International Journal of Science and Research (IJSR)
ISSN: 2319-7064
ResearchGate Impact Factor (2018): 0.28 | SJIF (2019): 7.583

Prospects and Challenges of Foreign Banking Entry to Ethiopian Financial Market

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Abstract: ***Based on Ethiopia Government's major policy shift in 2018 to partly privatize major state owned enterprises like ethiotelecom, Ethiopian Airlines, , the preparation to introduce stock market in Ethiopia by 2020, is an indication to help expect the possibility of allowing foreign banks to operate in Ethiopia in the future . Allowing foreign banks to operate in Ethiopia will bring both prospects and challenges to the incumbent state owned commercial and private banks in particular and the financial sector in general. As evidenced from literature, foreign bank entry to the domestic market will bring immense opportunity to the Ethiopian banking market, and create strong competition challenge between foreign and domestic banks and within the domestic banking institutions. Accordingly four strategies are recommended to be adapted by local banks in Ethiopia to follow either of: merger and acquisition, niche, do nothing, and joint venture, with merger and acquisition as an optimal strategy.***

Keywords: Foreign banking, entry, merger &acquisitions, Ethiopia

1. Background of the Study

Ethiopia is the second most populous country in Africa next to Nigeria with estimated population size of 107 million in 2018. With the recent government's major decision on the part of the privatization of major state owned enterprises including telecom, airline, shipping and other industries, many are curious about what prospects and challenges are going to face on financial service industry of Ethiopia if it is allowed for foreign banks to enter and operate in the country. Consequent to the privatization of major state owned enterprises previously owned by the government as a monopoly, Ethiopian nationals previously denied of share ownership in Ethiopian banks seem to be allowed to own and or invest in the Ethiopian banking sector pending the approval the Parliament. Before the grand decision made by the government in 2018, Ethiopian Government is known for its protectionist approach when it comes to the finance sector not to be owned by Ethiopian born foreign nationals let alone allowing foreign banks to operate in Ethiopian banking market. However, based on the major policy shift in the decision of the government to partly privatize major state owned enterprises like ethiotelecom, which is seemingly enjoying abnormal profit with trade off of company competitiveness; and the inclusion of Ethiopian Airlines, which is also a national flag carrier and Africa's pride and worlds class organization with successive success history as a candidate for partial privatization, the preparation to introduce stock market in Ethiopia by 2020,etc is naïve not to deduce the possibility of allowing foreign banks to operate in Ethiopia . Allowing foreign banks to operate in Ethiopia will bring both prospects and challenges to the incumbent state owned commercial and private banks in particular and the financial sector in general. Therefore, this paper analyzes the prospects and challenges of allowing foreign banks in Ethiopia and the strategies to be adapted by domestic banks in Ethiopia to survive and thrive with the new competitors entering and competing with them.

2. The Ban on Participation of Foreign Investment in Banks in Ethiopia

The Ethiopian banking sector has remained closed to foreign investors. It is known that the banking sector is among areas of investment exclusively reserved to Ethiopian nationals.

As per Art. 9 of the banking business proclamation No. 592/2008 reasserts the exclusion of foreigner investors and other domestic investors by stating that "foreign nationals or organizations fully or partially owned by foreign nationals may not be allowed to open banks or branch offices or subsidiaries of foreign banks in Ethiopia or acquire the shares of Ethiopian banks [1]. This pervasive provision asserts the continuation of banking business as exclusive domain of Ethiopian nationals and their own business entities. While the usual form of foreign participation in the banking sector is via opening branches or subsidiaries of foreign banks, the law does not give any loophole for foreign participation even by way of equity holdings [2]. Governments liberalize their banking markets in order to attract new capital and to promote the restructuring of their often rather inefficient banking systems. One possible channel for how foreign banks may foster such a restructuring process is spillover effects from foreign to domestic banks, another possible channel could be the increase in competition. However, the opening up of banking markets can also entail large risks since domestic banks need to undertake huge investments to become competitive with foreign banks [3]. At any rate in the context of Ethiopian law, the balance of pros and cons of foreign participation in banking has gone in favor of exclusion of foreigners. Ethiopian financial sector, Ethiopian Government and other stakeholders, including the leadership of the private banks and the Ethiopian Bankers' Association, have five main concerns raised on Ethiopian Financial sector [4].

a) The government believes that the development of a viable domestic banking sector will be threatened by foreign banks, because they have more capital, more experience, and better reputations. They argue that the

Ethiopian financial sector is too young and inexperienced to compete (the infant industry argument). Ethiopian government officials also believe that entry by foreign banks will further skew credit allocation towards large-scale industrial, real estate and service enterprises (including trade) and away from agriculture, small-scale and cottage/micro enterprises (sectors which are the priorities for the government's development strategy).

