

# MASTER THESIS

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Candidate name: Krishna Kunwar

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## Management Control System in Bank's Lending Structure in Relation with Government Rules: Evidence from Nepal

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## **Abstract**

The purpose of the master this is to identify the formal rules and regulations related to credit processing function of the bank, how they are communicated and used as the control elements for the management control system of credit function of commercial banks of Nepal.

The theoretical framework of administrative control system by Malmi and Brown (2008) and Simons four levers of control (1995) are used for master thesis. Both primary data collected through semi structured interviews and secondary data from various publication from government and private organizations are used.

The empirical findings show presence of unified directives and various internal policies and guidelines formulated by central bank and board of directors as the governing documents of credit functions. The compliance of them are assured by top management through the use of effective tools and techniques of management control system of bank through multi-layer formal organizational structure for credit sanction. The master thesis highlights the significant use of rules and regulations as a control factors of management control system of credit functions. There is major similarity in practice and theories presented in administrative control systems of Malmi and Brown (2008) and Simons four levers of control (1995). However, the thesis also identifies the presence of informal communication and control system and high influence of punishment mechanism in the behaviour of the employees of credit function.

The limited time for data collection and completion of overall research along with geographical location of the context act as the major limitation of the research.

**Keywords:** Management Control System, Administrative Control System, Simons levers of control, Nepalese banking sector, commercial banks, formal rules and regulations

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## **List of Abbreviations**

MCS	: Management Control System
AOS	: Accounting Organization and Society
MAR	: Management Accounting Research
LRP	: Long Range Planning
NRB	: Nepal Rastra Bank
BAFIA	: Bank and Financial Institutions Act
BFI	: Bank and Financial Institutions
ALM	: Assets and Liabilities Management
RM	: Relationship Manager
CPG	: Credit Policy Guidelines
SME	: Small Medium Enterprise
CRO	: Chief Risk Officer
CBO	: Chief Business Officer
CCO	: Chief Credit Officer
CEO	: Chief Executive Officer
CAD	: Credit Administrative Department
PP	: Product Papers
BCBS	: Basel Committee on Banking Supervision

# 1. Introduction

Over the years, management control system has evolved from mainly focusing on financially quantifiable information to much broader scope of information. These include the areas like external information related to customers, competitors and markets, non- financial information related to process of production, prediction of information and prospect of decision support mechanisms. It also includes scope related to informal way of both personal and social controls. The conventional perception of management control system as a passive tool has been evolved (Chenhall, 2003).

Malmi & Brown (2008) state that management control includes all the devices and systems the managers use, to ensure the behaviours and decisions of their employees, that are consistent with the organization's objectives and strategies, but exclude pure decision-support systems. Later on, Chenhall and Moers (2015, p.1) define management control system as "a set of many formal and informal inputs, process and output controls that are used by management to achieve organizational goals; controls are connected by many complementarity relationships".

Thus, management control system can be useful for all kinds of organizations despite of lots of differences among them. However, the research on manufacturing of product was mostly focused compare to non-manufacturing such as service and government. The reasons behind these were due to the historical involvement of manufacturing product costing and control of factory costs. The intention was to improve in product costing and manufacturing cost management (Shields,1997).

The claim was also supported by Billings and Capie (2004, p. 330) who stated that "the academic literature on the historical development of management accounting focuses mainly on manufacturing organizations, with relatively few papers on service companies."

However, focus on research related to management control in service sectors is present at the research literature (see e.g. Auzair and Langfield-Smith, 2005; Brignall and Ballantine, 1996; Hopper and Major, 2007) despite its intangible nature of services with difficulties for measurement and control. Similarly, in the field of service sectors, the banking industry is

considered as an important institution because of the activities of banks that always have an enormous influence on societies (Goonaratne and Hoque citing Bryan, 2013, p. 145).

### **1.1 Motivation of the study**

Aluko & Ajayi citing Levine (2017, p.1) mention that the banking sector performs five functions which can facilitate economic growth. These functions include providing ex ante information about possible investments and allocate capital, monitoring investments and exert corporate governance after providing credit, facilitating trading, risk diversification, risk management and mobilizing and pooling deposits, and facilitating the exchange of goods and services.

Further, Lerskullawat (2016) suggested that the policy maker should carefully control and monitor the banking sector and capital market development as this development can possibly create a weak or strong effect of the monetary policy on bank loan supply and the economy causing difficulties in controlling monetary policy. This shows that how important banking sector and its lending procedures are for the overall economy in contrast to manufacturing industries (Goonaratne and Hoque, 2013).

