and policy recommendations coming from a dedicated unit which is the Financial Stability Department. The FSD will also act as a secretariat for the FSC and should therefore fall directly under the Governor. The FSD staff should be experienced and have a mix of relevant expertise (supervision, monetary policy, payment systems, foreign exchange). An appropriate timeframe to work towards these organizational changes would be 1 to 2 years.

48. In the future, the FSC will play a central role in the macro-prudential policy cycle by coordinating the necessary actions of all relevant players within NBE. The macro-prudential policy cycle follows four stages: (i) the risk identification stage, where relevant indicators and proper analyses help detect and assess vulnerabilities; (ii) the instrument selection and calibration stage; (iii) the implementation and communication stage, where instruments are activated; and (iv)

the evaluation phase, where the impact of instruments is assessed (see Annex I section B for further details on the macro prudential cycle and roles of the FSC and FSD).

Box 3: Macro-prudential policy and Financial Stability Reports

The first FSR's were published almost a quarter century ago by the Bank of England (1996) and the Swedish Riksbank (1997). Those publications pioneered (forward looking) systemic risk analyses and were meant to inform policymakers and the general public about risks that were accumulating in the financial system. Other European countries adopted this practice quickly, and countries as diverse as Russia (2001), China (2005), Turkey (2005), India (2010) and the USA (2011) followed later, often after having experienced a financial crisis. In 2012, Čihak et al, counted already 86 countries that were publishing an FSR.

In most countries, the central bank was vested with this new power, sometimes shared with another (supervisory) agency. According to the latest IMF Macro Prudential Policy Survey, in 2017, a total of 136 out of 189 member countries had one (or sometimes more) designated macro-prudential authorities, while 141 countries were reporting to use macro-prudential instruments to address systemic risk accumulation. In line with these developments, Financial Stability Reports are more and more evolving into an accountability instrument for the macro-prudential authority.

Central banks in China, India, Hong Kong, Malaysia, Republic of Korea were seen to have taken the lead in implementing various macroprudential tools following their experience of the 1997 crisis. They used countercyclical provisioning, loan-to-value (LTV) ratios and direct controls on lending to specific sectors to manage procyclicality and they addressed aggregate risk in the financial system through capital surcharges and liquidity requirements.

Latin America, which has been prone to large and recurrent financial crises for a long time, has also started to reinforce the institutional underpinnings to prevent financial crises. Chile, Mexico, and Uruguay have created financial stability councils with the explicit mandate of monitoring systemic risks and recommending the use of macroprudential policy tools to mitigate those risks. Brazil, Peru, and Uruguay have also used reserve requirements on bank deposits as an instrument to constrain credit growth. Colombia, Peru, and Uruguay have established counter-cyclical dynamic provisioning as macroprudential tool to build up buffers to absorb increases in loan losses during economic downturns.

In the Africa region Kenya was an early mover with the publication of its first FSR in 2004. The report is published by the central bank, in collaboration with other financial sector regulators. Next to an assessment of systemic risk and vulnerabilities in the Kenyan financial system, it also outlines the policy actions that have been taken to mitigate those risks and vulnerabilities.
https://www.centralbank.go.ke/reports/financial-sector-stability-reports/

Other countries in the region that publish FSR's are:
Uganda (2009) https://www.bou.or.ug/bou/bouwebsite/FinancialStability/stabilityreport.html
Rwanda (2009) https://www.bnr.rw/index.php?id=153 and
Tanzania (2010) https://www.bot.go.tz/Publications/PublicationsAndStatistics.asp

Source: Čihak et al (2012): Financial Stability Reports: What Are They Good For?; IMF WP/12/1; IMF (2018) Macro Prudential Policy Survey https://www.elibrary-areaer.imf.org/Macroprudential/Pages/Reports.aspx

49. While such organizational changes take time, there is an immediate need to start gaining insight into the vulnerabilities and risks that are currently piling up in the system. With assistance from the World Bank the NBE took initial steps to start the work. A dedicated team of two experienced supervisors are collecting the necessary data and creating a database, to perform the analysis and prepare graphs and tables along the lines of a format, discussed at a

workshop held during a WBG mission. The next step will involve assisting NBE in compiling this information and analysis into the first pilot version of a macro-prudential Quarterly Banking Monitoring Report. At a later stage, this type of analysis can serve as one of the core chapters for a full-fledged Financial Stability Report.

50. Macro-prudential analysis tries to assess systemic risks with a cross-sectorial dimension, related to the accumulation of risk that can arise from interlinkages and common exposures, and a time dimension, linked to build-up of financial fragility over time. Both dimensions might come from many sources, for instance from abroad (pressure on the exchange rate, balance-of-payment problems), from the economy (increasing unemployment, inflation) and the government (sustainability of government debt). To assess systemic risk, smooth exchange of information with other government agencies and / or other departments within NBE is a prerequisite. For example, while there is detailed information on financing needs and financial performance of major SOEs at NBE's monetary policy and financial analyses department, this data is not shared with NBE's banking supervision department. This information is of utmost importance for the assessment of risk on the balance sheet of CBE, therefore, assessment of the stability of the whole Ethiopian financial system.

51. Until NBE's FSC and FSD functions have been built, it seems practical to have the macro-prudential monitoring reports discussed at the macroeconomic committee in the Prime Minister's Office. Since important decisions on monetary policy or foreign exchange rate policy are taken outside the NBE, it seems opportune to send the report to the forum that has the power to take the necessary mitigating actions, which is currently the macroeconomic committee and the Prime Minister. The macroeconomic committee will in the future be the right forum to handle crisis management arrangements (also to be built).

C. Crisis management and financial safety net

52. Crisis management arrangements and a financial safety net are currently absent in Ethiopia. A financial safety net includes at minimum a deposit guarantee scheme and a bank recovery and resolution framework, which are currently missing. In addition, the lender-of-last-resort function at NBE does not work effectively, mainly because of the absence of suitable collateral, and therefore needs to be upgraded. Building these arrangements will take time. It should be noted that the, NBE has recently drafted regulation for deposit insurance which will be submitted to the parliament in the fiscal year 2019/2020.[42] A properly functioning deposit insurance scheme prevents depositor runs and protects small depositors including SMEs. It shifts the cost of protecting depositors from the government to the banking industry.

Recommendations banking supervision and NBE

53. The NBE needs to update its supervisory standard. The NBE should move to Basel II standardized approach as soon as possible. Given the structure of the Ethiopian banking system and its inherent risks it should be supplemented with some features of Basel III, especially the capital surcharge for D-SIBs, a leverage ratio, and the LCR/NSFR as additional liquidity

[42] The draft proposal is based on a study, funded by the WBG, and conducted by IOS Partners in 2010.

requirements. In addition, the current practice of fining seems ineffective and should be reconsidered towards a risk-based approach. The NBE should therefore adopt a full risk-based supervision framework and align risk assessment with CAMEL Methodology. It is important that the NBE also engage and invest in supervisory dialogue with the sector. More transparency regarding supervisory rules and decisions could greatly contribute to their acceptance.

54. Increasing transparency however does not absolve the NBE from having to consider the unwanted and harmful side effects of regulation beforehand (which would be one of the tasks of the macro-prudential oversight function, to be built at NBE in the future). Hence the NBE should consider using the Qualitative Impact Studies (QIS) to engage with the sector before issuing important new regulation. Finally, with the increasing number of new banks seeking to get a license and the need for high level skills in finance and banking the NBE should review its framework for salary and benefits including incentives, with the objective of attracting talent and increasing retention rate. NBE should also consider introducing a cooling-off period for staff moving to private banks.

55. The NBE should come up with a comprehensive strategy to build capacity to supervise foreign owned banks. The first step will be to, change the Banking Proclamation and legal framework accordingly by introducing supervision on a consolidated basis and endorsing NBE with the mandate to take seat in supervisory colleges. The capacity building strategy should incorporate all key HR aspects (recruiting, rewarding and maintaining talent, training and exposure of NBE staff to more developed supervisors in other countries). This is particularly important when Ethiopia opens the sector to foreign ownership (to be noted that the CBE has 2 foreign subsidiaries one in South Sudan, one in Djibouti).

56. Following emerging international best-practice the GOE should establish a macro-prudential authority with hard powers in the institution best suited and equipped for this role. In this case the NBE would be the suitable entity since it is already an integrated central bank/supervisor. This mandate must be made explicit in the central bank law if it is to be effective. Relatedly, the NBE Board should endorse establishment of a Financial Stability Committee (FSC), chaired by the NBE Governor. The FSC should bring together at high management level all relevant expertise to be able to take decisions and enforce them within the organization. The NBE Board should also endorse establishment of a Financial Stability Department (FSD) that will feed the FSC with analyses and policy recommendations. Since the FSD will act as a secretariat to the committee, it should fall directly under the NBE Governor. To be able to perform proper systemic risk analyses, the MoF, other relevant agencies, and other departments of the NBE should provide the NBE banking supervision department with the necessary information. This includes at a minimum: data on government debt, budget, balance of payment, GDP and its components and information concerning the financial performance of important SOEs.

57. A proper crisis management framework and safety nets are integral components for the stability of the system and protection of consumers. The NBE should develop a crisis management framework, composed of recovery plans submitted by banks providing a realistic view of their recovery capacity in crisis conditions and resolution plans prepared by the NBE. Recovery plans should be used in the context of supervisory dialogue with credit institutions. It is equally important to put in place proper arrangements that help orderly resolve or restructure of

non-viable banks, identifying for each credit institutions the preferred resolution approach and the resolution tool (insolvency, bail-in, sale of business, bridge bank). Since CBE is state owned, the MOF will have to play a role to come to a viable solution; however, any action should be coordinated, involving both the supervisor (NBE) and MOF. This cooperation could provide MOF and NBE with valuable experience in working side-by-side in a crisis-situation, which can be used at a later stage as input for the design of a well-functioning crisis-management framework[43].The lender-of- last-resort function at NBE should also be modernized.

58. In developing a deposit insurance scheme, the NBE should take into consideration the core principles of effective Deposit Insurance Systems (2014). These include among other: regulation mandate, compulsory membership, governance, coverage, funding, legal protection and reimbursement.

59. The GOE should strengthen NBE's independence both in monetary policy and in supervisory functions. This includes putting in place a governance structure aligned with international best practice. Independence should be prescribed clearly by law, allowing no ambiguity to undermine it, and it should include entrusting NBE with effective fit and proper test and removal power of Board members (including at the CBE and DBE). NBE should also be able to enforce supervisory decisions whenever CBE and DBE breach prudential requirements. The public enterprise holding agency (PEHA), as representative of the government, should act as the main shareholder, maintain an arms' length oversight with regards to the banks' management and practices, and ensure that the governance structure and functions of SOFIs adhere to regulations and standards applied by the regulator and its supervision department. For PEHA, incorporating clear internal mechanisms that work to protect the soundness of SOFIs is particularly important as the agency supervises both public financial institutions and public enterprises funded by these same institutions.

60. Independence should not be a goal in and of itself, however, and proper accountability and a conflict resolution mechanism need to be included to ensure adequate checks and balances. Unbalanced independence may open the door to self-interest or could lead to ill-designed regulation, with additional cost for the industry. There are many ways to hold the supervisor accountable for the discharge of its functions. 'Check and balance' mechanisms include: clear objectives against which the supervisor performance can be measured; strict procedural requirements, to ensure 'due-process'; consultation procedures, which also serve to achieve greater acceptability of the regulatory process and increase the supervisor's legitimacy; reporting, providing Parliaments with an opportunity to probe and criticize (hearing, question-time, written inquires); substantial judicial review over the merit and the fact of the decisions; liability, which should nevertheless be mitigated with legal protection. A transparent framework detailing decision-making roles between government, the Parliament and NBE are key to ensuring that NBE is accountable while not being subject to influence by government or industry. Ideally

[43] A full-fledged crisis situation can only be solved when the central bank and the Ministry of Finance cooperate. While the central bank is essential for giving liquidity support, it may only do so for solvent, but illiquid institutions. Any capital support for an insolvent too-big-to-fail-institution therefore needs to come from the budget. It is essential that both central bank and Ministry of Finance know beforehand their role, have established information sharing arrangement and have worked out a contingency workplan.

the board of a Central Bank should not have direct government representatives. If this is not the case, government representatives should not have executive powers.

Table 5: List of recommendations, grouped by priority – bank supervision and NBE

Nr.	Recommendation Pillar I bank supervision and NBE	Timeframe
Precondition to the next step in the program		
	GOE (PM, MOF, NBE, PEHA) to review the legal and regulatory frameworks to strengthen NBE independence in managing monetary policy and removing ambiuguities preventing NBE's full enforcement-power towards the government-owned banks whenever they breach prudential requirements. NBE independence should include proper accountability, a conflict resolution mechanism, and a transparency framework to ensure adequate checks and balances are in place.	Immediate
	To be able to perform proper systemic risk analyses, MOF, other relevant agencies and other departments of NBE should provide the banking supervision dept. with the necessary information. This includes at a minimum: data on government debt, budget, balance of payment, GDP and its components and information concerning important SOE's financial performance.	Immediate
	NBE to review its frameworks for salary and benefits including incentives, with the objective of increasing retention rate.	Immediate
High Priority – Short-term according to priority		
1	Move to Basel II, credit risk standardized approach and operational risk basic approach. Given the structure of the Ethiopian banking system and its inherent risks it should be supplemented with some features of Basel III, especially the capital surcharge for SIFI's, a leverage ratio next to the CAR and the LCR/NSFR as an additional liquidity requirement.	Within 1 year Within next 2 years
2	Move to a full risk-based supervision framework and align risk assessment with the CAMEL methodology.	Within next 2 years (together with Rec. 1)
3	Follow emerging international best practice and establish a macro-prudential authority with hard powers. Give this authority to NBE since it is already an integrated central bank/supervisor and therefore best prepared. Make the mandate explicit in the central bank law.	Within next 2 years
4	NBE Board to endorse establishment of a Financial Stability Department that will feed the FSC with analyses and policy recommendations. Since the FSD will act as a secretariat to the committee, it should fall directly under the governor.	Within next year
5	Develop a safety net with proper crisis management arrangements, and a bank recovery and resolution framework. Also, the lender-of- last-resort function at NBE requires modernisation.	Within next year
6	GOE to modernize the legal framework related to the NBE and change the relevant laws to support the financial sector reform plan. In particular: i. NBE governance should be brought to international best practice, limiting government's interference (ideally no government representative in the Board) ii. Empowering NBE with an explicit macro-prudential mandate and enabling it to apply the proper tools (CCB, LTV, LTI, D-SIB buffer etc). *iii.* Enhancing NBE's objectivity, intrusiveness, and enforcement powers against CBE and DBE. Including entrusting NBE with effective fit and proper test and removal power of CBE and DBE Board members appointed by the government.	Within next 2 years
Medium term according to priority		
7	Engage and invest in supervisory dialogue with the sector. More transparency regarding supervisory rules and decisions could greatly contribute to their acceptance. The current	Within next 3 year (with Rec. 1)

	practice of fining seems ineffective and should be reconsidered towards a risk-based approach.	
8	Consider unwanted and harmful side effects of regulation beforehand. This will be one of the tasks of the macro-prudential oversight function, to be built at NBE in the future. Additionally, NBE should consider using the Qualitative Impact Studies (QIS) to engage with the sector before issuing important new regulation.	Within next 3 years (with Rec. 1)
9	NBE Board to endorse establishment of a Financial Stability Committee, chaired by the NBE Governor. The FSC should bring together at high management level all relevant expertise to be able to take decisions and enforce them within the organisation.	Within next 3 years
10	Open the banking market to all foreign ownership and investment. Adopt a comprehensive strategy to build capacity in supervision of foreign owned banks. First, change the Banking Proclamation and legal framework accordingly by introducing supervision on a consolidated basis and endorsing NBE with the mandate to take seat in supervisory colleges.	Within 3 years
11	GOE and NBE to Set up a Deposit Insurance scheme.	3 years

III. Pillar II: Long-Term Finance & Monetary Policy

Overview monetary policy foreign exchange management and capital market

1. **The NBE's Monetary Policy (MP) and monetary policy implementation is complicated by multiple and sometimes conflicting objectives of the monetary policy framework.** The MP framework comprises monetary aggregate targeting, with a ceiling on reserve money as the operating target. Pricing in the market is determined by a range of administered interest rates, which in no way reflects liquidity conditions in the money market or liquidity and risk premiums. The minimum deposit rate acts as the de facto policy rate, but it is not clear how this rate is determined. Moreover, efforts to channel resources to priority sectors and the government through artificially low interest rates, including through the NBE overdraft facility, "27 percent rule" and regular provision of liquidity to state-owned banks have contributed to faster money growth and high inflation, complicating the achievement of monetary objectives. While there have been caps on bank lending rates in the past, currently banks have the discretion to determine the lending rate on loans and advances and can therefore pass the cost impact of the "27 per cent rule" and the mandatory minimum reserve requirement rate on to their private sector borrowers.

2. **A highly overvalued real exchange rate, poor export performance, low levels of international reserves, a widening gap with the parallel exchange rate and acute shortages of foreign exchange suggest large and growing external imbalances.** These problems are structural and long term and require reforms to address them. The *de jure* exchange regime in Ethiopia is a managed float, but *de facto* it is a crawl-like regime. In spite of controlled nominal depreciation aimed at maintaining the competitiveness of the economy, the exchange rate has been (and is) overvalued in real terms. Based on the IMF's estimates, the ETB was overvalued by 12-18 percent based on available data from September 2018 and this has likely grown given continued appreciation of the real exchange rate. Extensive restrictions and overvaluation of ETB have resulted in an increase in the parallel market premium to as high as 40 percent and other distortions, including remittances avoiding official channels to enter the country and long queues for FX. The gap between supply and demand of FX and parallel market premiums will only grow and queuing for FX will continue as long as the exchange rate is not in line with macro fundamentals.

3. **Ethiopia does not have a developed capital market but is working to establish one[44].** There is no market-based issuance of domestic government debt in Ethiopia. There is no formal equity market, however it has been announced that one will be established by 2020. The only non-government bond issuance is that of SOEs, which is also not market based. The money market is not functional. Pension and insurance sectors which can support demand for market-based issuance of government bonds are under-developed. The strategy implemented by the Government of Ethiopia (GOE) to issue government debt and finance infrastructure at rates below inflation and deposit rates, has created distortions for financial sector and capital markets development. The 27

[44] The NBE is receiving technical assistance from the IMF and the ADB to develop the capital market.

percent rule being a case in point, and the mandatory obligation for pension funds to only invest in government securities, currently at negative rates of return which may affect pension funds ability to meet future pension obligations. The Market infrastructure for capital markets does not exist and will need to be developed. However, Ethiopia has a well-functioning commodity exchange, the Ethiopian Commodity Exchange (ECX), whose trading and settlement platforms could be leveraged to support market development.