b) They contend that foreign banks will concentrate lending in major urban centers using foreign funds, contributing little towards the development of rural banking. Furthermore, they contend that foreign banks will "cherry pick" the best companies and sectors.
c) Domestic savings mobilization has been identified as an area of concern to Ethiopian officials, who have suggested that foreign banks would lend in their home or other foreign currencies and would not be interested in mobilizing domestic savings.
d) There is concern that foreign banks may serve as conduits for the inward and outward flows of capital (e.g., through capital and money-market transactions; credit operations; personal capital movements; etc.). This may cause foreign exchange and/or liquidity shortages, with potentially adverse effects on the country's capital account. The concern becomes more pronounced in view of the limited regulatory capacity of the central bank.
e) Finally, it is strongly believed that the authorities will be unable at present to regulate and supervise foreign banks effectively.

3. Positive Effects of Foreign Bank Entry

a) Credit Availability:-Financial integration allows capital to flow from capital-abundant countries, where expected returns are low, to capital-scarce countries, where expected returns are high. [5]
b) Sounder Lending Practices:-Foreign bank presence may contribute to the stability of available lending by diversifying the capital and funding bases. [6]
c) Competition, Stability, and Dynamic Effects in the Banking System:-In developing countries, foreign bank entry may stabilize the financial system. First, foreign banks have sounder lending practices and accumulate fewer bad loans. In addition foreign banks may be more resilient to negative shocks because of their direct access to foreign savings [7]. On the other hand, foreign banks may introduce more volatility in lending because they can more easily find alternative investment opportunities [8].
d) Enhancing Banking Market Competition and Efficiency:-Empirical evidence shows that foreign bank entry leads to greater efficiency in the functioning of national banking markets, with positive welfare implications for banking customers. The relaxation of restrictions on foreign bank entry may similarly reduce domestic banking profits and force domestic banks to cut costs, but with positive overall welfare implications for the domestic economy [9].

4. Challenges of Foreign Bank Entry

a) Tendency for Bank Crises

There is a thesis on foreign banks that these banks will be more likely to shift their funds to more attractive markets during a crisis if their parents are weak. There are two related issues here: (i) whether the presence of foreign banks makes systemic banking crises more or less likely to occur, for example, by providing an additional avenue for capital flight, and (ii) whether there is a tendency for foreign banks to "cut and run" during a crisis. On the other hand, foreign banks can contribute to the stability of the domestic financial system, for example, if depositors shift their deposits to foreign banks from their risky local banks rather than engaging in a capital flight [10].

b) Challenging the Performance and Weakening Domestic Banks

The main argument against an early market entry of foreign banks is the risk that domestic financial institutions would not be able to withstand increased competitive pressure and might even risk facing bankruptcy. Such banking failures might have spillover effects on other banks and could possibly endanger stability in the financial market. [11] If domestic banks fall under the "too big to fail" category and thus require some support, suppressing competition from new entrants can be an inexpensive form of support.

5. Forms of Foreign Bank Entry and Form of Organization

Empirical evidence shows that in emerging markets, foreign banks are more profitable and more efficient than domestic banks, while being less profitable in more developed countries [12].

a) Representative Offices:-A representative office is the most limited but most easily established organizational form. It does not engage in attracting deposits and extending loans, but is generally established to test the possibility of further involvement [13].
b) Foreign Branch:-A foreign branch constitutes a higher level of commitment than a representative office or agency. The crucial difference between a foreign branch and a foreign subsidiary is that, legally, a branch is a unity with its parent and a subsidiary is an independent legal entity.
c) Bank Subsidiaries:-Bank subsidiaries' are separately incorporated from the parent bank, whose financial commitment to the subsidiary consists of the capital invested. Subsidiaries are usually involved in retail banking markets.
d) Establishing an Affiliate Relationship or Participating in a Joint venture:-This can be another way to engage in foreign expansion. This usually involves taking minority stakes in local entities, and the level of involvement in the management of the local banks by the foreign bank is normally low. The joint ventures modes are formed by more than one firm. They generally have a financial interest and a board membership. A joint venture is an arrangement where the firm is required to share equity and control of the venture with a partner from the host country.

6. The Future of Ethiopian Banking Sector

Ethiopia has taken a cautious approach towards the liberalization of its banking industry. For all intents and purposes, its industry is closed and generally less developed than its regional peers [14]. Foreign bank entry in Ethiopia could introduce new banking technologies, financial innovation and promote financial development. In addition, it enhances access to international capital and may precipitate the overseas expansion of domestic banks and greater integration of Ethiopian banks into international financial systems, which may enable them to provide a broader range of services, particularly to larger local firms with international operations [15]. On the other hand, the stiff competition with foreign banks may threaten the survival of domestic banks that may lead them to incur high cost in the short run and decline in profit. In addition, it may; bring shocks from other country, destabilize domestic credit and may serve more productive sectors only [16]. Kiyota *et al*. (2007) Ethiopian banking sector is affected by two factors that may constrain Ethiopia's financial development. One is the closed nature of the Ethiopian financial sector in which there are no foreign banks, a non-competitive market structure, and strong capital controls in place. The other is the dominant role of state-owned banks [17]. The Ethiopian economy would benefit from financial sector liberalization, especially from the entry of foreign banks and the associated privatization of state-owned banks [18].