Goonaratne and Hoque (2013, p. 144-145 ) stated that :

*‘A number of past researchers have conducted general reviews on various facets related to management accounting practices in the context of management control, performance measurement, management accounting innovations, new manufacturing costing and cost management, management accounting research in particular regions ...’*

and later argued that “... relatively few studies have been devoted to banking and financial institutions” ( p.145).

They have reviewed 40 studies carried out primary by consulting leading accounting journals, majority of which are from Long Range Planning ( LRP) , Management Accounting Research ( MAR) and Accounting Organizations and Society (AOS). They focus on paper that carry field study or empirical evidence and practical insights on management control issues in banks where 16 of them are qualitative in nature (Goonaratne and Hoque ,2013).

They have found that there are limited studies of management control issues in banking. Out of them, most of the studies were in the form of commentaries in contrast to in-depth inquiry and there is failure to clearly articulate the theoretical stance. Similarly, they have further informed that most of the studies are concerned with re-application of existing theories, certain studies even have absence of rigorous methodology which only focus on a single level such as unit or organization. They further add that majority of studies drawn from the developed countries in the West (p.156-159).

However, there are articles and journals about banking sectors of developing countries which are related to management control systems and other issues of the banks as well.

In recent time, the article by Aluko and Ajayi (2017) examines the determinants of banking sectors development in Sub-Sahara African countries from 1997 to 2014. The results show that population density and simultaneous openness to trade and capital promotes and enhance the stability of banking sector. However, financial liberalisation, economic growth and inflation hinders development and stability of banking sector (Aluko and Ajayi, 2017).

The impact of the intensity and length of bank-firm lending relationship on Tunisian bank's credit risk for the period of 2001-2012 has been analysed. In the context of private banks that there is improve in their loans portfolio quality by taking advantage of their close lending relationships with borrowers to mitigates asymmetry information (Belaid et al., 2017).

The above research articles are the examples that are conducted in the field of banking sectors which are mostly focused in the external factors and environment.

Similarly, there is also presence of recent articles and journals in the field of internal and management control systems in relation to banking sectors of developing countries. The case study in the impact of internal control in the banking sector of Nigeria was such an example. The aim of the study was to verify that effective and efficient internal control system as the best control mechanism to detect and prevent fraud using descriptive and inferential statistical methods. It was concluded that, to eliminate fraud and fraudulent tendencies the functions of fraud prevention, detection and control as internal control system are found to be highly significant (Olatunji , 2009).

Similar as another example, Hayali et al. (2013) expressed the important of internal control system and its impacts to the banking system in the context of Turkey. The secondary data was used and analysed with qualitative research methods. The study shows that international standard of internal control activities was adopted and effective control procedures exist with strong and stable banking sector (Hayali et al., 2013).

Regarding management control mechanisms in Malaysian Islamic banking in relations to fairness and trust, Alaudin et al. (2010) had concluded that there are other control mechanisms and practices at work in implementing the bank's strategy at operational level. This exist even there is presence of formal budgetary control and key performance indicators (KPIs) to constitute reward roles (Alaudin et al. , 2010).

In the context of Nepal, Rijal (2007) attempts to examine the application of management control system in Nepalese commercial banks. The study focuses on competitive situation, performance evaluation, reward system and encouragement regarding learning of new skill and knowledge. Both primary and secondary data had been considered. The primary data was collected with structured questionnaire from 102 respondents of 13 commercial banks. Similarly, the secondary data are collected through websites of related banks, regulators and stock exchange. He has described that commercial banks are very competitive in its service with the adaptation of differentiation strategy. They prioritised in customer retention and encourage its employees to upgrade their skills and knowledge. There is also existence of informal organizational and communication system along with congenial working environment (Rijal , 2007, p. 98-99).

Thus, it can be concluded based on above reviewed articles, there are some study on banking sectors in developing countries with focus on external environment (Aluko and Ajayi, 2017; Belaid et al., 2017), internal control system (Hayali et al., 2013; Olatunji, 2009) and management control system of overall banking system and operations (Alaudin et al. , 2010 ; Rijal , 2007).

These show, there is a gap in the study of management control system in the banking sector of developing countries specially in the context of particular departments and their functions. One of them is credit function of the bank which is concern with different credit processing departments and top-level managers of the bank.

Similarly, in line with call for more research (Goonaratne and Hoque, 2013, p. 157) on use of multiple theories that are outside the functionalist paradigm, studies related to different layers of banks, focus on in-depth or survey research and most importantly studies outside the developed world, my research will be focus on rules and regulations related to credit processing departments of commercial banks in Nepal. This project includes the different departments of credit processing function of banks where the data is collected with different hierarchal level of managers of more than one banks.