4. The following matrix provides an overview of the main issues with respect to different building blocks of the Ethiopian capital markets. Each element is further explained below.

Figure 6: Overview of the main issues related to Ethiopian capital markets

Money Market	Primary Govt Market	Secondary Govt Market	Market Infrastructure	Investor Base	Equity and Corporate bond Market
Instruments	Placement Method	Trading Platform	Dematerialization	Banks	Regulatory Authority
Transactions at government bond market price	Issuance Strategy	Post-trading information	CSD	Pension Funds	Tax, legal and regulatory Framework
GMRA/MRA/SBB	Benchmark size		ECX	Insurance Companies	Notification for OTC issuances
Reasonable haircut	Placement calendar		Tax, Legal and Regulatory Framework	Investment funds	Trading and Post Trading Infrastructure
				Foreign Investors	Intermediaries
				Retail Investors	

A. The Money Market

5. Money market activity in Ethiopia has been negatively affected under the current government funding model. In this market, participants trade short-term instruments with maturities of less than one year for liquidity management and investment purposes. Although a money market directive was implemented in 2003, it is still not functional and there is no regulatory framework. An interbank repo market does not exist, although there was one in the past. There is some limited uncollateralized interbank lending, with a longer tenor (~ 6 months) in the form of Certificates of Deposit, however the general lack of liquidity prevents further development.

6. Private banks are able to access liquidity from the NBE in the case of a shortage of liquidity. They can use Bills to cover shortfalls in liquidity and as collateral. However, the interest

rate is extremely punitive, being the maximum interest rate charged across the loan book of the bank seeking liquidity.

B. Primary Government Bond Market

7. No supply of tradable government securities exists currently in Ethiopia. The current supply of government debt instruments is composed of: Treasury Bills (T-bills) with a total outstanding stock of ETB 138.1 billion (June 2019); NBE Bonds (known in the market as NB Bills and the main funding tool used by the 27% rule) with a total outstanding stock of ETB 90.2 billion (June 2019); NBE advances to the GOE paid for by expanding the money supply (total outstanding stock as of June 2019 ETB 172 billion); and a substantial amount (approximately ETB 500+ billion) of SOE bonds. Bonds were also issued by the GOE in 2017 to recapitalize the CBE for an amount of ETB 27 billion.

8. All current issuances are traded at negative real rates to primarily captive investors[45]. The MOF issues T-bills on a weekly basis, on demand to the three public pensions funds. Pensions Funds are mandated to invest exclusively in T-bills (they cannot invest in bank deposits or any other asset). On a weekly basis, the pension funds inform the NBE of the amount of their pension inflows and MOF issues T-Bills equal to this amount. In June 2019, private banks were invited to participate in T-bill issuance. Some SOEs also invest in T-Bills (including DBE, predominantly in the 364-day T-Bill). The Grand Renaissance Dam Bonds issued by DBE for EEP to finance construction of the dam were issued to citizens and private entities, such as banks; and EEP corporate bonds were regularly issued to CBE. Both the GRD and EEP bonds to the CBE are guaranteed by the government.

9. A market-based government debt market will set the ground for broader development of capital markets, providing safer and relatively liquid investments to a broad array of investors. Government bond markets provide a yield curve, which then may be used to price corporate bond issues and the valuation of portfolios for investors. It also provides a basis for repo markets and a framework in which monetary policy may apply market tools for its policy objectives.

C. Secondary Government Bond Market

10. The secondary bond markets do not exist in Ethiopia for a number of technical and pricing reasons. Holders of government bonds do not want to trade bonds at market prices and

[45] T-Bills : Maturity and interest rate: 28 days at 1.25 percent; 91 days at 1.25 percent; and 364 days at 5 percent (aligned with the NB Bill rate); NB Bills : Maturity and interest rate: 5 years at 5 percent (increased in 2019 from 3 percent)/ interest paid yearly; NBE Advances to GOV : Interest rate of 3%; GRD bond: Holders of the bonds are citizens of Ethiopia. Bond 1 with a 5-year maturity and 5 percent interest rate has matured. Bond 2 has a 10-year maturity and 6 percent interest rate.

realize losses. On the other side, buyers are not willing to buy bonds below the market price, so trading of government securities is practically nonexistent. Securities are issued in the form of paper-certificates, i.e. are not dematerialized, and there is no CSD for government securities, making transactions more difficult. Their trading entails logistical and operational safety concerns. Ethiopia has no legal, regulatory, administrative or operational facilities for their trading, such as trading and post trading systems.

D. Market Infrastructure

11. Market infrastructure, essential for facilitating market-based issuance of government securities and secondary market trading and post trading, is not developed. There is no market-based placement method, such as auction and/or syndication; all Bills and bonds are currently issued in physical certificate form; and there is no central securities depository for bonds. The lack of trading venue, post trading and processing platforms make secondary market development difficult. With the establishment of a fully functional domestic secondary market for government securities, the government will be able to improve the price discovery and transparency of the domestic bond market.

12. It should be noted however, that Ethiopia does have a functioning exchange – the ECX. The ECX is fully government owned, has members that are commodity traders on the exchange, an electronic trading platform, and an electronic warehouse receipts depository that could be adapted to house the depository for capital markets securities. The legal framework for ECX has recently been amended to allow it to trade securities other than agricultural commodities, opening the potential to list equity securities. Leveraging the ECX platform could be a cost-effective way to establish necessary market infrastructure.

E. Investor Base

13. Some of the key sections of the investor base are already active in Ethiopia. With further development they could be harnessed to support the capital markets to fund government and the growing private sector.

14. The institutional investor base consists of three government pension funds and insurance companies. There are three defined benefit government pension funds, the Public Servants Social Security Agency (PSSSA), the Private Organization Employees Social Security Agency (POESSA) (both with contribution 18% of salary – 7% employee and 11% employer) and the Military and Police fund (contribution 25% of salary – 7% from employee and 18% from government). Given the negative real returns (against an inflation rate that has been between 10% and 14% in recent year) this implies, pension funds who are required to invest all assets under management in T-Bills, currently at 1.25 percent are at risk of not being able to pay reasonable future pensions obligations.

15. SOEs can invest in short-term T-bills, up to 182 days and DBE in 364-day T-bills. SOEs can only invest in 1.25 percent interest rate T-bills while DBE has the right to invest undisbursed funds into 364-day T-Bills at a rate reflective of the rate on NB Bills, currently 5 percent.

16. In June 2019, private banks invested in short dated T-Bills, at 1.25 percent. Although the return is far below the savings and deposit interest rates, they are investing the cash available in T-Bills as they don't have more profitable investment alternatives to manage liquidity. However, they mentioned their interest to invest regularly in T-bills and T-bonds at market-based interest rate.

17. Retail investors are already active in government infrastructure debt securities and in private share offerings and trading. They could be harnessed to develop the capital markets. The size of the potential retail investor base is not known, but with a population of 112 million it could be sizeable. The large funding needs of infrastructure led the MOF to facilitate the direct participation of retail investors in the primary market. Retail investors participated in the publicly offered Grand Renaissance Dam Bond, which was a sizeable issuance. Hence, they understand and are familiar with government securities issuance. Retail investors also participate in OTC share issuances, responding to advertisements for public share offerings placed in newspapers and on television.

18. Foreign investors are not allowed to participate in the capital market. Foreign investors typically invest in sizeable offerings, that are fairly liquid and require high levels of transparency and communication.

F. Corporate Bond and Equity Market

19. The public equity and corporate bond markets do not exist, there are no corporate bonds or equity shares registered for public offering and traded on a formal market in Ethiopia, but there are intentions to start their development. There is no legal and regulatory framework for this market nor the necessary market infrastructure. In addition, a securities market regulator to regulate, supervise and ensure confidence in the market does not exist. All these elements will need to be developed. A securities exchange could facilitate financing for private companies, provide an eventual avenue for the partial listing and privatization of SOEs, and create investible assets for pension funds that reflect Ethiopia's economy.

20. While expectations need to be managed with regards to time frame and sustainability of the markets, and reforms need to be sequenced, there are some positive indications regarding prospects for the development of the public equity market, based on:

- existing activity in the over the counter (OTC) equity offering market which could provide candidates for listing. It has been reported that real sector companies advertise share sales and conduct auctions on an over-counter basis, and that such shares are traded in an

informal market. Formalization of this market would strengthen investor protection and transparency;
- the existence of the ECX platform that can be leveraged;
- dispersed shareholdings of private banks that lacks price formation. Private banks have a dispersed shareholder base and expressed interest in having a secondary market trading platform for shareholders to be able to buy and sell bank shares at a transparent and market-based price;
- Eventually using the stock exchange platform for the partial listing of SOEs would bring governance and transparency benefits; and
- the size of the economy.

21. The potential for corporate bond markets in the short term is less certain, requiring first the development of the government debt markets as mentioned above.

22. There is some OTC secondary market trading of equities. Existing shareholders of private banks are able to sell their shares to other existing shareholders. Trades are negotiated bilaterally between shareholders, and the transaction is submitted to the bank's Board Secretariat for documentation in the shareholder registry. Secondary market share trading of real sector companies reportedly takes place at an informal but centralized venue. There are no regulations governing this trading and no oversight of the market.

G. Intermediaries

23. Licensed market intermediaries for the government debt markets do not exist and would need to be licensed to facilitate both primary and secondary government markets. The NBE will license, regulate, and supervise these intermediaries. It would be practical for the NBE to license private banks as the initial group of market intermediaries for government securities. Although informal intermediaries exist on the OTC share market, a class of licensed, regulated and supervised intermediaries would be necessary to prevent misconduct in the formal listed equity and corporate bond markets. For corporate securities, possible brokers could be private banks or trading members of ECX.

Recommendations development of capital markets

24. Comprehensive reforms are needed to modernize the monetary policy framework. Elimination of the 27 percent rule complemented with creation of a market auction for government securities will support the creation of liquid market instruments needed to modernize the monetary framework and meet monetary objectives more efficiently. The NBE should gradually phase out its reliance on direct instruments and develop indirect MP instruments which will focus on overnight rates as the trigger for effective monetary policy transition and the pricing of other financial market instruments and to establish the basis for further financial market development. The NBE should design a basic, transparent liquidity management framework, including regular Open Market Operations and Standing Facilities. The current practice of lending on an ad hoc

basis at each bank's maximum lending rate, even when banks have eligible collateral, is unduly punitive and should be replaced by a Standing Facility which provides liquidity automatically at banks' request available for overnight loans only – at a fixed margin over the central bank's policy rate – and with clear ex ante collateral requirements. The gradual adoption of the common international practice of averaging on reserve requirements would allow banks to meet the reserve requirements on average over the maintenance period. In order to transit to a price-based monetary policy implementation framework the NBE should formalize its monetary policy rate and use market operations to allow transmission to market rates. Development of a monetary policy communication strategy is also needed to increase the effectiveness of policy transmission.

25. While reforms to boost exports and FDI and stimulate inflows from the diaspora will help increase FX supply, it will need to be coupled with NBE policies to address the overvaluation in a durable manner. A gradual alignment with market fundamentals and eventual increase in flexibility should be accompanied by the appropriate macro policy settings to achieve inflation targets and explained to the public with careful communication and education efforts. In addition, the NBE should start a review of all FX regulation to support the process of gradual liberalization of FX market.

26. World Bank Group research has shown that emerging market countries with robust government bond markets were better able to manage the 2008 global financial crisis, averting major economic dislocations and helping firms and citizens maintain financial solvency and liquidity. In Ethiopia the development of local capital markets done under condition of prudent macroeconomic management, regulation, and investor protection can increase access to local currency financing and thereby help manage foreign exchange risk and inflation and provide benefits at the macroeconomic level by serving as a channel for managing liquidity and money in the economy.

27. The action plan to develop government bond markets is specific to Ethiopia and is comprised of key building blocks. Development of a Medium-Term Debt Strategy (MTDS), based on which governments draw guidelines on the level of exposure to domestic vs. external debt and on the overall profile of the government debt is important, publishing an auction calendar to enhance the transparency and predictability, extension of the maturity profile to reduce the refinancing risk, benchmark building to enhance price discovery, and yield curve development are key steps in developing the government debt markets. However, this roadmap focuses on the more immediate steps necessary to move to market-based financing of government. These are focused on developing efficient primary markets – to improve price formation, transparency and predictability in the issuance of government securities, and to promote competition; a sound legal, regulatory and market infrastructure framework to ensure investor protection and enhance cost-effective access by different types of investors; and a diversified investor base to secure financing of the public debt and enhance the potential liquidity of the bond market; and sound secondary market architecture to build the liquidity of government securities.

28. The path for development of Ethiopia's capital markets will require adequate sequencing across different components: (i) government debt markets and money markets; (ii) equity markets; and (iii) corporate bond markets. Experience in a broad range of countries has shown that there is path dependence and sequencing in the development of capital markets, which usually starts by developing market-based government bond markets that provide a supportive enabling environment (for example, for liquidity management and price references) for the launch of private sector instruments such as corporate bonds. Actions to support the development of equity markets may be contemplated in parallel but require an analysis to direct policy-makers on the right scope and potential for a cost-effective locally based securities exchange. In addition, close coordination and cooperation of the key stakeholders will be essential including between the MOF, the NBE, the Ministry of Trade (MOT) (as the ministry responsible for ECX), and the ECX to create the conditions to start capital markets activity in Ethiopia.

a) Develop the money market

Developing the money market will provide instruments for the NBE for liquidity management and anchor the short-term side of the yield curve. It allows banks to access liquidity when needed. The actions recommended to develop the money market include:

- Developing a regulatory framework for the money market;
- NBE to accept T-bills/bonds as collateral from banks seeking liquidity at a market-based rate and with a moderate haircut, instead of at the maximum rate on the bank's loan book, and on a regular basis (daily or weekly). The rate would need to align with the issuance rate of the bills and bonds.
- Analyzing the possibility of introducing a Global Master Repurchase Agreement (GMRA) agreement for the market, which allows for collateralized lending. As this may be too advanced for the financial sector at first a secure system of collateral management that allows local banks to do secured/collateralized lending between themselves could be developed first. This is often facilitated by the central bank at the start of market development. Alternatively, local repo agreement or sell-buy back (SBB) agreement, that allows the functioning of the money market, could be introduced.
- Once collateral is secured, an instrument to facilitate lending can be developed.
- Develop a recognized money market reference rate

b) Market Based issuance of government debt

29. GOE should move to market-based issuance of government debt, with a clear understanding of fiscal constraints in order not to disrupt financing. To determine the best strategy for doing so, an analysis of the funding implications under various scenarios for market-based debt has been undertaken by the WBG team based on current and forecast funding needs of government – to quantify costs. A scenario in which the gradual phasing out of NBE advances and increase of interest rates over a period of three years was analyzed to estimate the additional fiscal cost. It includes a scenario for phasing out of the 27 percent rule over 3 years(see Annex II).

30. This measure should, however, only be undertaken in conjunction with progress on the ongoing SOE debt restructuring, that will have fiscal implications for the GOE. The development of a new strategy for SOE and SOB funding, including EEP, CBE and DBE would be a part of their restructuring/new business model development.

31. Once the strategy has been implemented, and the entire stock of the current treasury bill issuance has been replaced with T-Bills sold at market rates, T-Bonds should be introduced at market rates. It is recommended to start with issuance of T-Bonds with medium term maturities of 2 years, and then 5 years. The curve could be slowly extended as the market develops. Overtime benchmark bond creation, the issuance of bonds with the same maturity dates to increase market depth, will be undertaken.

c) Market infrastructure to be modernized

32. Establishing efficient market infrastructure would increase the functioning of both the primary and secondary markets. It would increase liquidity and allow for improved and effective market supervision. The cost of setting up the infrastructure could be an obstacle to its development, therefore leveraging the existing systems of ECX systems would help. Connectivity costs could also prove substantial, however once again ECX has an electronic payment system already set up with the banks. A lack of capacity to build and manage such infrastructure is also of concern, however ECX has expertise in this area.
The following are areas to consider when setting up the necessary market infrastructure:

- **Creation of CSD:** A central securities depositary will be necessary to house dematerialized securities and provide post trading clearing and settlement services. One could be set up from scratch by the NBE, or the ECX depository could be developed to cater for all securities and not just commodity warehouse receipts. Many countries that set up two depositories have been analyzing a potential merger to gain efficiency. It should be considered whether the ECX depository is placed in a separate legal entity, which the NBE could have part ownership of, to reflect its interest in the safekeeping of government securities.
- **Immobilization[46] and dematerialization[47]:** Newly issued securities should be issued in electronic form and not in physical form and immobilized securities dematerialized. This will facilitate development of a secondary market for the trading of government instruments. Traded securities are transferred by electronic book entry in the depository[48]. *The legal framework may not allow for immobilization, and this should be addressed as a priority.*

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[46] Immobilization is the depositing in the custody of a CSD outstanding paper certificates, which would need to occur in Ethiopia for NB Bills. Immobilization makes the physical transfer of securities unnecessary and the process more efficient. It reduces operational errors, lowers transaction costs and facilitates secondary market trading.
[47] Dematerialization is the conversion of immobilized securities into electronic form. Dematerialization will allow the market to achieve straight-through processing (STP) by electronically connecting automated trading, clearing, settlement and custody systems.
[48] It must be noted that warehouse receipts traded on the ECX are in electronic form, and thus there is experience of electronic securities in Ethiopia.