7. Conclusions and Lessons from Empirical Evidences for Ethiopian Banking Industry

Ethiopian financial industry is highly regulated by a regulatory, which relative to other private industries in Ethiopia, proved to be successful in the last couple decades. The conclusions and recommendations drawn for the industry is equally important to take as a policy input for the regulator (NBE) for informed policy decision, and executive information for leaders of the industry as operators for strategic decision making process that will enable both (regulator and operator) for all possible scenarios of foreign bank entry and set of choices (strategies) to be made among the four strategies proposed. Based on the recent major government decision on the privatization of state owned enterprises, Ethiopia's potential for becoming WTO members with all the privileges and obligations, and most importantly Government's approval of African Continental Free Trade Area Agreement (ACFTA), it is inevitable to see for allowing foreign banks to operate in Ethiopian banking market sooner or later. As evidenced from literature, foreign bank entry to the domestic market will bring immense opportunity to the Ethiopian banking market, and create strong competition challenge between foreign and domestic banks and within the domestic banking institutions. In either of the case , as opportunity or challenge, it is a good news for the banking industry customers as new foreign bank entry to the Ethiopian banking market will further fuel competition and competition will force including domestic banks to innovate to survive and thrive. Therefore , it is recommended that Ethiopian domestic financial institutions should get prepared to design a strategy to enable them compete with the inevitable arrival of foreign banks to the Ethiopian market in either or combination of the following known strategies.

1) Merger and Acquisition: The existing state owned Commercial Bank and first and second generation private banks may initiate the negotiation process for possible merger to form one or two new big commercial and investment banks in Ethiopia, or state owned Commercial bank may think of acquisition of emerging recent private banks for further capital consolidation and better competitive position.
2) Niche Strategy- though different banks may follow their own unique strategy to be agile and survive with the foreign bank effect, some of them can niche to specific banking market by redefining their business mission where they have gained new capability and possess strong resources
3) Do Nothing- The incumbent domestic banks can maintain the status quo and continue to operate business as usual, hoping that the new entrants to the market will take long time to learn , adapt and thrive in Ethiopian banking business market. That will in turn help, Ethiopian banks to wait and learn the behavior of foreign banks and act on viable strategy to win competition later.
4) Joint venture-foreign banks can be perceived and treated as potential partner to work on banking business with. Therefore, with the assumption of win- win approach from both sides by finding reason to partner with each other; Ethiopian banks can opt for joint venturing with foreign banks in ownership share mode taking in to account the managerial control to be left in the Ethiopian hands.

Even though, the four strategies are viable courses of action to be taken in the context of each institution's core competence, if there is a necessity to prioritize among the available four set of choices, merger and acquisition can be considered as a first set of choice with the following theoretical base with its own pros and cons as a strategy, as explained below.

Every business want the optimum market share (growth) over their competitors, so companies are trying to get optimum growth by using the most common shortcut i.e. Merger and Acquisition (M&A). The growth main motive is financial stability of a business and also the shareholders wealth maximization and main coalition's personal motivations. Mergers and acquisitions (M&A) provides a business with a potentially bigger market share and it opens the business up to a more diversified market. In these days it is the most commonly use methods for the growth of companies. Merger and Acquisition (M&A) basically makes a business bigger, increase its production and gives it more financial strength to become stronger against their competitor on the same market. Mergers and acquisitions have obtained quality throughout the world within the current economic conditions attributable to globalization, advancements of new technology and augmented competitive business world [19]. In the last decade, M&A are the dominant means of organization's globalization [20]. Merger particularly could be a growing development that has become an area of the recent business conditions and it's apparent to possess affected each nation and trade [21].

The merger and acquisition (M&A) reduces flexibility. If a rival makes revolution and may currently market vital resources those are of superior quality, shift is tough. The change expense is the major distinction between the particular merger worth and also the merchandising value of the firm that can be of larger distinction.

As a Conclusion, though one size does not match all, several firms think that the most effective way to get ahead is to expand business boundaries through mergers and acquisitions (M&A). Mergers produce synergies and economies of scale, increasing operations and cutting prices. Investors will take comfort within the idea that a merger can deliver increased market power; stand tall to sustain competition from banks that may enter to the Ethiopian market, and finally innovate and thrive from the consolidated resource base that is accumulated through merger and acquisition.

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