Further, being an employee of some of the commercial banks of Nepal for three years, in the past, I became familiar with the banking sectors, its work culture, its management systems and style etc. I always what to know and get more knowledge about the banking sector which, I believe, helps to outperform all other sectors of the country despite of governing by strict rules and regulations.

## **1.2 Problem Statement and Research Question**

The purpose of this study is to understand how management control system is used to control credit-processing functions of the bank, and in what ways it is communicated by management to employees.

Thus, the study is mostly focus on the research questions, which are presented as follows:

- 1. What are the formal rules and regulations related to credit processing functions of the bank and how they are communicated?*

The question will be intended to identify major rules and regulations concerning credit facilities that are ensured by existing management control system of the bank. It helps to understand the boundary set by the governing body to control the behaviour of the employees. This further helps to identify the existing structure of the communication and control system.

- 2. How these rules and regulations are used as the control elements for the management control system of credit functions.*

The question will be appropriate for identifying relationship among different level of controls of the lending systems and how management is ensuring the control of the operations within the boundary of the rules and regulations to achieve its predetermined goals. This will also help

to understand the key control mechanism of bank's management control system or systems of credit function with the flexibility to incorporate new regulation if necessary.

### **1.3 Limitations of the study**

My study concerns management control system of credit function of commercial banks of Nepal. It doesn't cover the overall control and management control system of the commercial banks which comprises of different departments and functions such as operations functions related to cash and liquidity managements, deposit managements etc. Similarly, the collection of data is also limited to the number of employees that were interviewed. They have different social and educational backgrounds, experience, designations, assigned responsibilities and departments, etc. It also doesn't consider other financial institutions of the banking sectors which contains institutions like development banks, finance companies which are similar in nature of business as commercial banks and govern my central bank under the same laws and parameters.

## **2. Theoretical Framework**

The main purpose of this chapter is to provide theories on the management control system to answer the research questions. Theoretical framework act as the backbone for any research and it provides theoretical support to the research questions. The frame of reference provided in this chapter helps to explain the management control system of the bank in the context of rules and regulations. This research mainly focuses on management control system that are used by the managers in the credit function of the bank keeping rules and regulations as a key factor to influence the behaviour of the employees. I will try to identify prevailing rules and regulations and how these rules and regulations are used to maintain the control of credit functions of the bank in following chapters. Here, the relevant theories whose understanding will help me to convey the research and present my finding base in relations to them are discussed, i.e. Simon's four lever of controls along with administrative control, as one of the elements of MCS as package.

Section 2.1 provides the overview of management control system that was prevailing in banking system. Section 2.2 and section 2.3 presents the selected theories on administrative control which is a part of MCS as a package and Simons four levers of control respectively. Section 3.3 provides relationship between selected theories and how it is relevant to research questions and lastly 3.4 presents summary of the chapter.

### **2.1 Management Control System in bank**

As per Billings and Capie (2004), up to 1970s, there was less priority for the management control in banks as they were providing narrow range of services in the stable environment condition with limited demands for information.

However, the scenario has been changed from the late 1980s where banks were exposed to the different environment than previous, which leads to the reconstruction of bank's functions. With these, there were changes in the locations of banks, branches were taken as sales outlets and lending decisions were started to be taken in the regional level and all these changes demanded the specialization of expertise (Seal and Croft, 1997).

The globalization of markets and deregulations of economic, political and regulatory environment increased competition and decreased margin in macro level. Similarly, the use of decentralized organizational structure, innovative banking products and practices, technology advancement and focus on cost control in micro level helps for the development of MCS in bank ( Cobb et al., 1995 ; Helliard et al., 2002; Soin , 1995).

Likewise, as per Arnold (2009), the recent global financial crisis which brought huge number of negative consequences were because of poor management, poor governance structure, irresponsible lending and poor accounting controls of banks. Thus, that situation highlights the importance of effective MCS for banks (Gooneratne and Hoque , 2013).

In the context of my research, the definition of management control by Malmi and Brown (2008) as all the devices and systems which the managers use to influence and ensure the behaviours and decisions of their employees that are directed and consistent with the organization's objectives and strategies are more relevant. Similarly management control system as a formal organizational system designed and implemented by management to ensure the achievement of organizational goals (Gooneratne and Hoque , 2013) is also relevant .

## **2.2 Administrative Controls as an element of Management Control System as package**

A management control systems(MCS) package is a collection or set of controls and control systems. The individual control systems may be more traditional accounting controls such as budgets and financial measures, or administrative controls, for example organization structure and governance systems (Malmi and Brown, 2008).

According to Malmi and Brown (2008), there are five controls in the typology of MCS as a package. They are planning, cybernetic, reward and compensation, administrative and cultural controls. Administrative controls are at the bottom which is responsible to create the structure in which planning, cybernetic, and rewards and compensation control are executed.