- **Trading platform:** Trading platforms for all instruments will need to be set up. Once again, it should be considered whether to use the existing ECX system, which will require modification to allow for trading of financial securities. The cost effectiveness and appropriateness of the platform should be considered as key priorities when deciding on a platform.
- **Create (or improve) the connectivity:** among trading, clearing, settlement and depository systems and market participants.
- **Legal and Regulatory framework for market infrastructure:** Review the legal and regulatory framework for market infrastructure.
- **NBE to develop a licensing framework for intermediaries:** NBE could license private banks as the initial group of market intermediaries for government securities.

d) Expand and Diversify the Investor Base

33. Once market-based issuance occurs, actions by the authorities will need to be taken to attract investors to the market. If the actions recommended above are not accompanied by efforts to develop the investor base, there is a possibility that demand for market-based instruments would not be sufficient. As corporate markets are being developed, the investment rules for pensions and insurance companies will need to be amended to allow investments in assets other than T-Bills, as their current regulation only allows allocations in government securities. More access to information would increase investor confidence and therefore the demand for government bonds. In general, a diversified investor base tends to reduce the volatility of bonds in turbulent scenarios. They would create conditions for secondary market development.
Actions to assist in the development of the investor base include:

- **Improve the quality of information** (annual borrowing plan, auction announcements and results, relevant fiscal information etc.), on an annual, monthly, weekly and daily basis. This would increase the transparency and predictability of the market, giving investors more confidence;
- **Engage closely with broader investor base:** During process of design and through announcement of strategy to enhance predictability and stimulate demand (e.g. announcement of an annual borrowing plan); MOF – to conduct regular meetings with market participants (banks, pension funds, insurance companies, etc.);
- **Transparency:** Be as transparent as possible to avoid risk of collusion;
- **Expand distribution channels**: to facilitate access to a diverse range of investors. Introduce a strategy targeted at expanding distribution to different investor segments (banks, NBFIs, retail investors).
- **Review pension fund investment limits:** Pension fund limits should be reviewed to allow them to invest in a broader range of instruments, including equities, non-government bonds, money market instruments and bank deposits. This will allow them to diversify their portfolios to allow for improved sustainability, higher returns and risk management. This will also allow them to support capital markets development, and funding of the private sector through the public equity market.

- **The tax, legal and regulatory framework:** need to be reviewed carefully to permit full access to all segment of investors. Evaluate and adjust the tax and accounting framework to stimulate the market if necessary, to create incentives for investors and a level playing field among instruments. A balanced framework helps to expand and diversify the investor base, potentially increases demand, price discovery and reduces the premium paid by the issuers. A clear framework is particularly important to attract foreign investors as well as to avoid tax and regulatory arbitrages.

e) Corporate Bonds and Equity

34. The agenda for the development of corporate bond market and equity markets generally builds on progress in developing deeper government bond markets, a more diversified investor base and sound regulatory frameworks and market infrastructure. Building a reliable government bond yield curve, will create a reference interest rate curve allowing more effective pricing for the issuance of corporate debt securities and for their valuation in the investors' portfolios. Issuance of SOE bonds and partial SOE equity listing could be considered over the medium to long-term as a means of allowing entities including DBE and CBE to raise funding from the market instead of using government support. In order to issue, SOEs and SOBs will need to be reformed to establish the governance and financial transparency required by voluntary investors in these markets. As discussed, there appears to be some potential for the establishment of the equities market.

35. A vision for the scope and potential of the equity market should be agreed and a feasibility study undertaken to determine the sustainability of a securities exchange. Given the significant resources and efforts in building a market, the analysis should look at various cost-effective means to set up the exchange (e.g. leveraging the existing ECX platform). Based on the findings, a roadmap for the implementation of the exchange could be developed. The following topics and guidance should be considered when undertaking the feasibility study:

- **Regulatory authority:** As a first step, an entity should be established or appointed as the regulator and supervisor of the equity and corporate bond market to ensure that investors are protected, that markets are fair and transparent, and to reduce systemic risks[49]. The regulatory authority should embody the four pillars of good regulatory governance: independence, accountability, transparency, and integrity[50]. International experience shows that there is no single best approach to regulatory architecture. The NBE should conduct a cost-benefit analysis of various models of regulatory architecture to determine a set up optimal for Ethiopia's circumstances with respect to efficiency, accountability, and quality of prudential and business conduct supervision. The future pensions and insurance regulator should also be considered in the analysis[51].

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[49] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf
[50] http://documents.worldbank.org/curated/en/656541468151790948/Governance-of-securities-regulators-a-framework
[51] http://www.iopsweb.org/WpNo16Web.pdf

  - Possible entities for consideration as the regulatory authority are: the NBE, the ECX Authority, a new authority established under the authority of MoF, a new independent entity. As the ECX authority currently reports to the Ministry of Trade, this may not be the most suitable regulator for financial market instruments. It is recommended that either the NBE or a newly established authority (either independent or potentially reporting to the MoF) is appointed as regulator of the securities markets. NBE will continue to have oversight of primary government bond markets.
- **Legal Framework:** Once the regulatory authority has been appointed, the legal framework should be assessed as to what gaps remain with respect to the corporate markets.
- **OTC issuances:** At the start requirements should be placed around private or OTC offerings that are currently being conducted. The regulatory authority should require notice of all private offerings. It has been reported that certain of these offerings are raising issues and concerns with respect to investor protection. Investors in these cases are seeking support from the Ministry of Trade as the Ministry under which the ECX falls. The securities regulator can only regulate such offerings if it has notice of them.
- **Regulatory and supervisory Framework:** A regulatory and supervisory framework for the market should be developed that includes: the listing of companies (including listing rules, disclosure obligations, approval processes); market operators, intermediaries etc.
- **CSD** (see also Annex II part B)**:** It should be assessed whether it is better to leverage the ECX settlement infrastructure (recommended) or create a new CSD for financial instruments. If the ECX infrastructure is to be leveraged, then the best structure for the CSD should be considered. As the ECX is government owned the CSD could remain part of ECX. Alternatively, the CSD could be spun off as a separate legal entity under the ECX umbrella which would allow the NBE to have an ownership stake, which would give it oversight as the regulator for the government securities markets.
- **Trading Platform:** Consideration should be given to the most cost-effective way to introduce a share trading platform in a reasonable time including leveraging of the ECX electronic trading platform be leveraged to allow for share trading. The ECX law allows for the trading of shares. The legal structure of the exchange should be considered. It may be preferable to separate out the stock exchange entity from the commodity exchange entity. A structure whereby a holding company for the ECX (Commodity Exchange), the Ethiopian Stock Exchange and the CSD could be considered. The governance and ownership structure of these entities will need to be considered, with an eye to potential privatization of the exchanges.
- **Licensing of intermediaries:** The regulator would be responsible for the licensing and supervision of intermediaries for equities and corporate bonds. These are likely to be banks, trading members of ECX and potentially arrangers of OTC share issuances. The legal and regulatory framework would need to allow for the licensing and supervising of intermediaries.

Table 6: List of recommendations grouped by priority – long-term finance /financial markets

Nr.	Recommendation Pillar II Long-term Finance & Financial Markets	Timeframe
Precondition		
Adopt and implement strategy for phasing out the 27% rule – see Pillar I table 6 rec. 1		
Immediate		
•	GOE, MOF and NBE to agree on strategy for market based issuance	Immediate
High Priority – Short-term according to priority		
1	NBE to develop Money Market regulatory framework	1 year
2	NBE liquidity window at a market-based rate with a moderate haircut, to develop money markets	1 year
3	MOF and NBE to implement strategy for T-Bill issuance, develop auction system, issue T Bills	1 year
4	Immobilization and Dematerialization of physical certificates into electronic form	1 year
5	NBE to develop legal and regulatory framework for market infrastructure for government bonds	1 year
6	NBE to develop licensing framework for government bond market intermediaries	1 year
7	NBE and MOF to engage with broader investor base during process of design and through announcement of the strategy; MOF – to conduct regular meetings with market participants (banks, pension funds, insurance companies, etc);	1 year
8	NBE and MOF to adopt and enforce transparency to avoid collusion	1 year
9	NBE to conduct feasibility study and roadmap for equity market	1 year
10	MOF and NBE to establish legal framework for the securities markets	12- 18 months
11	Securities market regulator to require notice of OTC issuances	12-18 months
Medium term according to priority		
12	MOF and NBE to establish securities regulatory and supervisory authority for equity and corporate bond market	2 years
13	NBE to develop tax legal and regulatory framework for investors	18 – 24 months
14	NBE to introduce Introduce GMRA or SBB to allow for collateralized lending, to develop the money market	Within 2 years
15	NBE to create CSD – see also Annex II part B	2-3 years
16	NBE to develop lending instrument for money market (once collateral is secured)	Within 2 years
17	NBE to develop Money Market reference rate	Within 2 years
18	MOF and NBE to issueT bonds at market rates, beginning with medium term maturities of 2 and then 5 years	Within 3 years
19	NBE to create a trading platform for government securities	Within 2 years
20	NBE to create (or improve) market connectivity: among trading, clearing, settlement and depository systems and market participants.	Within 3 years
21	MOF and NBE to improve quality of information (annual borrowing plan, auction announcements and results, relevant fiscal information etc.), on an annual, monthly, weekly and daily basis.	Within 2 years

22	NBE to expand distribution channels to facilitate access to a diverse range of investors by introducing a strategy targeted at expanding distribution to different investor segments.	Within 2 years
23	NBE to review institutional investor limits	Within 2 years

IV. Pillar III: Access to Finance and Financial Inclusion

A. Financial Inclusion in Ethiopia

Overview

1. **The GOE has been committed to enhancing financial inclusion over the past 5 years.** With the aim of expanding financial inclusion in Ethiopia, the Government launched a National Financial Inclusion Strategy (NFIS) in October 2017. The headline indicator for the strategy is to increase the percentage of adults with a transaction account to 60 percent in 2020. The strategy outlines digital financial services as a driver for financial inclusion and it sets an ambitious target to increase uptake of electronic payment by adults to 40 percent in 2020 (up from 6% in 2015). To meet this indicator, on the supply side, the strategy envisages to increase the number of ATMs, POS machines, and agents per 100,000 adults to 25.4, 120.4, and 229.4, respectively.

2. **Despite making progress in expanding financial inclusion two- thirds of Ethiopian adults do not have a transaction account.** In 2017, the percentage of adults with an account rose to 35 percent, up from 22 percent in 2014 (Findex2017). Account usage has improved as well. Now 26 percent of adults save at financial institutions (as compared to 14% in 2014) and 11 percent borrow from financial institutions (as compared to 7% in 2014). Despite this increase in account ownership, Ethiopia lags its neighboring countries. In Kenya, for example, 82 percent of adults have an account, while in Rwanda, account ownership stands at 50 percent. And in the region overall, 43 percent of adults have an account.

3. **People rely more on informal institutions for their financial needs.** Although 62 percent of Ethiopians reported saving money in the past year, only 26 percent saved formally at financial institutions, while 38 percent saved with a person outside of a family or at an informal savings club (for example Iqub[52]). During the same period, 41 percent of Ethiopians said they borrowed money, but only 11 percent borrowed from financial institutions. The rest borrowed from family or friends (31 percent) and 8 percent borrowed from a savings club.

4. **The gender gap is widening.** Women account for a disproportionate share of the unbanked and, the gender gap jumped from being negligible in 2014 to 12 percent in 2017. Account ownership among men has nearly doubled in three years, but for women it has increased by only eight percentage points. Today, 41 percent of men have an account, compared to 29 percent of women, whereas in 2014 account ownership was essentially even, with 23 percent of men and 21 percent of women with an account.

5. **The socio-economic and rural/urban gaps are high with wealthier adults twice as likely as poorer ones to have an account.** Among adults in the richest 60 percent of households

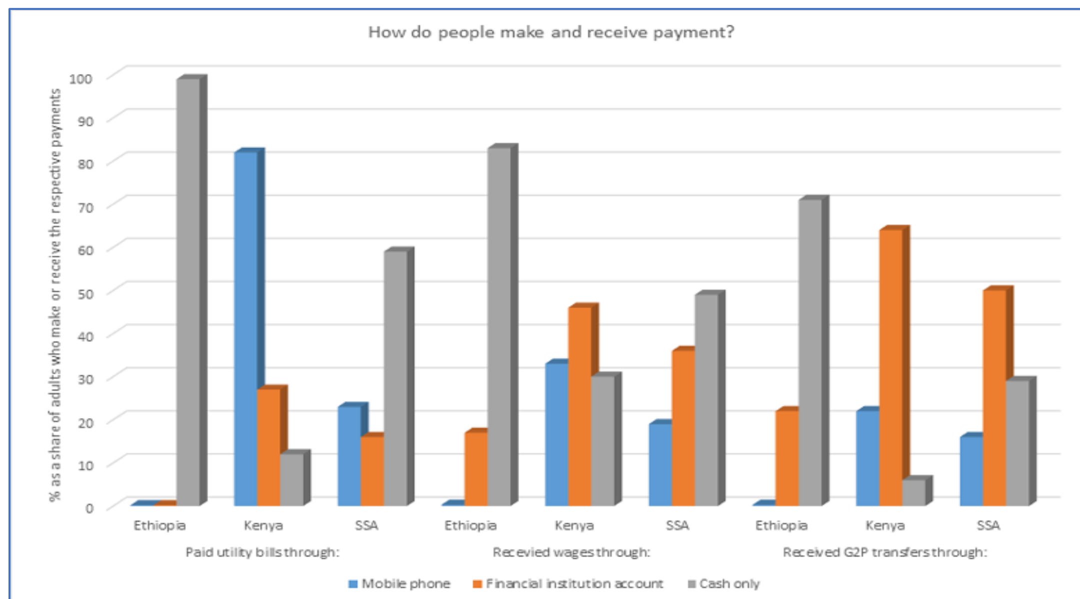
[52] Iqub is a rotating saving and credit association where each member agrees to regularly pay a small sum into a common pool so that each, in rotation, can receive one large sum

within Ethiopia, 43 percent have an account as compared to 22 percent account ownership among the poorest 40 percent of adults. In general, women, rural, less educated, unemployed, and poorer adults are less likely to own an account. This seems to signal a perception among adults that 'financial services are not meant for the poor.

6. 'Insufficient funds' is reported as a key barrier for financial inclusion. Of the total unbanked adults surveyed, 85 percent reported insufficient funds as a reason for not opening an account.' Distance (cited by 20% adults) and lack of documentation (cited by 11% of adults) were mentioned as the second and third barriers for financial inclusion. The cost of financial services doesn't seem to be much of a barrier, cited by only 5 percent of adults without an account. This is not surprising considering that banks and microfinance institutions (MFIs) provide, free of charge, basic financial transactions like opening an account and making deposits and withdrawals. The minimum balance to open an account is less than a dollar (Birr 25).

7. Cash is an overwhelmingly dominant payment method. Most people still rely on cash to pay utility bills and receive payments. Almost all (99%) adults pay utility bills with cash, compared to 12 percent of people in Kenya and 59 percent in the region.

Figure 6: Payment methods



Source: Global Findex database

8. Ethiopia is an outlier among its peers when it comes to access to and usage of digital financial services. Ethiopia hasn't taken advantage of digital financial services (DFS) that have driven access to and usage of financial services in Sub-Saharan Africa, as illustrated in the table below.

Table 7: Usage of Digital financial services Ethiopia and other comparators

	Ethiopia	Kenya	Rwanda	SSA Average
Mobile money accounts (in %, age 15+)	0.3	73	31	21
Debit card ownership (%, age 15+)	4	38	5	18
Made or received digital payments in the past year (%)	12	79	39	34
Paid utility bills using a mobile phone (out of adults who paid utility bills)	0	82	44	23
Paid utility bills using an account (out of adults who paid utility bills)	0.2	85	48	31
Received wages into an account (out of adults who received wages)	17	68	33	45
Received payments for agricultural products into an account (out of adults who received ag. payments)	1	46	14	
Used a mobile phone or the internet to access a financial institution account in the past year (out of adults with a financial institution account, age 15+)	1	57	13	24

Source: Global Findex database

Housing finance

9. A recent WBG study[53] indicates housing finance is underdeveloped in Ethiopia impacted by the government-led model of land allocation that exhibits multiple inefficiencies and limited land transfers to the private sector. Constraints of the current government land allocation system on development of the housing finance market and access to finance include, inability of the market to accurately price land, help financial institutions to assess the value of the proposed collateral and take risk, and help borrowers to make educated decisions. The private sector – households and firms – has little direct access to formal land supply because the majority of the land is allocated for government-led priority programs such as Integrated Housing Development Program (IHDP) or government uses. There is a noticeable lack of developer and construction financing on the supply side; on the demand side, most formal mortgages are originated through the IHDP program which is not affordable to 40 percent of the population living at the bottom of the pyramid. Consequently, most of the housing is financed through informal channels. Although banks are growing their loan books, they are still unable to offer affordable products to regular clients. This is primarily due to the high risk associated with mortgage lending and a lack of long-term funds. MFIs should not be overlooked, as they have considerable presence in Ethiopia and are gaining market share in home loans.

[53] Unlocking Ethiopia's Urban Land and Housing Markets, the WBG, 2019.

Recommendations to expand financial inclusion in Ethiopia

10. **Promote digital approach to financial inclusion:** Digital financial services are critical to expanding access, ownership and usage of a broad range of financial services and to reaching the unserved and underserved segments of the society. The G-20 high level principles for financial inclusion stresses the need to promote digital financial services (DFS) as a priority to drive development of inclusive financial systems. To take advantage of changes in the regulatory environment and to reflect the role of digital financial service as a driver for financial inclusion, it is recommended to refresh the existing national Financial Inclusion Strategy. Development of a digital ID system will spearhead uptake and usage of digital financial services and increase financial inclusion.

11. **Diversify financial products and services:** Despite recent positive developments in the supply of financial services, there is a need for a greater diversity of financial products targeting underserved segments of the society. Financial products such as factoring, leasing, digital payment services, early stage equity financing for startups, micro insurance, and affordable housing finance, must be either further developed or started afresh (in the case of factoring[54]). Given a Muslim population of more than one third of the total population, there is significant demand for sharia-compliant financial services which needs to be further developed. Along with a less constrained private banking sector and re-vamping of the DBE there is opportunity to develop several new financial tools and services to enhance intermediation and support private sector growth.

12. **Financial literacy and consumer protection:** Sound financial consumer protection framework and a dispute resolution mechanism are fundamental to maintaining transparency and trust in the system while increasing financial access. To this end, the NBE, with the support of the WBG, is drafting comprehensive directives for financial consumer protection covering all main topics of consumer protection and applicable to all entities regulated by NBE including MFIs. In addition, key fact statements (KFS) for are being developed for savings accounts, fixed deposits and fixed term loans, in order to provide transparent, easy, accessible information to consumers to help them compare and choose appropriate products for their circumstances. The NBE should also explore options, including establishment of a financial ombudsman service to offer an impartial and objective means for settling disputes between financial institutions and their customers. The immediate priority will be to finalize and put in place the financial consumer protection directives and the KFSs. The NBE, with close support from the WBG, has already drafted a National Financial Capability Strategy and the immediate next steps will be to launch the strategy and implement it jointly with other stakeholders.

13. **Lastly, it is worth noting that with the appropriate level of support and access to capital markets, Ethiopia's nascent housing finance system has the potential to mature into a dynamic marketplace, attracting both local and foreign investment and increasing private sector housing supply dramatically.** The Federal government, through MOF and NBE, should spearhead the development of the housing finance system. Building the housing finance system is

[54] There is no regulatory framework for factoring or invoice financing.

essential for the broader housing market because it encourages supply through development and construction loans, and it supports demand by enabling households to purchase their own homes with mortgage products. The government should initiate reforms to remove main blockages within the housing finance system. Basic institutions need to be in place for the market to effectively manage risk and price housing. NBE should expand its banking supervision activities, and government should introduce measures to increase transparency and the flow of market information, and hence confidence in the real estate and construction sectors. Banks and MFIs need access to long term capital, as well as support to go down-market. Households should be encouraged to leverage their savings, and government should support the creation of specialized housing finance products to meet underserved market segments.

Table 8: List of recommendation grouped by priority – financial inclusion

Nr.	Recommendation – Financial Inclusion	Timeframe
Financial Inclusion		
1	NBE to refresh the National Financial Inclusion strategy to accomodate recent developments in regulatory enviroment and in recognition of DFS as a driver for financial inclusion. In the medium term enable through regulatory framework the financial industry to diversify products and services which are tailored to unserved and underserved segments of the society (eg. Micro loans, micro insurance, digital payment, factoring, etc...)	Within 1 year
2	Issue a Financial Consumer Protection Law and enforce financial institutions to implement key fact statements for major banking products (eg. Savings Accounts, Fixed Deposits and Fixed Term Credit	Within 1 Year
3	Launch a National Financial Capability Strategy for Ethiopia and start implementation	1 year
4	Implement tiered account opening	Medium term
5	MOF and NBE, to spearhead the development of the housing finance system.	Medium term
6	NBE to work with the sector to develop new financial products including through new role for DBE to support growth of the sector and facilitate improved intermediation.	Medium term

B. Payment systems

Overview

14. Payment systems in Ethiopia were radically modernized in 2011, when the NBE launched the Ethiopian Automated Transfer System (EATS), a modern digital clearing and settlement system. The parliament of Ethiopia issued the National Payment System (NPS) Proclamation No. 718/2011. It aims to provide effective guidance for the NPS and covers areas like, Central Bank authority over the NPS, finality and irrevocability, designation/licensing/authorizing Payment System Operators and service providers, and Other provisions. The Proclamation delegates the authority of enforcement to the NBE which then has the power to release regulations on topical issues as they arise. The NBE issued Regulation of “Mobile and Agent Banking Services” in 2012, and a number of circulars in 2013 and 2014 on mobile money services.

15. Government use of digital payments lacks harmonization, leadership, and consistency. The major "government to person" G2P payments (salaries, pensions, suppliers, and subsidies) are not digitized or operate in a limited way, and the same for government collections from persons (P2G) and businesses (B2G) (taxes, customs, and fees). Any modernization in government payments and collections can catalyze the development of the whole digital payments landscape in the country and should be encouraged.

16. The payment systems infrastructure is owned and managed by the National Bank of Ethiopia (NBE) and it includes a real-time gross settlement (RTGS) system, which provide facilities for the final settlement of payments between banks. The automated clearing house (ACH) system, to be used for the clearing of retail payments, is not yet operational. The national e-payment switch, EthSwitch, was launched in 2016, with the goal of allowing the interoperability of automated teller machines (ATMs), mobile money and, point of sale (POS) networks.

17. The NBE has fully completed the implementation of the RTGS. Such a system is aimed at settling in real time any payment above the amount of ETB 200,000. The direct participation in the RTGS is currently allowed only to banks, while other institutions can have indirect access via an authorized participant.

18. The NBE is currently working on the implementation of the ACH Credit Transfer system. Such a system would allow the clearing and netting of high-volume, low-value payments below the amount of ETB 200,000. An ACH system allows clearing of bulk, low-value interbank payments, including credit transfers, and direct debits. By end of business cycle, an ACH system creates the summary of the net settlement positions of the different participating entities, consolidates and typically submits to the RTGS system for final settlement. This infrastructure is a critical element to foster the development of electronic payment instruments and services in Ethiopia, as it would increase the efficiency, interoperability and cost-effectiveness of payments for both the private and the public sector.

19. The EthSwitch is the domestic interbank card switch that banks launched in 2016 to fully integrate ATM and POS networks. EthSwitch is equally owned by all the banks and it has recorded ETB 6 billion worth of transactions among the banks during the 2017 fiscal year, a large increase from the previous year. The system enables all cardholders to use any of the ATM terminals in Ethiopia, irrespective of the bank, for an ETB 5 service fee for every ETB 1,000 worth of withdrawals. The fees generated through the use of the service are split between acquirers, EthSwitch, and the NBE. The system is currently active for ATM switching, but the platform for mobile payments interoperability is yet to be introduced and integrated with service providing banks. Cleared positions are settled the next day via the RTGS at the NBE.

20. The activities of money transfer operators (MTOs) in Ethiopia are limited. MTOs can offer their services only through banks or other financial institutions licensed by the NBE, which then act as the distribution network of the MTOs. MTOs are prohibited from offering their services

“directly”, through a proprietary network of agencies, or from establishing franchised services in retail stores, supermarkets, or other outlets. Hence, the distribution network is available only through commercial bank branches in main cities, and access points hardly exists in rural areas.

21. Bank branches, ATMs, and POS terminals are important access points to achieve financial inclusion. In Ethiopia, the domestic banking infrastructure is concentrated in urban areas: access points and non-cash payment instruments are available only in certain areas. In rural and remote areas, the banking sector has very limited coverage and the connectivity challenges are still preventing the development of digital alternatives. There are more than 2,700 operational ATMs and 8,800 POS terminals in Ethiopia, owned by both the state and private banks. In 2017, the 19 banks operated via approximately 5,500 branches. Overall 33 percent of bank branches and 50 percent of ATMs are in Addis Ababa where only 3 percent of the population live. The POS terminal network in the country is much less extensive than in other countries in the region. Finally, in 2019, the overall number of agents can be estimated around the limited amount of 10,000. Considering the large population of Ethiopia and the flow of remittances, the number, availability and distribution of service locations appears to be still very narrow.

22. Despite the many steps taken by the NBE to develop oversight of payment systems and services, there is room for improvement. Oversight aims at safety and efficiency of payment systems and services, financial inclusion, financial consumer protection, ensuring competitive market conditions, avoiding market fragmentation, and keeping trust in the financial system as part of trust in the currency in general. The scope of development in oversight should include review of existing regulations, recommendations on updates or amendments to those regulations, capacity building of payment systems staff, development of procedures for the oversight unit, and development of off-site reporting and on-site inspection processes. Technical assistance on payment system oversight will be provided by the WBG over this fiscal and next fiscal year.

23. Considering the large population of Ethiopia and the flow of remittances, the number, availability and distribution of service locations appears to be still very narrow. There is good remittance price transparency in Ethiopia however financial consumer protection and dispute resolution mechanisms are lacking. Although the payment system has undergone significant modernization – most remittances are terminated in cash. Consumer preferences and low financial inclusion levels contribute to why inward remittances continue to be predominately terminated as cash with beneficiaries collecting funds at bank branches most of which are in urban centers. Terminating international remittances in bank accounts on the other hand will impact positively foreign exchange flow in to the country. Opportunities to terminate international remittances transactions into bank accounts and/or other transaction accounts will be further enhanced once the ACH is fully functional with all banks directly participating.

24. Agent banking and other methods are not being utilized to improve access to financial services including those used to deliver international remittances. Whilst agent banking has been introduced, few banks have used it to develop their footprint in other parts of the country.

MFIs are well placed to serve the population of Ethiopia with 885 branches, predominately in rural areas however, they are currently only permitted to participate in the remittances market, as a sub agent of a banking partner.

C. Fintech

25. The Ethiopian Fintech market is nascent, and fintech companies are mainly providing digital payment services. BelCash and MBirr (both foreign investment), work directly through banks or MFIs, others like Ride and YenePay provide their services as mobile applications or web sites directly to the public. They provide basic mobile payment services including cash-in/cash-out services and domestic person-to-person (P2P) transfers. Uptake is increasing with a combined number of around 800,000 accounts managed by Banks and MFIs. MBirr, has already developed a service for the provision of government social payments for about 750,000 households and both MBirr and BelCash are supporting the objective of financial inclusion through the mobile phone and person-to-person (P2P) transfers

26. The lack of traction within the mobile money market is in part due to the bank-led approach to licensing services providers and low coverage and penetration of mobile services in the country. Fintech companies are typically licensed by the Ministry of Trade and Ministry of Innovation and Technology which implies a license for a technology provider not a financial service provider. Consequently, the NBE which does not license the technology providers, tends to outsource the due diligence of those providers to commercial banks who work directly with those providers. This approach leaves the fintech companies in an ambiguous position and creates a gap in understanding the risks introduced by those providers. Fintech companies also complained of constraints in accessing formal channels of financing mainly because commercial banks don't tend to finance start-ups or technology (non-manufacturing) companies. In addition, despite efforts by EthioTelecom, penetration rate for mobile services is less than in other Eastern African and Sub-Saharan countries, and access to data services and smart phones are still very rare. The plans for EthioTelecom privatization and to introduce further mobile network operators to the market will fill-in a significant gap in access to basic internet and data services.

D. AML/CFT

Overview

27. Ethiopia is a member of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), a FATF Style Regional Body[55]. The mutual evaluation report[56] (MER),

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[55] Ethiopia's efforts to combat money laundering and terrorist financing (ML/TF) were assessed against the Financial Action Task Force (FATF) 2012 Recommendations and 2013 FATF Methodology by a team from the World Bank. The 2012 FATF Recommendations have placed an increased emphasis on jurisdictions understanding their risks for ML/TF and implementing effective measures to mitigate these identified risks; to include taking a risk-based approach.

[56] The 2015 MER provides a summary of the anti-money laundering and countering the financing of terrorism (AML/CFT) measures in place in Ethiopia. The mutual evaluation process analyses the level of compliance with the

Ethiopia's first mutual evaluation, was adopted by ESAAMLG, at its 29th Task Force of Senior Officials meeting held in Arusha, Tanzania in March 2015 and approved by way of a round robin resolution by its Council of Ministers on the 5th of June 2015. Engaging and supporting the mutual evaluation process was an important step by Ethiopia in meeting its international accepted obligations to effectively combat money laundering, terrorist financing and proliferation financing. Considering the mutual evaluation process commenced in 2014, it is predictably challenging for jurisdictions to demonstrate "effectiveness" of its AML/CFT regime shortly after substantial legal revisions have been adopted (2013).

28. Context is an important component of understanding risk and Ethiopia's risk profile is impacted by its relative economic isolation due to the limited extent to which it is integrated into the regional or global economy. Foreign currency controls are vigorously enforced and all financial institutions, by law, are fully owned by Ethiopians or Ethiopian legal entities (which in turn are fully Ethiopian owned). Linked to this isolation, is the relatively basic level of development of the financial sector.[57] With a large informal sector and the practice of large-scale financial transactions like real estate purchases or vehicles being routinely conducted in cash[58], the appeal of the formal financial sector as a means to launder illicit proceeds in Ethiopia is limited.

29. Ethiopia has taken steps to strengthen supervision of MVTs, but challenges remain. Money or value transfer services (MVTS) are now subject to licensing before providing such services; and, carrying out the services without obtaining a license or authorization from the NBE invites dissuasive penalties including criminal sanctions. Also, authorities have instituted monitoring measures for illegal money transfer services which have been substantiated by the identification, prosecution and conviction of 29 Illegal-hawala operators. The FIU disseminated 248 Illegal-hawala cases to the Ethiopian Federal Bureau of Investigation (EFBI) as of April 2018. In addition, the Ethiopian FIU has conducted strategic analysis of this issue and disseminated the appropriate findings to relevant private and government stakeholders.[59]

Remaining Challenges in AML/CFT

30. Even with the progress made by Ethiopia in combating ML/TF, there are still many important challenges still facing the country. Corruption; tax fraud/evasion; human trafficking and migrant smuggling; arms trafficking; smuggling of contraband; and profit made from providing illicit financial services continue to be main sources of illicit proceeds generating activity. Ethiopia faces many challenges in implementing an effective AML/CFT regime (see areas of TA needs in Annex III part B.).

FATF Recommendations, concentrating on the level of effectiveness of Ethiopia's AML/CFT system. The MER also provides recommendations on how the AML/CFT system could be strengthened.

[57] http://www.fatf-gafi.org/media/fatf/documents/reports/mer-fsrb/WB-ESAAMLG-Mutual-Evaluation-Report-Ethiopia-2015.pdf, p.3

[58] https://blogs.worldbank.org/africacan/financial-inclusion-in-ethiopia-10-takeaways-from-findex-2017

[59] https://esaamlg.org/reports/FUR%20Ethiopia-%20September%202018.pdf

31. Lack of domestic coordination continues to pose a challenge for Ethiopian officials. As articulated in the ESAAMLG enhanced follow-up report, Ethiopia has not provided adequate information that indicates they have addressed all the deficiencies outlined in the MER concerning domestic coordination. Moreover, additional information indicates that the relationship between the FIU and law enforcement investigatory bodies is not operating at the optimal level of cooperation/collaboration. While, Ethiopia should be praised for the progress they have made in the area of Technical Compliance the more challenging area is effectiveness where Ethiopia encounters difficulties in supervision; preventive measures; financial intelligence; ML investigations and prosecutions; confiscation; TF investigations and prosecutions. Integral components of the aforementioned are, domestic coordination and international cooperation.

32. Considering Ethiopia's recent history of relative economic isolation authorities have limited experience when it comes to international cooperation on AML/CFT and related matters. Identifying and utilizing formal and informal avenues of international cooperation on AML/CFT matters is very new for most Ethiopian officials. However, the Ethiopian Financial Intelligence Unit's (FIU's) recent admission into the Egmont Group of FIUs is a very positive step forward. Officials have indicated a need for more training and capacity building on the identification of suspicious transactions; proper analysis (operational & strategic); investigations and prosecutions. Asset recovery (identifying, tracing, recovering) and confiscation are also areas where capacity is low.

33. Other supervisors/regulators need to develop capacity to assist the FIU conduct risk-based supervision of the appropriate designated non-financial businesses and professionals (DNFBP) sector. Given the expansion of the AML/CFT regime to all DNFBPs, the MER determined that the FIC lacks the capacity to conduct all supervision by itself. The authorities have however, taken great strides in addressing the challenges they face from the MVTS sector. While considering the size of the sector and the continued challenges to ensure proper licensing throughout the country of all operators, authorities need to implement a risk-based approach based on proper assessments.

34. Respecting Ethiopia's vast and porous land borders, cash couriers and currency smuggling are genuine concerns. The deficiencies outlined in the MER were determined to be material and can potentially undermine effective deterrence of cross-border movement of currency or BNIs for money laundering or terrorist financing purposes.

Recommendations Payment systems, Fintech and AML/CFT

35. The market and stakeholders are seeking a leadership role from the NBE in expanding digital financial services and promoting digital service providers. The NBE should develop a strategy for digital financial services with the support of the Ethiopian Government and payments market stakeholders (both banks and non-banks). The NBE should develop a strategy for digital financial services, for key specific digital payments, with the support of the GOE and market stakeholders (banks and non-banks). A concerted effort is required to digitize G2P, G2B,

P2G, as well as business to government (B2G) payments, including expanding access to financial institutions, modernizing the government financial management systems, enhancing the payments infrastructure, among others. The strategy should include a comprehensive approach and should cover: financing for fintech start-ups, access to financial services, inconsistencies in the regulatory framework, policy directions for expansion of digital financial services, gaps in infrastructure, lack of trust in digital payments, lack of awareness, role of non-banks and intermediaries, deficiencies in government systems and procedures, and other components. The strategy should seek market consensus and ownership and include an action plan, and a timeline.

36. The automation of Government payments and collections is a major cornerstone in transitioning to a less-cash society. The government of Ethiopia has made a few steps towards electronic payments, including payment of government employees' salaries through cards issued by the CBE, and the on-going work at Ministry of Revenue to automate tax collection. However, several changes are needed, starting from putting in place an architecture for government payments and collections, automation of the payments process at MOF, implementation of a Single Treasury Account, automation of government units at Federal and regional levels, collection of government fees and utilities through private sector bill aggregators, and development of a more advanced e-government platform. Automation of government payments and collections is typically challenging as it requires significant investment, government commitment, changes in the business processes of government units, and upgrade in infrastructure. The Ministry of Finance and Ministry of Revenue should work closely with the NBE and other government stakeholders on modernizing the financial management information system (FMIS) with the aim of modernizing and automating government payments and collection processes. Hence, automation of government payments and collections should be preceded by a detailed assessment of existing capabilities, agreement on the scope and required changes, and a study of the required financial and technical resources. Successful implementation of such an e-payment system in government will have a big impact on budget control, reduction of overall expenditures, and a huge impact on expanding financial inclusion in the country.

37. The NBE needs to develop a modernized national payment system oversight framework based on best practices. The oversight scope should extend to: payment systems and all Financial Market Infrastructure (FMI), including central securities depositories; payment services; payment instruments; and their operators and providers whether banks or non-banks. The scope of development in oversight should include review of existing regulations, recommending updates or amendments to those regulations, capacity building of payment systems staff at NBE, developing procedures for the oversight unit, and developing off-site reporting and on-site inspection processes.

38. The payment systems industry and authorities must work together to better manage risks within the system as well as putting strategies in place to improve the overall efficiency of the market. Specific areas of focus can include: better management of risks by developing a risk management framework for different payment systems and services; monitoring the national payment system market in a proportional approach, giving more focus to the systems and services

that may affect its safety and efficiency; and digitizing data collection methods to better leverage data for market development and growth.

39. The regulatory framework for onboarding of individuals and small businesses into financial institutions needs streamlining and introducing a risk-based AML/CFT regulation is needed to achieve better financial inclusion. These efforts should cover regulations, procedures and guidelines for customer due diligence to enable Risk Based Approach to AML/CFT[60], including tiered Know-your-customer (KYC) requirements where simplified due-diligence and electronic remote KYC (eKYC) is allowed. This process may include clear definition of micro and small enterprises, their simplified requirements, and certain exemptions, it may expand the role of Agents and Super Agents in registration for financial services. It needs to foster development of a broader use of Digital ID[61] in the financial sector (see box 4).