<b>Cultural Controls</b>		
Clan	Value	Symbols
<b>Planning</b>	<b>Cybernetic Controls</b>	<b>Reward and Compensation</b>
<b>Administrative Controls</b>		
Governance Structure	Organization Structure	Policies and Procedures

Figure 1: Management Control System Package. Source: adopted from Malmi and Brown (2008)

The focus on my research will be in the administrative controls to identify prevailing rules, regulations and procedures of bank related to credit functions and how they are communicated. Similarly, it will also help me to identify and understand the control system of the bank. Thus, let's look into the view of Malmi and Brown (2008) about administrative control system and its components which is relevant to my research.

In the context of administrative control systems, Malmi and Brown (p. 293) states that the system direct employee behaviour through the organizing of individuals and groups, the monitoring of behaviour and assignment of responsible person for behaviour of employees, and the process of specifying how tasks are to be performed. They have classified three groups of administrative controls:

- procedures and policies
- organization design and structure and
- governance structures within the firm

<b>Administrative Control</b>		
Policies and Procedures	Organization Structure	Governance Structure

Figure 2. Administrative Control systems and its elements. Source: adopted from Malmi and Brown (2008)

### 2.2.1 Procedures and Policies

Malmi and Brown argued that policies and procedures includes standard operating procedures and practices along with rules and policies (p. 294). They further claimed that they provide more complete concept of administrative tools managers uses to control behaviour along with

call action control i.e behaviour constraints, pre-action reviews and action accountability (Malmi and Brown citing Merchant and Van der Stede, 2008, p. 294).

One of the focus of my study is to identify the rules, regulations, procedures and policies of the bank or banks under consideration and how they are communicated which influence the control system. This group related to administrative controls will be suitable to my research to identify formal standard operating procedures and practices that is present in credit function of bank.

Similarly, to identify how rules and regulations are communicated among employees and be standardized as the control element for the control of credit function. The administrative control will be appropriate as Malmi and Brown (2008, p. 294) claims that “the use of policies and procedures is the bureaucratic approach to specifying the process and behaviour within an organization”.

### **2.2.2 Organization Design and Structure**

Organization design can encourage certain types of contact and relationships by using a particular structure and it can be act as an important control device (Malmi and Brown , 2008). The organization design can be key to understand the management control system of credit department of the bank which a mechanism can be to flow and communicate the information from top level to operational one.

I believe, the credit function is based on the series of analysis and joint effort of credit processing departments of the bank. So, the organizational design help to understand the relationship among employees and the department in the process of credit function.

Similarly, in my research, the study of organizational design can portrait where rules and regulations are formed and under which mechanism they are communicated as Malmi and Brown (2008) perceive that organization design is something managers can change as than to something that is imposed.

Organizational structure, as a group of administrative control, is a form of control which works through functional specification and contributes to control through refusing the variability of behaviour and increase its predictability (Malmi and Brown, 2008). In this context, along with boundary system of Simon’s lever of control, the constrains impose by controllers can be

examined to find the role of rules and regulations in the management control system in credit function.

### **2.2.3 Governance Structure**

Governance structure, one of the group of administrative controls, includes various management and project teams in relations to company's broad structure and composition. It is the formal lines of authority and accountability of system that ensure the coordination of activities of various functions and unit's representatives both vertically and horizontally. Meetings and meeting schedules etc can be examples of its tools which are used to direct the behaviour of organizational members (Malmi and Brown, 2008).

I believe, the study of governance structure will enable to understand and examine how different departments of credit processing is linked and what roles they play in control system. Eventually, this will allow me to find the results regarding the role of rules and regulations in management control system of the bank.

### **2.3 Management Control design in line with Simons Levers of Control**

Simon's framework is the presentation of opposite forces which manage tension between freedom and constraints, empowerment and accountability, top down direction and bottom up creativity and finally between experimentation and efficiency (Tessier and Otley, 2012).

According to Simon (1995), the framework consists of four control levers which has a distinct purpose for managers attempting to harness the creativity of employee. They are diagnostic, beliefs, boundary and interactive control systems. Diagnostic control system ensure important goals are achieved efficiently and effectively, beliefs control systems empower and encourage employees to search for new opportunities, boundary control system establish rules and actions that employee must avoid and interactive control system enable top level managers to focus on strategic uncertainty and learn about threats and opportunities and respond proactively (Simon, 1995).

Tessier and Otley (2012) claims that Simon's classified these four controls as positive and negative control systems. Belief system and interactive control systems are defined as positive whereas boundary systems and diagnostic control systems are negative.