Box 4: Role of digital ID systems in financial access

The World Bank's 2017 Global Findex Survey found that the lack of documentation was a critical barrier to accessing financial services, cited by 26 percent of unbanked people in low-income countries. A barrier more pronounced in marginalized segments of society such as women, poor rural farmers, migrants, refugees and stateless persons. The survey found that the poorest 40 percent of women in low income countries are, on average, about 30 percent less likely to have an ID than men in the same wealth quintiles.

A reliable ID is integral to providing and obtaining financial services because it is needed at various stages in an individual's interaction with the formal financial sector. During account opening, a customer needs identity credentials so that the financial service provider (FSP) can match that information against other sources, such as a national population registry, civil registry or a credit bureau hence reliably validating that individual. Once validated, a transaction identifier, such as a Personal Identification Number (PIN) is issued by the FSP to allow a customer to continue carrying out financial transactions without the need for re-validation for each transaction.

ID systems that provide digital authentication services can help service providers carry out Customer Due Diligence (CDD) requirements and expand the use of financial services. For example, India's Aadhaar system enables agents equipped with point of sale devices to satisfy CDD regulations for bank accounts opening nearly-instantaneously by using just the Aadhaar number and authentication factor (e.g. a fingerprint or One Time Password by SMS). One of the key components of financial inclusion strategies in many countries is to introduce a basic account—offered by either banks or non-bank entities—with stringent limits on number of transactions and value of transactions. Inclusive digital ID systems address the lack of documentation to access financial services. It can provide an efficient means of meeting CDD needs.

Source: https://blogs.worldbank.org/psd/digital-id-critical-enabler-financial-inclusion

[60] Anti-Money Laundering/Combating Financing of Terrorism

[61] The World Bank developed the 10 Principles on Identification for Sustainable Development – endorsed by 25 organizations to date – which outline what a 'good' ID system looks like. The considerations address factors including the importance of integrated ID frameworks; appropriate regulatory frameworks; risk-mitigating oversight models considering new players beyond traditionally regulated financial institutions; authentication and personal data protection; procedures for redress when the security of personal data is comprised; empowering the private sector to develop services drawing the foundational ID infrastructure; and the close monitoring of emerging trends in ID, such new models (e.g. federated and decentralized ID).

40. EthSwitch[62] needs a longer-term investment plan, capacity building, and a strategy that positions the company to be customer-oriented, focusing on serving commercial banks, and non-bank financial institutions. For development of the EthSwitch, the NBE should envision the institution as a hub and a connector for other service providers performing its role as an interoperability platform to access cards, mobile and bank accounts, and also, connecting it to other bill aggregators, payment gateways, government portal (Derash), and any eKYC or digital ID infrastructure.

41. In depth changes are desired for agents' regulations to allow playing a stronger role as front end for financial service providers. In addition, to developing regulations allowing non-bank payment service providers (NB-PSPs) to issue e-money, and to provide intermediary services like bill payment, and merchant aggregation; changes need to consider in a reasonable way the participation of foreign investments in such expansion of financial services.

42. In addition, the dialogue among different market stakeholders should be maintained and institutionalized through the National Payment Council (NPC) to begin with. As one of the roles of central bank in relation to payment systems is to act as catalyst for change, the NBE needs to establish continuous dialogue with all market stakeholders, including commercial banks, non-bank payment service providers, technology providers, agents' networks, startups, incubators, plus the government. Such dialogue should be open to address market requisites, comments on draft regulations, and feedback from the market. Such dialogue could be a prologue to the introduction of "Sandbox" approach by the NBE, later. Meanwhile, the NBE should establish the NPC as required by the "Payments Proclamation" to ensure proper market consensus on payments and digital financial services strategy and action plans.

43. Such an ambitious agenda will need a plethora of skilled resources at the NBE in particular, at the Payment Systems Department (PSD). The department will need an immediate hiring plan with qualified resources from the market and will require continuous capacity building. Adequate resources should be allocated to the department to implement such ambitious reforms (see Annex III part A. on NBE capacity building).

Table 9: List of recommendations according to priority – payment systems digital financial services & AML/CFT

Nr.	Recommendation Pillar III Payment systems and DFS	Timeframe
High Priority – Short-term according to priority		
1	**Digital payments:** GOE to develop legal and regulatory framework for digital payments. This activity has to be communicated with parallel activities performed to update the digital payments regulations at the NBE by BMGF & UNCDF. A primary list of proposed laws and regulations could include: o E-Commerce Law o E-signature law	2 years

[62] The EthSwitch is the domestic interbank card switch that banks launched in 2016 to fully integrate ATM and POS networks. EthSwitch is equally owned by all the banks and it has recorded ETB 6 billion worth of transactions among banks during the 2017 fiscal year, a large increase from the previous year.

	o Updates to the National Payment System Proclamation including establishment of the National Payment Council (NPC) o Payment service regulations, or e-money/m-money issuers regulations, including, NBE to issue licenses to MNOs to offer mobile money services – start by issuing a license to existing technology providers followed by other MNOs. o Updates to the agent banking regulations. Expand range of services allowed to be offered by the agents to include; customer due diligence, account opening, and document capturing. Provide for participation of agent aggregators or 'super agents' model. o Regulations for outsourcing of financial services. NBE to allow banks and financial service providers to outsource some elements of their financial services to third-party processors, including operations of accounts and core banking systems. This should apply to commercial banks, MFIs and insurance companies; and o NBE to enhance the service point strategy by adjusting the target for banks to focus on the number of new customers, and new access points (ATM, POS terminals and agents) reached per year, rather than the number of new branches.	
2	**Government payment systems:** the GOE to adopt a strategy accepting digital payments for all services provided by government, and to disburse digital payments for all types of government payments. The strategy should include an action plan, and a timeline as well as: o Development of a government portal integrating all government services, and a plan to avail government services as an integral component with different payment service providers. o A strategy for changes not only in the payment systems and payment infrastructure, but also deep changes in government management information systems (MIS), accounting systems, budget control, accounting and invoicing rules, government procedures, reconciliation systems, and others. o To fully automate P2G transfers and payments, government and NBE to develop suitable business models, including business processes, infrastructure and organizational requirements, technical specifications, pricing models, and logistical arrangements to facilitate transition to digital government payments giving choice to individuals and businesses on which payment instruments to use; o Technology providers in cooperation with the GOE to develop more specialized portals to serve critical sectors (coffee, agriculture, manufacturing) thereby decreasing operating and borrowing costs and increasing efficiency. A typical portal that will combine coffee farmers, banks, insurers, MFIs, service providers like transportation, coffee factories, and others will create one platform that manages the life cycle of coffee production, giving access to different market players at different stages, and ensuring a seamless integration among all stakeholders.	2 years

3	**Setting measures that are favoring electronic payments:** NBE to create policy to discourage check and cash payments; examples include limits on minimum amounts that can be paid through checks effectively mandating bank customers to utilize electronic payments for all transactions above a certain value, imposing a minimum value for e-payment transactions and imposing higher fees on cash handling (India and Nigeria); and/or issuing a law mandating all government transactions above a certain threshold and purchase of assets (Land, real estate, autos, and similar) to be paid in electronic payments (Egypt).	18 months
4	**Opening sector to non bank payment service providers:** NBE to develop suitable regulations to license, monitor, and oversee non-bank payment service providers. Regulation to be based on the function or service provided, rather than nature of the provider, and include a risk-based approach to reduce and mitigate risks on safety and efficiency of the national payment system	18 months
5	**NBE to develop a modernized national payment system oversight framework based on best practices.** Scope should extend to: payment systems and all Financial Market Infrastructure (FMI), including central securities depositories; payment services; payment instruments; and their operators and providers whether banks or non-banks.	18 months
Medium term according to priority		
6	**Remittances:** NBE to develop regulations and practices to enhance the remittances market, including: o a clear legal framework for issues around transparency and dispute resolution. o Review and reform of current legal and regulatory framework opening the market to new operators, new technologies and innovative schemes, including to provision of international remittances services by MFIs and MNOs, and through agents. o The NBE to improve data collection on remittances and compiling and publishing data on the cost of remittance services o Allow MTOs to provide remittance services independently, with appropriate NBE supervision	3 years
7	**Acceptance and Usage of digital payments:** NBE to encourage banks to provide internet banking and mobile banking services by: identifying standards for those channels, providing incentives for transactions initiated from the internet and mobile, waiving fees for non-face-to-face transactions at the bank branches, integrating commercial banks' core banking systems with the NBE ACH and the EthSwitch, and encouraging the use of Application Program Interfaces (APIs); and NBE to adopt new technology to expand usage of digital financial services such as, QR codes for merchant acceptance and expansion of mobile money use cases. This solicits the need to provide interoperability among mobile money providers (P2P and person to merchant (P2M)) through the use of a market wide standard for QR Codes, and the use of EthSwitch as an interoperable platform for mobile-money providers.	2 years
8	**Effective implementation of the AML/CFT framework:** NBE and the GOE to bolster their legal framework, improve risk-based supervision of financial institutions and DNFBPs, and the use of financial intelligence in an effort to progress combating corruption, tax evasion and other illicit flows.	Within 2 years

E. Microfinance

Overview

44. The microfinance sector in Ethiopia plays an important role in financial inclusion and is characterized by a heterogenous mix of institutions. There are currently 38 microfinance institutions (MFIs) in Ethiopia serving more than 5M loan customers, a much greater number than the 250,000 loan clients served by banks.[63] The sector is dominated by a handful of large MFIs affiliated with regional governments, along with smaller private, commercial MFIs and MFIs affiliated with NGOs. MFIs primarily use the group lending methodology to serve those without traditional collateral and operate outlets in rural areas, helping to address lack of physical access in rural areas. There has also been recent expansion into individual lending, credit to SMEs, and the use of agent/mobile banking. Non-performing loans (NPLs) for the sector are relatively low.

45. The importance of the microfinance sector has increased over time, especially in rural areas. As of late 2018, total assets of Ethiopian MFIs were estimated at about 67 billion ETB . The sector remains highly concentrated, with the five largest MFIs (owned by regional governments) accounting for 89 percent of total sector assets and 88 percent of total outstanding credit. The value of total savings (ETB 32.4 billion) stood at 69 percent of the value of outstanding credit (ETB 46.8 billion). Based on the most recent data (end 2018) provided by the Association of Ethiopian Microfinance Institutions (AEMFI), covering a major share of the microfinance industry, MFIs have about 5.1 million active borrowers (of which 2.3 million are women), with an average loan size of some 8,500 Ethiopian birr (corresponding to a little less than $300). Difficulties in mobilizing savings, and, in general, the lack of funds for on-lending to clients were indicated as the most severe constraints to the development of the microfinance sector by the representatives of MFIs as well as the industry association met during fieldwork. The severity of this obstacle is compounded by the fact that MFIs cannot be owned or participated in by foreign entities.

46. Currently many MFIs do not operate efficiently and have limited outreach. MFIs have limited product offerings and limited innovation and drive. MFIs face a lack of capital, low savings mobilization, and difficulty accessing commercial financing, limiting the extent to which MFIs can meet the high demand for credit. There is a widespread lack of modern technology, in particular management information systems (MIS) and core banking systems, and capacity of staff is low.

47. The dominance of government-affiliated MFIs, which do not operate on a fully commercial basis, has distorted overall growth in the microfinance sector. Government representatives make up the vast majority of shareholders and board members of such MFIs, which are often used as channels by regional government to provide subsidized lending to underserved segments. Management can face pressure to use looser lending criteria to disburse loans at below-

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[63] Internal discussion with NBE.

market rates and with lighter terms and conditions. While these are worthy policy objectives, it is not appropriate to utilize deposit-taking MFIs as a direct implementation tool for government development objectives.

48. This situation results in several unintended negative consequences. As government-affiliated MFIs access concessionary funds to fund their loan portfolios, such entities are less motivated to mobilize retail deposits or innovate in product design or service delivery.[64] At the same time, an unlevel playing field is created for MFIs that do operate on a commercial basis, who end up facing higher relative funding costs and are required to charge higher rates.

49. In addition, there is a widespread perception among the public that MFIs are government-affiliated entities which are credit-focused and not fully commercialized. The MFI sector has gained a reputation among consumers as a source of low-cost credit and not as a safe, commercial, formally regulated place to save, harming the ability of all MFIs to mobilize retail deposits. Consumers perceive MFIs to be riskier and have greater trust in banks as safe, commercial institutions required to comply with strict rules and regulations. As a result, the MFI sector is not well-poised for long-term sustainable growth or innovation.

50. In other countries, commercialization of microfinance has resulted in greater efficiency, sophistication, and scale of operations. Commercialization of MFI sectors typically entails transitioning from donor-funded, subsidized operations to private, financially sustainable institutions with a for-profit orientation. Commercialization often entails (1) adoption of a for-profit orientation, (2) progress towards operational and financial self-sufficiency, (3) usage of market-based sources of funds, and (4) operation as a for-profit, formal institution subject to prudential regulation and supervision and able to attract equity investment.[65] Commercialization of MFIs in other countries has resulted in more modernized MFIs with easier access to commercial finance, increased efficiency, and expanded operations, thereby allowing for outreach to greater numbers of underserved consumers and a larger contribution to financial inclusion goals.

51. Such a fundamental shift in mindset will be necessary to achieve the greater scale and efficiency needed to address Ethiopia's financial inclusion objectives. In particular, upscaling of product offerings is required to help address the significant remaining gaps in SME finance. Greater sophistication of operations will also be necessary in order for MFIs to modernize and be better positioned to leverage improving financial infrastructure in Ethiopia, which will further enable MFIs to expand product offerings. Commercialization can be a win-win scenario for both MFIs as well as the increased number of consumers who are then able to access and benefit from MFI products and services. It is worth noting that a restructured DBE can play a role as an apex institution to support new financial instruments, as well as develop a more commercial micro finance sector operating more effectively and under improved sector code of conduct.

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[64] For example, according to internal NBE statistics, government-affiliated MFIs mobilize fewer deposits relative to their size compared to other MFIs.

[65] Charitonenko, Stephanie and Ismah Afwan. "Commercialization of Microfinance: Indonesia." Asian Development Bank, 2003.

Recommendations Microfinance sector

52. Greater commercialization of the MFI sector is necessary for the sector to advance in sophistication, expand outreach efficiently, and reach its potential of contributing to inclusive growth in Ethiopia. The MFI sector has the potential to more greatly contribute to critical national policy objectives such as increased employment and inclusive growth. Commercialization of the Ethiopian MFI sector will help MFIs to move beyond the mindset of operating as non-profit entities providing poverty alleviation services to the bottom of the pyramid, and instead shift to more vibrant, innovative entities with an expanded mission to contribute to inclusive growth. To support greater commercialization of the MFI sector, policy actions should be taken in three key and related areas: (1) increasing the independence of government-affiliated MFIs, (2) expanding available funding sources, and (3) improving the capacity of MFIs.

53. As a fundamental first step towards commercialization, government-affiliated MFIs should be given greater independence. Increased independence of government-affiliated MFIs is a necessary starting point to unlock the potential of the MFI sector for innovation and growth and is a precondition to the remaining recommended policy actions. Such MFIs should be separated from government influence and allowed to operate on a sustainable, market-oriented basis.

54. Greater independence of government-affiliated MFIs can be implemented in a staged manner. This can be achieved by gradually diversifying shareholders and board members of such MFIs to include broader private sector participation as well as independent board members. The ultimate goal should be to remove government involvement in institutional operations and allow MFIs the autonomy to pursue their own defined objectives. As experience in other countries has shown, the social mission of privatized MFIs can be maintained by careful selection of private sector shareholders and board members with aligned social interests (such as social investors) who can help to maintain the balance between a MFI's social mission and profitability.[66] Corporate governance should be strengthened across the financial sector, including for all MFIs, to ensure board independence and "fit and proper" qualifications that meet international standards. The current consumer protection framework developed by the NBE with support from the WBG incorporates all relevant code of conduct and responsible finance elements in the sector.

55. Successful commercialization of the MFI sector will also require expansion in domestic and international funding sources. Long-term sustainability and growth of a commercialized MFI sector will require adequate sources of domestic and international funding and investment to modernize and further expand operations. The sector should be opened to foreign investment (particularly social investors), which can help bring both necessary funding as well as technical expertise specific to microfinance. Broader efforts are also required to develop domestic funding and investment sources. In addition to encouraging private investment, policymakers should consider further actions such as converting concessionary funds currently

[66] For example, see Frank, Christina. "Stemming the Tide of Mission Drift: Microfinance Transformations and the Double Bottom Line." Women's World Banking, 2008.

directed exclusively to government-affiliated MFIs into facilities that are available to all financial service providers on a competitive basis, with clear selection criteria, guidelines on target borrowers, and monitoring of results. Establishment of an apex organization for funding of MFIs could also be considered in order to more efficiently coordinate funding from multiple donors.[67]

56. Strengthening accounting standards can also help to facilitate greater MFI access to commercial financing. Accounting standards should be strengthened, at a minimum for larger and more sophisticated MFIs, in line with the recent adoption of IFRS reporting in Ethiopia. Accounting principles and rules that follow internationally accepted standards will help ensure the reliability and usefulness of supervisory reports, as well as improve the viability of MFIs for commercial financing.

57. Improved systems and staff at MFIs are critical components to enable increased commercialization of MFIs. Privatizing government-affiliated MFIs will create a more level playing field and provide the opportunity for private, commercially-oriented MFIs to expand. But most MFIs currently face significant constraints due to lack of technology and are dependent on manual records and bookkeeping. To enable increased expansion and sophistication of MFIs, policymakers should support the improvement of technology at MFIs. For example, support could be provided to the Association of Ethiopian Microfinance Institutions (AEMFI), which is currently developing a shared MIS system for the MFI sector, as well as to ET Inclusive Finance Technology (ETIFT), which provides the technology system for M-BIRR to MFIs.

58. Capacity-building and training should also be provided to MFIs, particularly in the areas of corporate governance, risk management, and MIS. Training may also be useful in expanding to more individual lending and cash-flow based lending. In particular, efforts should be made to build up local training institutions, of which there are currently few in the market. Similar to banks, a rule could be considered requiring a minimum percentage of MFI budget be allocated for training purposes. Such policy initiatives are a more appropriate role for government to play (as opposed to direct ownership of MFIs), as such initiatives are less distortive to the market, benefit the entire MFI sector, have a longer-term impact, and are a more efficient use of government resources.[68] While initial capacity-building may require support from policymakers, training services can transition to be commercially based over time, as MFIs themselves become more sophisticated.

[67] However, policymakers should consider the costs required to establish and operate an apex institution effectively, which requires qualified management and political independence. In addition, strong MFIs are needed to channel apex funds effectively and not the other way around (i.e. availability of funds will not help MFIs commercialize). For further global lessons, see "Apex Institutions in Microfinance." CGAP, 2002.

[68] Other more appropriate and effective government roles that should be continued and expanded include demand-side initiatives such as financial literacy efforts and training for SMEs. For example, financial literacy efforts could help to educate consumers on the benefits of saving in regulated institutions, to shift the over-reliance of consumers on traditional, informal savings methods. Financial literacy efforts would also be beneficial in familiarizing consumers with the benefits and risks of DFS.

59. In addition to supporting the increased commercialization of MFIs, the regulatory and supervisory framework for MFIs should be strengthened. Improved regulatory and supervisory frameworks can help strengthen the operations and financial stability of MFIs, while also improving the overall reputation of the sector among consumers. Loan loss provisioning should be made stricter to align with international best practice, with shorter timeframes to classify non-performing loans and a more aggressive provisioning schedule for delinquent microloans. While these changes will require short-term costs to MFIs, they will ultimately help the underserved by ensuring that MFIs are strong and sustainable. Other regulatory requirements could be made more permissive. For example, MFIs should be given flexibility in product and service offerings and target clientele. In revising regulation, policymakers should pay particular attention to proportionality, ensuring that revised rules are focused and limited to what is necessary to achieve specific policy objectives and take into account a MFI's size, structure, and the complexity of its activities.

60. Supervision of MFIs requires strengthening as well, particularly as commercialized MFIs expand into more sophisticated operations and mobilize greater retail savings. Surveillance of MFIs should leverage National Bank of Ethiopia (NBE) technology such as the Banking Supervision Application, which automates off-site surveillance and allows for online reporting by MFIs. However, for such systems to be effective, MFI capacity must first be increased to ensure more accurate and electronic recordkeeping, in order to ensure that robust and timely data is provided for supervisory purposes. Supervisory capacity should be increased, and risk-based supervisory approaches employed, combining off-site monitoring and industry-wide surveillance with enhanced supervision at select institutions, particularly larger MFIs. The NBE will also need practical enforcement power against government-affiliated MFIs (which is currently lacking) until such MFIs become more fully independent.

61. Finally, broader financial infrastructure reforms and DFS/fintech policies should designed to include and benefit MFIs. For example, as MFIs become more sophisticated and develop core banking systems, policymakers should consider providing access to the national payments system. Similarly, policy efforts should be continued to ensure that MFIs are included within the credit reporting system and movable collateral registry system, particularly as the number MFI loans far exceeds bank loans. The use of agent and mobile banking is still limited due to regulatory uncertainties surrounding DFS, and there is significant opportunity for MFIs to further leverage agent and mobile banking to reach greater numbers of underserved at lower cost. A more enabling regulatory environment for DFS and low-cost delivery channels (addressed in detail in the payment system and DFS section C above), such as tiered customer due diligence (CDD), more permissive rules on agent banking, and interoperability between accounts, agents, and providers can greatly facilitate expanded outreach of the MFI sector.

Table 10: List of recommendation grouped by priority – microfinance

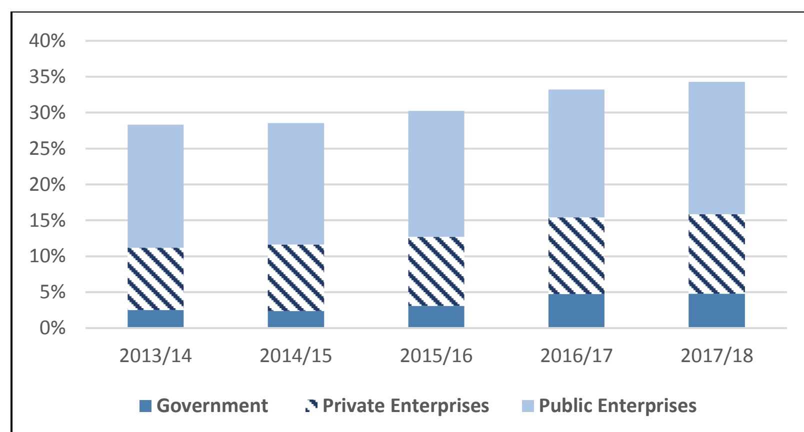
No.	Recommendations Microfinance	Timeframe
Short-term		
1	Increase independence of government-affiliated MFIs via diversification of shareholders and board members to include broader private sector participation, while also improving corporate governance	1 year
2	Open up MFI sector to foreign investment	1 year
3	Strengthen accounting standards for MFIs	1 year
4	Support improvement of technology at MFIs	1 year
5	Support increased capacity-building and training to MFI staff	1 year
Medium term		
6	Strengthen the regulatory and supervisory framework for MFIs	2 years
7	Consider establishment of an apex organization for MFIs	2 years

F. Credit Information Reporting Systems

Overview

62. Ethiopia's credit markets are relatively underdeveloped, with domestic credit as a ratio of GDP estimated below 40 percent, compared to 150 percent in South Africa and even greater values in OECD countries. This is a result of several binding constraints, including lack of appropriate collateral MSMEs can pledge for loans, and underdeveloped credit infrastructures such as a modern collateral registry, secured transactions framework and credit reporting system. For example, according to the WBG Enterprise survey of 2015, it was reported that the proportion of loans requiring collateral was 85.8 percent a and value of collateral to loan is 296.2 percent. Whereas a developed credit reporting system could help ease the collateral requirements, the credit reporting system in Ethiopia, (the NBE Credit Bureau), is still nascent; even though it has registered key progress since it was first established in 2012.

Figure 7: Domestic Credit as Share of GDP in Ethiopia (2013/14-2017/18)



Source: IMF

63. Ethiopia ranks 175 out of 190 countries in the Getting Credit indicator of the Doing Business report for 2019. The Doing Business assesses the sharing of credit information and the legal rights of borrowers and lenders with respect to secured transactions through two sets of indicators: 1) the depth of credit information index measures rules and practices affecting the coverage, scope and accessibility of credit information available through a credit registry or a credit bureau; 2) the strength of legal rights index measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending. Together, these two indicators account for 20 points in the overall DB rating. Ethiopia's ranking for these two indicators is "3": Depth of credit information index is "0" and the strength of legal rights index is "3". Even though the NBE Credit bureau has been operating since 2011, the ranking remains at "0" for the depth of credit information indicator because the bureau did not meet the pre-condition of a minimum coverage of 5 percent of the adult population. Currently the Bureau at NBE has a coverage of 0.4 percent.

64. The inclusion of borrowers from the MFI and Capital Goods Finance companies (CGFCs) in the NBE credit reference bureau (CRB) was a logical path of development for Ethiopia's credit bureau system because it promotes greater financial inclusion and access to un-served and underserved entrepreneurs who may be able to leverage their credit histories (reputational collateral) across financial institutions. Data from the Microfinance companies would facilitate improved risk management by lenders and would increase exponentially the number of borrowers reported to the NBE CRB as MFIs hold the largest loan portfolio for consumers and micro and small businesses.

65. The government of Ethiopia is committed to improving its ranking in the Doing Business 2020 and 2021, for which a national Doing Business improvement reform roadmap has been developed and agreed between the Prime Minister and all implementing agencies, including NBE. Accordingly, the Prime Minister tasked the Governor of NBE to take the necessary steps to improve the Getting Credit indicator as follows: In the short term, to enhance the Depth of credit information by increasing the coverage of the credit bureau to reach a minimum of 5 percent of the adult population reported to its database and to pass the Secured Transaction's law. In the medium term, to operationalize collateral registry system, and in the long term to engage in a Public Private Partnership to provide a sustainable "new complete solution" to the Credit Information system in Ethiopia.

66. The game-changer for NBE CRB occurred at the political level when in February 2019, the prime minister instructed the NBE governor to integrate the microfinance and leasing sectors into the CRB to improve Ethiopia's *Doing Business* 'Getting Credit' indicator. NBE instructed MFIs and CGFCs to work towards their integration in the CRB, thus a major collaborative effort, involving all relevant stakeholders (NBE, MFIs, CGFCs, and service providers), was deployed to address the several integration challenges. Based on the acquired role of a trusted counterpart, IFC was requested to largely drive this challenging endeavor.

67. On April 20, 2.8 million borrowers from 20 MFIs were uploaded to the NBE credit bureau database. This amount together with the existing 222,000 borrowers from banks adds to 3 million borrowers that represent 5.2 percent of the adult population (estimated at 58 million).

68. After achieving this important milestone, NBE CRB must still ensure the sustainability of the system and the regular reporting of borrowers' credit information by all commercial banks and MFIs to the NBE CRB database. Two major tasks are still underway in order to achieve the expected level of sustainability: 1) in the short term, a formal and documented MFI Credit reporting application fully operational; and 2) in the medium term, the design and deployment of a new complete Credit Reporting Solution, for which NBE agreed to consider a Public Private Partnership (PPP) as an option. A PPP option could present a viable solution for the NBE credit bureau operations.

69. Globally, credit Bureaus provide a specialized technical service and require continuous investment and upgrades in skills and technology. The NBE CRB is still understaffed and under resourced and will require substantial investments in technology and expertise in for service provision to diverse lenders and to also develop value added services and products that could cater to lenders' needs.

Recommendations Credit Information System

70. A Credit Bureau requires adequate technical infrastructure and communications networks to process and manage large volumes of data and to guarantee effective and secure delivery of credit reports to the users (credit providers, borrowers, other authorities, etc.). These technical infrastructure systems are not off-the-shelf solutions that can be acquired and installed into a computer hardware system. A credit bureau must develop or acquire specialized systems, that must be adapted to new technologies, to enable data collection from many sources in different formats. The development process involves an analysis of available data from data sources, preparation of functional specifications, actual system development, and acceptance testing, among others. The process of lenders extracting data from their core systems is one of the most challenging and potentially time-consuming elements that must be addressed as a bureau is established and should not be underestimated. In a PPP contract, most of the operational risks will be transferred to the private entity, which results in greater efficiency and better service to the industry. Considering the current status of the CRB in Ethiopia, and that the existing model of contracting an external vendor to provide the credit reporting application resulted in sub optimal outcomes, the NBE has agreed to consider a PPP solution to leverage private sector technology and innovation to deliver better services through improved operational efficiency.

71. Following the guidelines in the PPP Proclamation and international best practices, the WBG team proposes the following activities to initiate the design of the PPP roadmap that best fits the needs of the financial industry in Ethiopia:

1- Socialize the PPP initiative starting with a workshop by PPP experts to present to NBE the possibilities under the Ethiopia PPP Proclamation followed by, a study tour for NBE officials to leverage knowledge and lessons in this area from other countries.

2- Create a working group with representatives of the relevant authorities and stakeholders following the PPP Proclamation guidelines.

3- Design a roadmap / strategy based on the requirements established in the PPP Proclamation and best practice to help the authorities decide whether to adopt a PPP solution for a new complete Credit Information system. At a minimum, the following activities should be considered:
   - Conduct a feasibility study to consider the appropriateness of a PPP for the credit reporting industry in Ethiopia.
   - Evaluate the different options of PPP modalities in the Ethiopian context
   - Clearly identify the criteria (technical, operational, administrative, financial, etc.) that will be considered in the procurement process.
   - Make the decision to proceed with the PPP.
   - If the decision is positive, prepare a detailed action plan with the support of specialized PPP experts.

Table 11: List of recommendations Credit infrastructure

No.	Recommendations Credit Reporting	Timeframe
1	GOE to socialize the Public Private Partnership initiative starting with a workshop followed by a Sudy tour. Workshop will include WBG PPP experts to present to NBE the possibilities under the Ethiopia PPP Proclamation.	Short Term
3	GOE to create a working group with representatives of the relevant authorities and stakeholders following the PPP Proclamation guidelines.	Medium term
4	GOE to design a roadmap / strategy based on the requirements established in the PPP Proclamation and best practice to help the authorities decide whether to adopt a PPP solution for a new complete Credit Information system. At a minimum, the following activities should be considered: 1. Conduct a feasibility study to consider the appropriateness of a PPP for the credit reporting industry in Ethiopia. 2. Evaluate the different options of PPP modalities in the Ethiopian context 3. Clearly identify the criteria (technical, operational, administrative, financial, etc.) that will be considered in the procurement process. 4. Make the decision to proceed with the PPP. If the decision is positive, prepare a detailed action plan with the support of specialized PPP experts.	Medium term

G. Leasing

Overview

72. Since 2014, with support from the WBG the NBE has worked to create a favorable regulatory environment to help grow the country's US$153.7 million leasing market to reach its estimated US$1.05 billion potential. The NBE is currently revising the existing Proclamation for leasing and capital goods business in partnership with the Ministry of Trade and Industry, and with technical support from the WBG. In January 2019, major policy shifts and changes in the prudential guidelines for capital goods and leasing business were approved by NBE related to the lifting of the interest rate cap; access to foreign borrowing; allowance to include big ticket leases within portfolios; increase of the single borrower's limit; and lifting of restrictions on the number of branches and operations required in the country. Following these reforms, the NBE licensed the first foreign owned independent leasing company in Ethiopia.

73. Leasing is the only financial sector open to foreign investment in Ethiopia. As of June 2018, over 2,921 MSMEs have accessed finance through leases valued at US$79 million. Despite the progress made in the regulatory environment there continue to exist high market/stakeholders, expectations for additional reforms in the sector. For example, local borrowing is still not allowed for foreign owned leasing companies operating in Ethiopia a key element for foreign investors considering investment in Ethiopia.

Recommendations leasing sector

74. The NBE should further review the existing legal framework for the CGFB sector and draft/issue a revised proclamation including licensing regulation and harmonize with existing related proclamations (i.e. tax and depreciation). Policies and a procedures manual should be developed for offsite surveillance activities for the CGFB including private and foreign leasing companies to be established in the country. This should include improving policies and procedures, leasing operations, and portfolio management of the five regional leasing companies.

75. NBE should implement the national leasing sustainability strategy including establishment and operation of a national leasing association and 'training of trainers' for the leasing association to enable it to provide capacity building, resolve challenges and work towards sector development. The NBE with support from the IFC should offer training modules and leasing education and information awareness seminars to SMEs and relevant stakeholders.

Table 12: List of recommendations leasing sector

No.	Recommendations leasing	Timeframe
Short-term		
1	NBE to improve policies and procedures, leasing operations, and portfolio management of the five regional leasing companies.	1 year
2	NBE to further review the existing legal framework for the CGFB sector and draft/issue a revised proclamation including licensing regulation and harmonize with existing related proclamations (i.e. tax and depreciation). NBE to develop a policies and procedures manual for offsite surveillance activities for the CGFB including private and foreign leasing companies to be established in the country.	1 year 18 – 24 months
Medium term		
3	NBE to implement the national leasing sustainability strategy including establishment and operation of a national leasing association and 'training of trainers' for the leasing association to enable it to provide capacity building, resolve challenges and work towards sector development.	2 years

H. Insurance

Overview

76. Generally, the insurance transfer-of-risk mechanism brings social and financial benefits to citizens, while the insurance industry's investment of premium monies adds vibrancy to a country's economy. However, the insurance industry in Ethiopia is moribund, with premiums amounting to less than half of one percent of GDP. In neighboring Kenya, the per capita expenditure on insurance is more than 13 times greater than the figure for Ethiopia.

77. There are 17 insurers active in the Ethiopian market, of which 9 are composite companies – those that are transacting in both long-term and short-term insurance**.** It is estimated that 85 percent of premium volume is by direct selling, that is, through branch office and head office distribution, with the remainder more or less evenly split between agents and brokers. In addition, the presence of composite insurers is hindering development of a more vibrant life insurance industry in the country. The largest single insurer is the state-owned Ethiopian Insurance Company (EIC), which until 1994, had a monopoly on insurance business in the country. There is also a local reinsurer, Ethiopian Re, which commenced business in 2016 and which is 20 percent owned by EIC and 20 percent by the CBE, with other insurance companies also having ownership positions. Every licensed insurer is required to cede at least 25 percent of its treaty premium and 5 percent of each policy premium to the state-owned reinsurer.

78. Foreign branch insurers are not permitted to be licensed in the country and foreign shareholdings in Ethiopian insurance companies are not allowed. Foreign participation is not permitted in the Ethiopian insurance industry, either by company, individual officer or board member, meaning that Ethiopian insurers do not have the option of bringing in knowledgeable, experienced insurance executives from other jurisdictions, who would be able to transfer their skills to local insurers.

79. With a premium volume of approximately US$300 million, the Ethiopia ranks 96th in the world in terms of insurance premium volume by country. The enormous discrepancy between the 12th largest population in the world and the 96th largest insurance market highlights the fact that the insurance business in Ethiopia is vastly under-utilized. This impression is further emphasized by the data shown in Table 10 below, where 92 percent of premium is in respect of short-term business with a miniscule 5 percent, or about US$15 million, being attributable to long-term insurance coverage. An additional 3 percent of premium is generated by Personal Accident and Health business. Fully 57 percent of the short-term market is in respect of Motor coverage, much of which will pertain to the compulsory 3rd party Motor Liability line, so in that case, purchase does not suggest that the buyer necessarily recognizes the utility of the insurance product, but only that the person is complying with the law of the land.

Table 12: Insurance Premium by Class of Business

	Life	Non-Life	Personal Accident & Health	Total Market
Premium in ETD mn	333.01	5,909.02	184.66	**6,426.69**
Premium in USD mn	15.34	272.19	8.51	**296.04**
% of total market	5.18	91.95	2.87	**100.00**

Source: WBG team research

80. In addition to compulsory 3rd party Motor Liability insurance, there are a number of other types of coverage which, from a business or investment perspective, are virtually compulsory. For example, major corporations such as airlines, construction firms and so on, must protect themselves from liability and so of necessity will purchase Liability coverage. In addition to the large 57 percent market share for Motor Insurance, the market is also comprised of 6.9 percent Construction and Engineering coverage and 12.7 percent Marine, Aviation and Transit coverage. Together with Motor coverage, these lines account for almost 77 percent of the total short-term market and can probably be considered to be compulsory types of coverage.

81. The NBE has not invested in supervision of the insurance sector given the small size of the sector. Leading members of the industry are supportive of moving insurance supervision away from NBE to a dedicated entity that can focus on reforming and supporting the sector. In the case of Ethiopia this may have to be done by an independent entity other than the NBE. Insurance supervisory agencies in other African countries have been given broad mandates, not limited to technical supervisory issues, but also including the development of micro-insurance programs, building insurance inclusion and fostering insurance training, all of which would be positive developments for the industry and the country. A move to a dedicated agency would not be a unique situation among African countries. The table below, developed from World Bank research, shows that in fully 33 of 63 jurisdictions reviewed, there is a dedicated agency for insurance supervision or insurance and pension supervision.