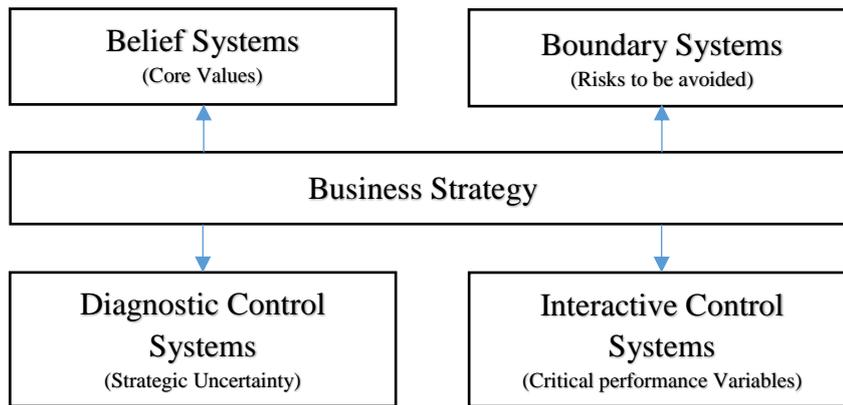


Figure 3. Four levers of Control. Source: adopted from Simons (1995)

The proposed framework will enable in my study to identify management control systems of the bank in relation to their belief and boundary systems. Similarly, interactive and diagnostic systems can be used to examine the relationship between level of managements and how management motivates employees to perform work towards organization’s credit function objectives.

Thus, let’s look into the four levers of control presented by Simons as follows which is relevant to identify the management control system of the bank and understand how rules and regulations are incorporated as an important component of control.

### 2.3.1 Diagnostic Control System

Simons state that diagnostic control system helps managers to track the progress of individuals, departments or production facilities towards strategically important goals. It’s one of the main purposes is to eliminate the manager’s burden of constant monitoring (Simons, 1995).

Diagnostic control system is embedded with firm’s critical success factors and communicated to its employees. The intension of it is to motivate employees to perform work towards organizational objectives (as cited in Widener, 2007, p. 759).

The diagnostic system allows managers to manage results on an exception basis (Widener, 2007) and the main purpose of the system is to eliminate the burden of managers of constant monitoring (Simons ,1995).

### **2.3.2 Beliefs System**

As per Simons, the belief system is the explicit set of organizational definitions which are communicate formally by senior managers that reinforce systematically to provide basic values, purpose and directions. It implies that the beliefs system communicates core values for the inspiration and motivation of to explore, search, expand and create effort in order to engage in appropriate actions (as cited in Widener, 2007, p. 759).

Simons (1995, p. 83) further stated that, “belief systems can also inspire employees to create new opportunities: they can motivate individuals to search for new ways of creating value”. He believes that beliefs systems can augment diagnostic control system to give managers greater amounts of control.

### **2.3.3 Boundary System**

Simons stated that boundary systems are based on management principle of “power of negative thinking”. He further stated that “boundary systems are an organizational break and like racing cars, the fastest companies need the best breaks” (1995, p. 84).

Simons stated that boundary system is a minimum standard used to limit the behaviour of employees in the process of achieving challenging results in the dynamic and complex organization. The code of conduct, confidentiality and non-disclosure agreements can be taken as examples. The organizations which heavily depend on the trust to maintain their reputation and image have more importance for this system (as cited in Tessier and Otley, 2012, p. 172). It has been supported by Windener (2007 p. 782), who stated that, “it also provides structure through delineating the areas of-limit to employees”.

### **2.3.4 Interactive Control System**

Simons stated that interactive control systems are the formal tools which enable management to involve in the decision of the employees. It includes regular personal contact, in the form of face to face meetings, periodic meetings, weekly and monthly reports etc. These systems encourage communication and flow of information among all the levels of organization and

enable management to participate in decisions of the employees (as cited in Tessier and Otley, 2012, p. 172).

According to Simons (1995) interactive control systems have four characteristics:

- focus on constantly changing information that senior managers consider potentially strategic.
- information is significant enough to demand frequent and regular attention from operating managers at all levels of organization
- data generated by the interactive system are best interpreted and discussed in face to face meetings of supervisors, subordinates and peers
- interactive control system is a catalyst for an ongoing debate about underlying data, assumptions and actions plans.

To sum up, framework observed from literature of Simons four levers of control, will be considered to check in the following chapters applying qualitative data. Thus, by identifying the process, tools and strategies followed by banks for its credit processing and its control (based on theoretical considerations), the intention of thesis will be to contribute to study about existing rules and regulations presented in management control system of banks' credit structure in the context of Nepal.