Table 13 – Location of Insurance Supervisory Agency in African Countries*

The Insurance Supervisory Authority is:	
Part of the ministry of finance	19
Part of the central bank	4
A dedicated agency for insurance or insurance and pensions	33
Part of a larger agency covering NBFIs	4
An integrated financial supervisory agency covering the whole sector	3

*Note: there is some double-counting in the table because some jurisdictions report insurance supervision as falling into more than one category.

Recommendations insurance sector

82. Given the current system it is recommended that supervision of the insurance system is administered by an independent agency that is not part of the formal public service and delivering a more focused level of policy development and industry oversight. In addition to non-bank financial supervision the mandate of the independent agency should include being responsible for programs designed to increase the frequency and effectiveness of micro-insurance and financial inclusion for insurance in the country similar to what the NAMFISA has done in Namibia. In addition to operating under a modern insurance supervisory statute that conforms to international standards and best practices, the mandate of a new insurance supervisory agency should include working closely with the industry to further develop micro-insurance programs in Ethiopia.

83. Fostering development of the actuarial profession in Ethiopia as well as building awareness and education on insurance are important mandates. In addition, the industry should be opened to foreign participation as this will inject new knowledge and experience into the insurance marketplace, to the benefit of Ethiopian insurance consumers.

84. The NBE should also adopt a policy to phase out Composite insurers. The NBE should start by not licensing any new ventures, and by prescribing a transitional period by the end of which, all of the currently licensed composite insurers would have to be converted to short-term business only, or life insurance business only.

85. As Ethiopia is highly vulnerable to climate shocks, the government may want to require a fiscal assessment of climate risks and prepare a disaster risk finance strategy to optimize the use of financing instruments to address different layers of risk. Risk transfer instruments are gaining traction, especially in addressing the production shock in the agriculture sector. Increased productivity and resilience are remarkable in countries that have adopted agriculture insurance as a risk-mitigating tool. However, market failure, in terms of the inability of the private sector to provide appropriate insurance products at affordable rates, necessitates public sector intervention. Faced with the reality of persistent and recurrent droughts and resultant loss and damage in the livestock sector, countries in the Horn of Africa (HoA), including Ethiopia, recognize insurance for pastoralist as an essential policy initiative. The HOA collaborative

approach in addressing the negative impact of weather-related shocks in pastoral regions offers an excellent opportunity for GOE to scale-up the number of households purchasing insurance in the Somali and Borana region.

Table 14: List of recommendations insurance sector

No.	Recommendations insurance sector	
Short-term		
1	NBE to revise the insurance supervisory system in the country to be administered by an independent agency in accordance to international best practice. The independent agency should: • be funded by a levy set initially at between 1.5% and 2.0% on insurance premiums as is done in many countries; • have a mandate encompassing building micro insurance, and to develop actuarial expertise	1 year
2	NBE to adopt policy to phase out Composite insurers. Start by not licensing any new ventures, and by prescribing a transitional period by the end of which, all of the currently licensed composite insurers would have to be converted to short-term business only, or life insurance business only.	Immediate
Medium term		
3	The GOE to open the industry to foreign participation. Start by an immediate relaxation of current rules that prevent foreign experts from holding management and board positions (but still subject to fitness and propriety rules).	2 years
4	GOE to conduct a fiscal assessment of climate risks and prepare a disaster risk finance strategy to address different layers of risk.	2 years

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ANNEX I: Pillar I

Banking Supervision at NBE

A. Supervisory process

i. Off-site supervision

1. All banks[69] report their quarterly returns to NBE electronically, within 20 days after the end of each quarter. The system automatically conducts some simple checks on completeness and accuracy of the data. Then the data is distributed to the relevant on-site supervisory teams, who prepare a two-pager report per bank, while, the Analyses & Policy team calculates several basic stress-tests for each bank. The two-pager contains:

i. the CAMEL-rating (aggregate and components),
ii. outcomes of basic stress-tests (credit risk, exchange rate risk and liquidity risk),
iii. a list of supervisory concerns; and
iv. matters that require attention, whereby (iii) and (iv) are mainly overlapping.

2. All two-pagers of individual banks are compiled into a quarterly off-site surveillance report. That report has a little less than 80 pages and contains the following sections:

i. an industry-wide analysis (8 pages). The analysis consists of adding up the individual banks' figures to macro-totals (NBE is aware that this is something different than a macro-prudential analyses);
ii. information on DBE (1 page) - DBE is treated separately because a set of different regulatory rules apply to that bank;
iii. the information-set per individual bank (all the two-pagers totalling 33 pages); and
iv. a statistical annex (33 pages) that contains 12 tables with industry wide aggregates, 6 tables providing an overview of the different stress-test outcomes per bank plus, two tables per bank with key balance sheet and profit & loss information.

3. This off-site surveillance report provides the most important management information on the health of the banks to the board of NBE. It takes approximately a month to draft and have it reviewed by the principal. The reviews by the deputy director and the director of the BSD together take another 2 weeks. After approval by the Vice-Governor Financial Institutions Supervision it is sent to the Governor for information. The report is also discussed at the Board. At the end of the cycle, each individual bank receives its own two-pager.

4. NBE uses a fully web-based reporting system called the Banking Supervision Application (BSA). Currently banks submit 56 different supervisory forms to NBE on a regular basis as follows:

i. On a quarterly basis: 45 forms, notably information concerning on- and off-balance sheet items, risks weights, regulatory capital, NPL's, provisioning, big depositors/creditors, profit & loss account.
ii. On a monthly basis: 8 forms, mainly concerning the balance sheet and loan quality.

[69] The 2 government-owned banks and 16 private banks.

iii. On a weekly basis: 2 forms, concerning liquidity and reserve requirements and
iv. On a daily basis: 1 form regarding the open foreign currency position.

5. The BSA-system was initially developed in 2003/2004, hosted by the South African Reserve Bank and advanced by the Bank of Mozambique. In 2007, the system moved to Mozambique. It is used by the following African countries: Angola, South Africa, Botswana, DRC, Malawi, Kenya, Lesotho, Mozambique, Namibia, Seychelles, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe. NBE joined in May 2018 for an initial subscription fee of 110,000 US$. The annual maintenance fee equals 35,000 US$.

6. The BSA-system contains two modules: Banking Supervision System (BSS) and Risk Automation Analysis System (RAAS). NBE uses both and is very satisfied with the system. This view is corroborated by the World bank team who when requesting a multitude of data at various times were able to receive it quickly and in flexible formats from NBE.

ii. On-site supervision

7. A supervisory plan based on the risk profiles of financial institutions is prepared at the beginning of each fiscal year[70] and approved by the Vice-Governor. In principle, every institution should get an on-site inspection at least every two years. However, the BSD was not able to meet this goal in recent years due to the serious understaffing. The reorganization and the accompanying increase in capacity management should address this issue moving forward.

The on-site inspection process is undertaken along the following steps and timeframe:

i. The institution receives a letter in which the inspection is announced.
ii. Before going on-site, a (NBE-internal) preliminary review is held, based on off-site inspection data, to decide the appropriate scope of examination. If necessary, NBE will request additional data. The scope can be either full, therefore, dealing with the overall banking operation, or targeted, that is limited to one or several risks,
iii. The scope and a detailed work-plan is approved by the director of BSD.
iv. A team of 6-8 examiners then performs the supervision work-plan at the institution. An on-site examination takes on average 1.5 months, depending on the size of the bank (in theory, the work should be done in 1 month).
v. All supervisory team-members thereafter submit their findings to a portfolio manager, who will compile the different contributions into one report. After quality assurance done by the principal Examiner, the draft is submitted to the director of the BSD for comment and directions. That process takes approximately 3 weeks.
vi. The draft report is then sent to the supervised institution for feedback (within 2 weeks). The inspection is concluded by an exit-meeting.
vii. The feedback from the supervised institution is discussed and accommodated (if valid) by the quality assurance committee (comprising team leaders and senior examiners) after endorsement by the BSD director.
viii. Within 1 week, the report is finalized by NBE and sent to the board of the supervised institution.

[70] The Ethiopian fiscal year goes from July 1 to June 30 of the following calendar year.

ix. The board of the supervised institution is invited to NBE for discussions. After that, the supervised institution gets 3 months to take the necessary follow-up measures to address identified shortcomings.
x. NBE returns for a short one to two-week follow-up inspection to see whether the measures are implemented. The follow-up mission is already planned for in the beginning of the process and is part of the work-plan.

B. Macro prudential policy cycle and roles of the FSC and FSD

8. **Figure 1 below provides an example of how the macro-prudential policy cycle would function at the NBE.** The financial stability committee (FSC) and the financial stability department form the fundamental structure for macro prudential monitoring. The standard macro-prudential policy cycle and roles of the FSC and FSD is as follows:

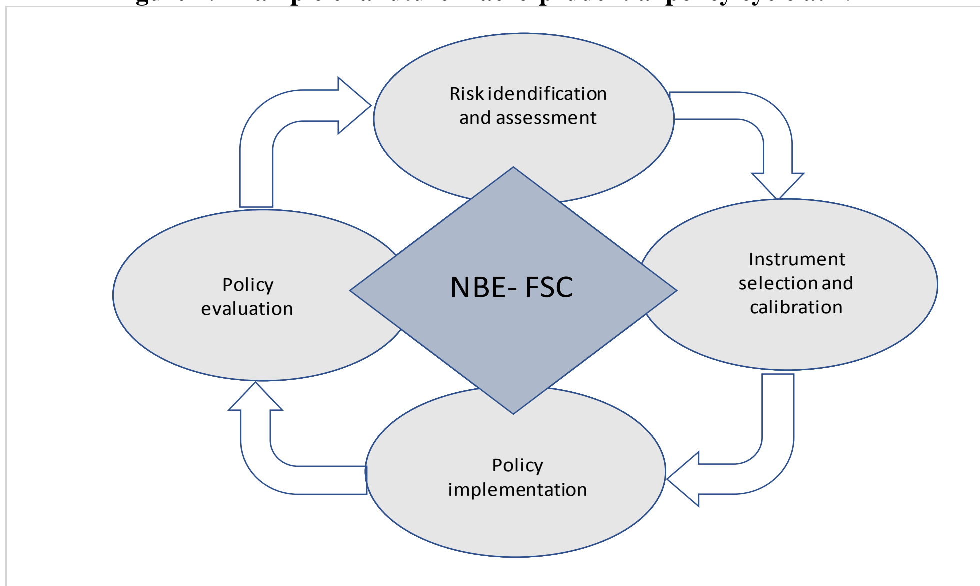
i. Risk identification stage: The Financial Stability Department is responsible for macro-prudential risk monitoring and systemic risk analyses. The FSD will provide the input for the FSC on a quarterly basis in the form of the Banking Sector Monitoring Report. This report will also include a list of recommended policy actions to mitigate the vulnerabilities. The analysis and recommendations will be discussed and agreed upon within the FSC.

ii. Instrument selection stage: The FSC decides on the policy instrument and its calibration. Often, there are several policy instruments that potentially could help address a vulnerability. For instance, unsustainable credit growth or over-crediting can be mitigated in several ways, with different policy instruments who carry different side-effects. Possible instruments would be: increasing the interest rate, attaching additional risk weights to loans, introduce LTI and/or LTV ratios. Different departments have those instruments under their control and careful calibration of instruments is needed. FSD should provide (in cooperation with the respective departments and possibly supported by the Research Department) a menu with possible instruments and their probable impact (positive and negative). Since all the relevant expertise comes together in the FSC, it is best suited to ultimately select from the toolkit the most promising (combination of) instrument(s).

iii. Policy implementation stage: The agreed upon policy measures will be implemented by the departments that have the instruments under their respective control. It also means the BSD will take the necessary supervisory actions, including a proper communication strategy towards the supervised institutions. The FSD will monitor follow-up of the decision and report back to the FSC.

iv. Evaluation phase: The impact of the policy measures is assessed. Depending on the outcome of the assessment, it might be necessary to recalibrate existing policy instruments, develop new instruments or phase out existing policies. The evaluation will be done by the FSD, in cooperation with the relevant departments and supported by the Research Department. The assessment must be discussed and endorsed by the FSC.

Figure 1: Example of a future macro-prudential policy cycle at NBE



ANNEX II: Pillar II

I. Detailed Actions and Timeframe by thematic area– Capital Markets

A. Develop framework and instruments for the money market

#	Action	Priority	Year	Responsible
A1	Regulatory Framework for the Money Market	ST	2019	NBE
A2	NBE liquidity window	ST	2019	NBE
A3	Introduce GMRA agreement	MT	2020-2021	NBE
A4	Develop lending instrument	MT	2020-2021	NBE
A5	Develop Money Market reference rate	MT	2020-2021	NBE

B. Move to market-based issuance of Government Debt and phase-out NBE advances

B1	Agree strategy for market-based issuance	I	2019	GOE/MOF/NBE
B2	Implement strategy for T-Bill issuance, develop auction system, issue T-Bills	ST	2019-2020	MOF/NBE
B3	Issuance of T Bonds	MT	2021-2023	MOF/NBE

A. Market infrastructure to be modernized

C1	Creation of CSD	I	2019-2020	MOF/NBE/ MOT (?)
C2	Immobilization and Dematerialization	ST	2019-2020	NBE
C4	Trading Platform	MT	2020-2021	NBE
C5	Market connectivity	MT-LT	2021-2022	NBE
C6	NBE to develop legal and regulatory framework for market infrastructure for government bonds	ST-MT	2020-2021	MoF/NBE
C7	Licensing framework for government bond market intermediaries	ST	2019-2020	NBE

D. Expand and diversify the investor base

D1	Improve the quality of Information	MT	2020-2021	NBE/MoF
D2	Engage with broader investor base	ST	2019-2020	NBE/MoF
D3	Transparency	ST	2019-2020	NBE/MoF
D5	Expand distribution channels	MT	2020-2021	NBE
D6	Review institutional investor limits	MT	2020	NBE
D7	Tax, legal and regulatory framework	ST-MT	2019-2021	NBE

E1	Agree strategy to phase out the "27 percent rule"	I	2019	NBE
E2	Implement strategy	ST	2019-2021	NBE

C. Establish the public equity and corporate bond market

F1	Feasibility study and roadmap for equity market	ST	2019	NBE
F2	Establish securities regulatory and supervisory authority	ST	2019-2020	MoF/NBE
F3	Establish legal framework for the securities markets	ST-MT	2019-2021	MoF/NBE
F4	Require notice for OTC equity issuance	ST	2019	

Reform scenario simulation - this does not take into account SOE debt restructuring, as this topic is still under discussion. The scenario takes into account various assumptions as follows:

Outstanding Debt

- Considered FY20, FY21 and FY22
- Projected outstanding T-bill is ETB 143.4 bn in Jul 1st, 2019 (current + ETB 15 bn new)
- For FY20, FY21 and FY22 added volumes of new T-bills according to the scenarios
- Nominal value in July 1st, 2019 adjusted with the current interest rate
- Projected distribution of debt tenors is according to the current distribution

Scenarios

- New T-bills in the Reform Scenario: 1st year– ETB 45.8bn; 2nd year– ETB 69.5bn; 3rd year – ETB 100bn
- New T-bills in the Base Scenario: 1st year – ETB 35.8bn; 2nd year– ETB 47bn 3rd year– ETB 60.9bn

Cost of Debt/Interest Rates

- Current cost of the debt: T-bills up to 182 days (1.2%) and 364 days (3%)

Proposed interest rates

- Adjust 25% of the interest rate of the outstanding + new T-bills in the 1st year (5% on average interest rate),
- Adjust 60% of the interest rate of the outstanding + new T-bills in the 2nd year (7% on average interest rate)
- Adjust 100% of the interest rate of the outstanding + new T-bills in the 3rd year (9% on average interest rate)

Methodology

- The simulation assumes that the debt at current interest is 100% rolled over; and the difference to the market rate is paid out to investors

New Debt - T-bills							
Month	New T-Bills FY18-19	Base Scenario			Reform Scenario		
		1st year	2nd year	3rd year	1st year	2nd year	3rd year
		35,800	47,000	60,900	45,800	69,500	100,000
July	1,400	1,671	2,193	2,842	2,137	3,243	4,667
August	3,839	4,581	6,014	7,793	5,861	8,894	12,797
September	1,589	1,896	2,489	3,226	2,426	3,681	5,297
October	2,615	3,121	4,097	5,308	3,992	6,058	8,717
November	2,040	2,434	3,196	4,141	3,114	4,726	6,800
December	1,517	1,810	2,377	3,080	2,316	3,514	5,057
January	2,833	3,381	4,439	5,752	4,326	6,564	9,444
February	2,833	3,381	4,439	5,752	4,326	6,564	9,444
March	2,833	3,381	4,439	5,752	4,326	6,564	9,444
April	2,833	3,381	4,439	5,752	4,326	6,564	9,444
May	2,833	3,381	4,439	5,752	4,326	6,564	9,444
June	2,833	3,381	4,439	5,752	4,326	6,564	9,444
	30,000	35,800	47,000	60,900	45,800	69,500	100,000

Details of the Cost Simulation (Additional Cost) – Base and Reform Scenario of the Domestic Bond Market to move to market-based debt issuance (ETB million)

Base Scenario			Reform Scenario	
Fiscal Year	Total Additional Cost (Outstanding+New)		Fiscal Year	Total Additional Cost (Outstanding+New)
2020	1,490		2020	1,614
2021	6,009		2021	6,975
2022	15,764		2022	19,192

Domestic Debt Outstanding in June 30, 2019 (in ETB Billion)

	2014	2015	2016	2017	Mar 31, 2018	Jan 8, 2019	Jun 30, 2019	
Total	**232.2**	**311.6**	**381.5**	**501.5**	**582.9**	**655.9**	**697.3**	
Government Bonds	**10.9**	**10.3**	**9.2**	**37.4**	**37.1**	**36.6**	**36.6**	
NBE	9	8.9	8.3	7.9	7.9	7.4	7.4	
CBE	1.8	1.4	0.8	27	27	26.6	26.6	*recapitalization of CBE*
DBE	0.1	0.1	0.1	2.6	2.6	2.6	2.6	
Treasury Bills	**32.3**	**43.6**	**57.3**	**73.3**	**90.1**	**120.7**	**143.2**	
Direct Advance	**64.3**	**83.3**	**100.8**	**127.8**	**152.3**	**173.6**	**175.3**	
SOE Bonds and Loans	**124.7**	**174.6**	**214.2**	**263**	**303.4**	**251.1**	**251.1**	
NB Bills outstanding					**70**	**73.9**	**91.13**	

II. Central Securities Deposit System (CSD)

The CSD System will be able to provide all services related to public debt securities, bookkeeping entry, asset servicing, and clearing and settlement of both primary and secondary markets. The main objectives of the CSD are to:

- Provide an online centralized electronic registry for all Government and central bank (and in future potentially other issuers') securities which will meet the needs of all issues, issuers, holders, asset managers and other interested parties;
- Provide on-line, web-based, access to their holdings for all authorized parties (mandatory requirement);
- Provide a high level of efficiency and security by operating on the basis of both Delivery versus Payment (DVP) and Straight-Through Processing (STP), through linkages with the central bank's Real Time Gross Settlement (RTGS) system;
- Integrate the clearance and settlement of all government securities transactions;
- Support intraday liquidity management and other monetary policy operations of the central bank;
- Provide risk and collateral management facilities;
- Support portfolio management by instrument and maturity profile;
- Facilitate entitlement processing including redemption, interest and tax payments;
- Facilitate the electronic processing of repurchase agreements (Repos);
- Provide online enquiry facilities to all legitimate enquirers (mandatory requirement);
- Interact through interconnections and interfaces with other payment systems, CSDs, markets, etc.;
- Support system administration facilities including billing and accounting services, service maintenance and management, and other;
- Provide robust analytical tools to supervise the system activity.