## **2.4 Relationship between selected theories and its relevancy**

Malmi and Brown (2008, p. 297) requested to find out how the elements within control package related to each other as they had very little knowledge about how systems of elements are actually configured as a package across organizations. Malmi and Brown further describe value based controls as one of the aspect of cultural control and stated that, "Simons (1995) developed the concept of value controls through what he described as belief systems" ( Malmi and Brown, 2008, p. 294).

Thus, in my research, I am trying to identify the rules and regulation that is prevailing in the credit processing function of the bank and how they are used as the control elements in each functional and control structure of the credit department. The focus is on both administrative controls which contains policies and procedures and belief controls system which is used to communicate the core values, mission, principles and purposes to the employees.

In addition to that, administrative controls comprise of procedures and policies (Malmi and Brown, 2008) which is one of the essential elements and components of the boundary system that govern the behaviour of the employees (Simon, 1995). My study will be one of such attempts to study the control mechanism of credit processing of bank with the use of both administrative controls and boundary control systems.

Similarly, Marginson (2002) forms the cluster of management control systems (MCS) with design and use of three groups of MCS comprise of belief and boundary system, administrative control and performance measurement systems to study the relationship between MCS and the strategy process of strategic management. Thus, the research by Marginson (2002) inspires me to consider the components of different theories together as complement factors to research related subject matters.

The formal organization is one of the determinants of communication network and work-group structure influences flow of new ideas (Allen and Cohen, 1969). These can be considered that the flow of the information related to policies, rules and regulations etc can done through the organizational structure. Thus, the combine study of administrative controls and interactive control system can be relevant under these assumptions.

Administrative control systems are linked with Diagnostic and Boundary systems of Simons level of controls to examine the structure of the bank and role of rules and regulations in the credit sanction authority. The theoretical framework or structure will examine the research problem of finding out how rules and regulations are including in these organizational structures along with who are responsible for controlling the behaviour of the employees toward goals.

Widener (2007, p. 782) stated that, “the diagnostic control system provides the structure that enables the interactive system to be effective since the diagnostic mechanism is a mechanism by which the employees learn of the new strategies and consequently new goals and objectives with which to align behaviour”.

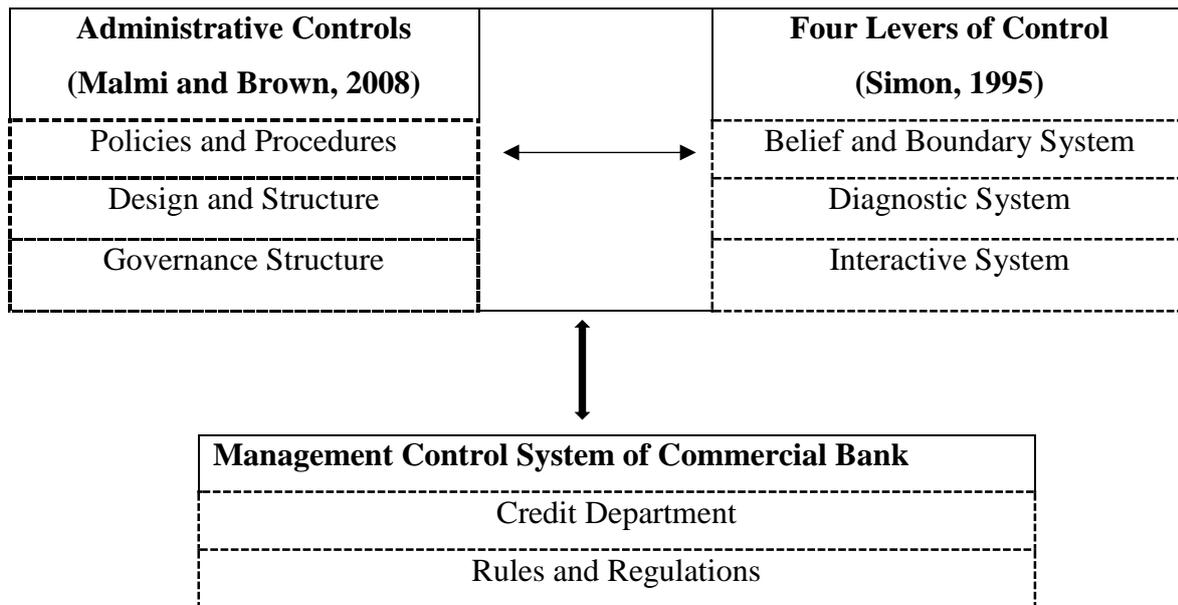


Figure 4: Approach to study

Thus, by studying the administrative controls along with four levels of controls, I am trying to find the results related to my research questions to the identification of rules and regulations and their influence in the management controls systems of the bank.

## 2.5 Summary

In order to identify major rules and regulations concerning credit facilities that are ensured by existing management control system of the bank and related control system of credit lending function of bank, this chapter is focused on discussing two major theoretical approaches i.e. Simon's four levels of controls (Simon, 1995) and administrative controls, one of the components of MSC as a package (Malmi and Brown, 2008).

Under Simon's four levers of control, the beliefs and diagnostic systems are used in order to identify relevant rules and regulations along with identifying related mechanisms and processes in relations with credit facilities. Similarly, boundary system will also be used to identify rules along with those mechanisms which are used to identify the actions of the employees. It will be used to describe and analyse how the system works to avoid unwanted responses of the employees' today attainment of goals in line with rules presented by top level manager.

Interactive system of Simon's lever of control will also be considered to find the features of the system that are used by the senior managers to consider frequently changing information as per

their potential strategies. Likewise, how the banks handle information that are generated among the employees and process new information that are obtained in all level of operations.

Administrative controls are also considered to identify policies and procedure of the bank and under what structure those are communicated. It will also be useful for identify the boundary and belief system of the organization in relation to credit functions. It can also be considered to identify how top managers uses different control systems to take desirable result in relation to credit processing.

Thus, the above discussed theories will help to guide the empirical findings of this research regarding existing rules and regulations presented in management control system of banks' lending structure.

### **3. Methodology**

In this chapter, the methods which are used to collect the relevant data for my researcher are presented. It also includes what tools and techniques are adopted and what are the reasons behind choosing those for my research. The chapter includes 3.1 introduction of research design, 3.2 data collection method, 3.3 data collection process, data analysis, validity and reliability followed by 3.4 limitation and summary.

#### **3.1 Introduction of Research design**

Research is a term that are generally used for any types of investigation which are directed to uncover new and interesting facts. It involves the activities that involves a systematic way to find out things which are generally not in the knowledge of all. It is to search for the knowledge which no-one else knew about. Thus, research is about acquisition of knowledge and development of understanding, collection of facts and interpretation of those facts to build up the picture of the world which is around and within us (Walliman, 2011).

As per Green et al. (1998), the specification of methods and procedures for acquiring the information, needed to structure or to solve problems can be defined as research design. It is concern with framework of overall operation of any project that specifies target and desire information which should be collected, along with its source and process to obtain that information.

#### **3.2 Qualitative Research Design**

As per Walliman (2011, p.73), “qualitative research depends on definition of the meaning of words, the development of concepts and variables, and the plotting of interrelationships between these”. Qualitative research includes various ranges of tools and techniques where the typical examples are interview transcripts, observation notes, literary text, historical records, memos and recollections, minutes of meetings, documentary films (Walliman , 2011).

Thus, the MCS preliminary concern with process and events so the choice of qualitative data for research design is appropriate. The researcher need to obtain information and understand the experience and even reconstruct the events which he/she was not part of, so the simple or

brief answers to questions cannot be sufficient which encourage qualitative methods rather than quantitative method which includes survey and other quantitative methods to obtain information (Rubin and Rubin, 2005).

The main methods used for this research are the interviews with control managers who are directly involved in the middle and top level of management. They are responsible for the formulation and implementation of the control mechanism as per the plan to follow the rules and regulations directly by governments through central bank of Nepal. The interviews of operational managers are also considered which also plays certain level of control as per instruction of top and senior level managers along with understanding of overall system.

The banks have been selected among the list of banks who has authority to operate as an “A” class commercial bank by Central Bank of Nepal in Nepalese market. In addition to this, it was easy to make contact with selected banks base on my previous working relations and academic relations with some of the employees of the target banks.

The number of interviews are based on the organizational structure and number of managers who are responsible for different level of controls and operations.

Similarly, secondary data consisting review of relevant literature, surveys, reports, analyses, publications by related firms and governmental organizations especially central bank will be used to get overview of the existing rules and regulations, research problem and to support the empirical data gathered by the means of interviews.

### **3.3 Interviews**

In the view of Walliman (2011, p. 99), “interviews are more suitable for questions that require probing to obtain adequate information. The use of interviews to question samples of people is a very flexible tool with a wide range of applications”. Walliman ( 2011) further stated that interviews are particularly useful when there is requirement for qualitative data and can be used for both general or specific nature of subjects, and for very sensitive topics with the correct preparation.

The research is conducted with semi structured interviews as it is the most suitable way of gathering insight into a one or few particular organizations. The semi structured interviews contain both structure and unstructured sections which have standardized and open type questions. (Walliman , 2011).