ANNEX III: Pillar III

A. Payment systems technical assistance

Capacity Building for the NBE

- Training for performing assessment for Cyber Resilience of FMI.
- Workshop on regulating Fintech.
- Workshop for NBE Executives on Payment Systems Oversight and role of non-bank payment service providers.
- A dedicated payment systems expert who can work at NBE premises for a full year, to follow up and track payments activities.

Central Securities Depository Implementation

- TA to provide support pre-implementation, identifying requirements and providing requirements document. This process may need a number of consultants covering business, IT and legal aspects, and may take a period of 6 months. It should be done in parallel with the work on capital Markets and govt. Bond market.
- Based on the type of procurement, the TA may include developing bidding documents.
- Another TA to provide support during implementation. Covering the following aspects,
  - Providing Knowledge transfer workshops mainly focusing on the implementation in Ethiopia,
  - Developing internal policies, rules and procedures required for implementation,
  - Advise about implementation of the relevant sections of the Roadmap.
  - Assessment of existing legal and regulatory framework covering the securities trading and settlement and advise about legal and regulatory changes required to ensure proper launch of CSD activities and mitigation of legal risks.
  - Advise about IT requirements, including mainly, the infrastructure hardware and communications and security, and the integration requirements.

The TA will work in parallel with project activities and may expand after the CSD goes live.

B. WBG Technical Assistance to Credit Bureau at NBE - project status

IFC, through a technical assistance cooperation agreement signed in 2015, provided support to NBE to improve the performance of the Credit Information System in Ethiopia. There has been substantial progress in the NBE credit bureau performance since 2016 when the NBE credit bureau system experienced a complete outage and was unavailable to all banks for processing. During the outage, there was also a complete breakdown of the communication and support to NBE from the Credit bureau application service provider. IFC deployed international consultant to the NBE credit bureau in order to resolve the most relevant issues pertaining to the CRB operations and service provision. For a period of 24 months, the expert consultant completed six missions; and through a series of interventions led by IFC and the consultant, NBE re-established the engagement with the service provider; NBE implemented several key operational,

infrastructure and process improvements to the NBE production datacenter with the service provider; NBE deployed a new disaster recovery environment (DR site) with connectivity to the NBE production datacenter; NBE designed and has initiated construction on a new NBE production datacenter; NBE deployed new HP infrastructure to host the credit bureau application in the DR site with improved network connectivity; the CRB application was migrated to the new HP infrastructure and the service provider installed an updated version of the front office application that enhanced considerably the performance of the credit bureau system and provided a stable system environment between the banks and the NBE CRB application since November 2018. There are still some issues outstanding from the service provider that must be resolved; however, in the meantime, the service provider conducts daily monitoring of the IT environment together with NBE technical staff and a formal process to report and resolve technical issues has been implemented.

On December 14th, 2018, IFC and NBE signed a new (Phase 3) Cooperation Agreement to implement a Technical Assistance project aimed at strengthening Ethiopia's credit reporting system by stabilizing the existing service and supporting the inclusion of credit information from MFIs and leasing companies. Under the terms of the agreement, IFC will provide technical support to NBE to implement key project activities which include: (i) a technical evaluation of the current NBE credit bureau system, (ii) integration of Microfinance (MFI) and Capital Goods Finance Companies (CGFC) into the bureau (with the aim to improve Ethiopia's Doing Business indicators for 2020); (iii) support for the sourcing and deployment of a complete new credit bureau solution for the National Bank of Ethiopia (including funding for a new software solution) that will replace the existing credit bureau solution / system; and (iv) a consumer awareness and financial literacy campaign on credit reporting, among others. It was agreed by the authorities in mission held that the expected "Complete new credit bureau solution" could be based on a public private partnership (PPP) approach, which was recently regulated by the Ministry of Finance and Economic Cooperation.[71]

From February to April 2019, IFC team provided support to the NBE to accomplish the task to integrate MFIs and CGFCs into the NBE credit bureau assigned by the Governor of NBE; that led to the amendment of the directive to allow for MFI borrowers into the NBE CRB database and to the increase of the database coverage to 5.2% of the adult population (2.8 million additional borrowers from MFIs plus 222,000 borrowers from commercial banks). The main activities supported by the IFC team were:

1) the organization and coordination of a three-day Kick-Off workshop, that was attended by representatives of all relevant stakeholders to assess the complexity of the integration exercise and the creation of a working group to implement the project
2) the design of a detailed action plan with timelines and assigned responsibilities to stakeholders; with and weekly follow up and status meetings;
3) technical support to the NBE to complete the task on time and to address and resolve challenges that arose during implementation for this large data integration into the CRS.

[71] The Public Private Partnership Proclamation No. 1076/2018 was enacted in February 2018.

In addition, IFC supported NBE in drafting the amended CRB directive and prepared a complete proposal for the CRB medium term re-structuring and staffing.

The IFC continues supporting NBE to resolve current challenges and design the roadmap for the complete solution to replace the Credit Information System:

1) Specific issues remain with inappropriately sized ICT infrastructure, inadequate solution functionality, potential short-cutting of processes and procedures (due to inadequate human and technical resources), and lack of automated monitoring capabilities. Lack of industry standard operational processes are a potential root cause of system instability and are a significant business risk to the CRB service.
2) As the full integration of MFI and GCFS data in bureau will result in approximately 300% more creditors and 6,250% more clients, the need for adequate and efficient ICT infrastructure is imperative for CRB to perform its operations at the optimum level.
3) Another major challenge faced by the CRB is the sub-optimal facility for the disaster recovery (DR) center, which has insufficient computing resources. This poses an extremely high business risk for the ECRB service and this risk level is further increased as the primary data Centre's building is a construction zone.
4) Apart from the ICT related issues and challenges, there is also a need to expand the service offering of the credit bureau to include additional value-added services such as credit scores, triggers and alerts, benchmarking, decisioning tools, and further related services. Moreover, NBE would like to expand data suppliers to the credit bureau from the retailer, insurance, telecommunication, utility, courts, and other similar sectors that have to do with credit granting, which will need flexible ICT facilities.
5) WBG team will support NBE in researching and learning about Public Private Partnerships (PPPs) to be considered as a possible solution for replacing the current Credit reporting system with a new complete solution.

C. AML/CFT

9. Subsequent to the adoption of the MER report, Ethiopia was determined to have a significant number of deficiencies addressed in its efforts to combat money laundering, terrorist financing and proliferation financing. As a result of these findings it was placed in enhanced follow-up.

In terms of the "Technical Compliance" aspect of the mutual evaluation report, Ethiopia received the following ratings:

RATING	DESCRIPTION	RECOMMENDATION	TOTAL
NC (Non-compliant)	there are major shortcomings	R 1, 6, 7, 40	4
PC (Partially compliant)	there are moderate shortcomings	R 2, 8, 14, 19, 24, 28, 32-34, 36	10
LC (Largely compliant)	there are only minor shortcomings	R 3-5, 10, 15, 18, 21-23, 26, 29-31, 35, 37-39	17
C (Compliant)	there are no shortcomings	9, 11-13, 16, 17, 20, 27	8

NA (Not applicable)	a requirement does not apply, due to the structural, legal or institutional features of a country	R 25	1

10. Concerning the assessment on "Effectiveness," equally as important as the assessment on Technical Compliance, Ethiopia received nine ratings of a Low level of effectiveness (meaning the Immediate Outcome is not achieved or achieved to a negligible extent – fundamental improvements needed); and, two ratings of Moderate level of effectiveness (meaning the Immediate Outcome is achieved to some extent – major improvements needed).[72]

As a result of the ratings received by Ethiopia on their mutual evaluation, they were placed in the ESAAMLG enhanced follow-up process in an effort to monitor their progress in meeting the technical deficiencies identified.[73] Based on the report, Ethiopia was expected to make improvement on fourteen Recommendations (Recommendations 1, 2, 6-8, 14, 19, 24, 28, 32-34, 36 and 40) - those that they received a rating of NC or PC. Also, based on progress made, re-ratings on the Technical Compliance assessment were granted where sufficient improvement by Ethiopia had been made.[74] As of the mid-October 2019 FATF meeting Ethiopia has left the gray list.

The table below outlines the progress made on Technical Compliance by Ethiopia as indicated in their ESAAMLG 5th Enhanced Follow-up Report & Technical Compliance Re-rating, September 2018:

RECOMMENDATION	**RATING**	**NEW RATING**	**NOTES**
R 1	NC	C	deficiencies identified in the MER have been addressed.
R 2	PC	PC	Ethiopia has not provided adequate information/ documents to assist in determining whether or not Ethiopia has implemented the recommendations in relation to c.2.2; therefore, PC rating should be retained
R 6	NC	LC	Quality and Consistency Review process (FATF)
R 7	NC		NO FURTHER INFORMATION IN LAST REPORT
R 8	PC	PC	Ethiopia has made progress, which includes carrying out the NPO sector risk assessment, authorities have not addressed some of the obligations under the revised Recommendation 8 and therefore the Task Force determined that

[72] Within the FATF Methodology there are eleven Immediate Outcomes and each one of these Immediate Outcomes represents one of the key goals which an effective AML/CFT system should achieve.
[73] Follow up process concerning deficiencies related to "Effectiveness" and the "Immediate Outcomes" will be analyzed as part of a later follow-up assessment.
[74] The follow-up report also analyzed progress made in implementing new requirements relating to FATF Recommendation 8 which have changed since the MER was adopted.

			there is no adequate basis for considering favorably the request for re-rating
R 14	PC	C	Ethiopia has addressed the deficiencies; therefore, re-rating of Compliant
R 19	PC	LC	Most of the deficiencies identified in the MER have been addressed and only minor deficiencies remain; re-rating to LC.
R 24	PC		NO FURTHER INFORMATION IN LAST REPORT
R 28	PC	LC	approved re-rating to Largely Compliant
R 32			NO FURTHER INFORMATION IN LAST REPORT
R 33	PC	LC	Given the progress made in addressing deficiencies under this Recommendation approved re-rating to LC.
R 34	PC	PC	The progress reported is not sufficient to warrant a re-rating; therefore, rated Partially Compliant on R.34.
R 36	PC		NO FURTHER INFORMATION IN LAST REPORT
R 40	NC		NO FURTHER INFORMATION IN LAST REPORT

AML/CFT Technical Assistance

11. **The World Bank is well positioned to support Ethiopia on a number of technical assistance activities,** both, through its financial markets integrity unit and through the StAR, a partnership between the World Bank and the United Nations on Drug and Crime (UNODC), initiative.

a. **Supervision for financial institutions, and DNFBPs.** Provide support to the Ethiopian authorities in revising and strengthening their supervision systems and assist in implementing a risk-based approach. This can be done through training and capacity building workshops.

b. **Building capacity to develop and utilize financial intelligence.** Support can be provided to the Ethiopian FIU in developing increased capacity to cultivate and analyze financial intelligence, which is fundamental to the identification and the tracing of proceeds of crime. The WBG can also support improving domestic coordination by encouraging secondment arrangements, MOUs, and other means.

c. **Building investigatory and prosecutorial capacity**. The WBG and StAR can improve the capacity of investigators and prosecutors to investigate and prosecute financial crimes to include ML/TF, associated predicate offenses, to include corruption.

d. **Support informal and formal international cooperation.** The WBG participates actively in FATF meetings; FATF style regional bodies (FSRBs) meetings, as well

as asset recovery and other events. The WBG and StAR are well placed to build connections between Ethiopian authorities and foreign authorities as needed, promoting enhanced cooperation. Moreover, the WBG and StAR can provide training and capacity building workshops to improve the effectiveness of the relevant competent authorities to conduct informal and formal international cooperation, to include mutual legal assistance.

e. **Confiscation and recovering proceeds of corruption.** Through the StAR initiative, StAR is already supporting the efforts of the Asset Recovery Investigative Task Force (ARITF) operating under the auspices of the Attorney General's Office. StAR is providing capacity building workshops on relevant topics as well as a mentor to assist the ARITF in achieving its mandate. StAR will continue to focus on supporting Ethiopia's efforts in identifying, tracing, confiscating and repatriating proceeds of corruption. This is a comprehensive effort that will include legislative reform, strengthening financial investigative skills, domestic cooperation, informal and formal international cooperation to include enhancing mutual legal assistance capacity.

f. **Legislative reforms.** The UNCAC assessment of Ethiopia in 2015 identified several areas where legislation can be improved. The WBG and StAR can support Ethiopia's efforts to bolster their legal framework in an effort to progress combating corruption.

g. **Cross border movement of cash and BNI.** Ethiopia received a PC rating concerning cash couriers, highlighting several deficiencies. EFI can support the competent authorities involved in implementing this FATF Recommendation through training, legislative reforms, and other capacity building measures.

Implementation Risks

12. Ethnic tensions and regional security concerns in Ethiopia could make sustained and effective engagement on the aforementioned technical assistance challenging. Moreover, government commitment in participating, providing access, supporting operations and providing the indispensable resources required to effect change may wane in an environment of ethnic and political tensions compounded by and somber security concerns.

ANNEX IV: List of Stakeholders Consulted

Name	Title	Organization
Ato Tiruneh Mitaffa	Vice Governor, Financial Stability	NBE
Ato Yemane Yoseph	Vice Governor, Corporate Services	NBE
Abate Mitiku	Director, Change Management, Planning and Communication Directorate	NBE
Salomon Desta	Director, Banking Supervision Directorate (BSD)	NBE
Kifle Negash	Head Credit Reference Bureau, BSD	NBE
Tesfamariam Hailu	Head Licensing Unit, BSD	NBE
Teshale Benti	Head of Supervision 1 Team, BSD	NBE
Merga Gemeda	Head of Supervision 2 Team, BSD	NBE
Sintayehu Desalegu	Head of the Analyses Team, BSD	NBE
Belete Fola	Head of Supervision 3 Team, BSD	NBE
Muluneh Gobezie	Director, Monetary and Financial Analyses Directorate	NBE
Frezer Ayalew	Director, Micro Financial Institutions Supervision	NBE
Temesgen Zeleke	Director, Financial Inclusion Secretariat	NBE
Eyob G/Eyesus	Head of Payments Systems and Settlements	NBE
Belay Tulu	Director - Insurance Supervision Directorate	NBE
Weynshet Zeberga	Chief Research Officer Legal services Directorate	NBE
Kibre Moges	Director Legal Services Directorate	NBE
Gebreyesus Guntie	Sr. Advisor to the Governor	NBE
Martha Hailemariam	Advisor to V/Governor, Financial Institutions Supervision Cluster	NBE
Fikadu Digafe	A/Director, External Economic Analysis and International Relations Directorate	NBE
Befakadu Gashaw	Director, Economic Modeling and Statistical Analysis Directorate	NBE

Yenehasab Tadesse	Director, Foreign Exchange Monitoring and Reserve Management Directorate	NBE
Abebe Senbete	Director, Currency Management Directorate	NBE
Mesfin Getachew	Chief Legal Expert	NBE
Gemechis Dugasa	Senior Examiner	NBE
Mawek Tesfaye	Senior Research Officer	NBE
Abel Solomon	Chief Communication Officer	NBE
Temesgen Goshana	Research Officer	NBE
Getnet Adane	Chief Financial Inclusion Officer	NBE
Muhidin Shifa	Prinicipal Financial Inclusion Officer	NBE
Solomon Damtew	Principal Payment System	NBE
Gaim Addisalem	Senior Examiner	NBE
Anteneh Geremew	Senior Research Officer	NBE
Shambel Teshome	FX Fund and Risk Manager	NBE
Gebe Yamatew	Senior Research Officer	NBE
Chalachew Abinet	Senior Research Officer	NBE
Mengesha Manedo	Research Officer	NBE
Ibrahim Fereja	Senior Research Officer	NBE
Firew Haile	Senior Expert	MoF
Getu Getahun	Team Leader	MoF
Muhammed Fentahun	Junior Expert	MoF
Girma Demass	Junior Debt Expert	MoF
Deselegn Beksisa	Expert	MoF
Samuel Wolde	Domestic Debt Expert	MoF
Tewodros Ayele	Application Management Officer	MoF
Kirubel Araya	Research Officer	MoF
Yonas Fantaye	Senior Officert	MoF
Esayas Lire	Fiscal Policy Expert	MoF
Melika Bedri	Chief Finance Officer	CBE

Tiruberhan Hailu	Chief Risk Officer	CBE
Kifle H/Eyesus	Director of Strategy	DBE
Nebil Kellow	Managing Director	Enterprise Partners
Bekure Tamirat	Director of Operations	Gebeya Inc
Nurhassen Mensur	Business Communication Director	YenePay Financial Technologies P.L.C
Endashaw Tesfay	Commercial Manager	MBIRR
Rolina Negussie	Corporate Strategy Lead	Blue Moon
Ato Zewdu Assefa	Deputy CEO and his team	Bel Cash
H.E Dr. Ahmedin	State Minister	Ministry of Innovation and Technology
Ato Yilebese Addis	CEO	EthSwitch
Ato Shimeles	Chief Information Officer	Dashen Bank
Ato Kefyalew		Awash Bank