I have used the two sets of interview guides where one is for middle or processing managers and the other one is for senior or top-level managers. I believed, the two sets of interview guides helped me to obtain wide range of information base on their experience and knowledge and perception of employees involve in different level of management. Similarly, the other reason on dividing interview guides were to obtain views of both the implementer and executors of the system. The interview guides which was used for the interviews are represented in Appendix 1.

Due to the ease of communication and to obtain natural flow of the conversation, interviews were planned to conduct in local language i.e Nepali. However, as majority of interviews are conducted in local language, some are in mix language i.e both in Nepali and English and some are only in English. Special attention has been taken to translate and interpret the conversation with proper interview transcript. I have also considered the written answers of interview questions due to the physical unavailability of potential respondents because of different reasons.

### **3.4 Data Collection**

For my research, I have collected data from multiple sources which consist of both primary and secondary data. The primary data is collected mostly through interviews and in some case written answer whereas secondary data are collected through website, journals, published materials and documents from both governmental organizations and private organizations.

#### **3.4.1 Primary Data**

Majority of interviews have been planned for face to face interviews. I have personally travelled to Nepal for the collection of data through interviews and contacted potential participants. Prior to my traveling, at the initial phase, I have contacted the potential participants informally through social medias with whom I have previous professional relationship. Majority of them

gave me the positive response and committed to provide relevant information. In addition, I have also asked for assistance from academic colleagues working at the human resource department in the commercial bank to make contact with potential participants for the interviews at this bank.

I have contacted around 22 potential participants from four different banks as per their request for explanation and handover of participation request form of master thesis research interview for data collection.

Out of 22 potential participants, I managed to conduct face-to-face interviews with 7 participants where four of them agreed to record the interviews and three disagreed on the basis of their comfort and organizational rules. All of the interviews were conducted in their respective work place in Kathmandu. Similarly, I was only able to collect information from three banks out of four banks which I initially approached. The limited time of my stay in Nepal also acts as a limitation for me to conduct some more interviews despite the willingness and availability of some of the potential participants for face-to-face interaction, email reply and telephonic conversation.

Similarly, as per the request form for the participation of research project I have provided detailed information under the titles of background and purpose of the research, what participation implies, what will happen to the information, voluntary participation and consent for the participation in the study. In the context of accessibility and storage of the information, all the participants agreed and permitted me to handle the data among research student, supervisors of research, data processor and thesis reviewer as per the requirements till the completion of the project. Similarly, they have also permitted me and my supervisor for the further use of the provided information for research, if necessary, under the same terms. They have also agreed for the storage of the data within my personal electronic devices such as laptops and cell phone as a research student along with my research supervisor.

Out of seven interviews, two of the participants of recorded interviews and one non-recorded interview permitted me to use both their personal and organizational names and remaining others only permitted me to use their personal name and request for the anonymity of their organization's name. However, despite their permission, I have neither used their personal name nor the organization's name in my master thesis.

The details regarding data collection has been presented as follows

Interviewee	Name of Bank	Designation	Interview Form	Interview Duration
*Respondent 1	Bank A	Head – Credit and Risk Dept (Top Level Manager)	Face to Face	20 min
*Respondent 2	Bank A	Branch Manager (Middle Level Manager)	Face to Face	60 min
*Respondent 3	Bank A	Branch Manager (Middle Level Manager)	Face to Face	25 min
Respondent 4	Bank A	Credit Risk Analyst	Face to Face	20 min
Respondent 5	Bank B	Head-Credit Approval (Senior Level Manager)	Face to Face	20 min
Respondent 6	Bank C	Head-Business Banking (Senior Level Manager)	Face to Face	20 min
*Respondent 7	Bank C	Relationship Manager (Operational Level)	Face to Face	30 min

\* Have voice recorded data

Table 1. List of Interviewees

### 3.4.2 Secondary Data

In addition, secondary data consisting review of relevant literature, surveys, different kinds of reports such as annual reports , statistical reports , supervision reports etc , working papers of scholar and employees of governmental organizations especially central bank of Nepal, relevant laws and acts of government and publications by related banks in the form of annual reports etc have been considered and used to identify and understand the existing rules and regulations, research problems and to support the empirical data gathered by the means of interviews.

## **4. Banking System of Nepal**

This chapter is mainly focus on providing information about historical background along with current scenario of banking system of Nepal.

Section 4.1 provides the historical background of the Nepalese banking system. Section 4.2 present regulator and supervisor role of Rasta Bank as a central bank of Nepal section 4.3 presents the regarding commercial bank and their status and lastly section 4.4 provides summary of the chapter.

### **4.1 Historical Background**

The history of financial system of Nepal began with the establishment of first commercial bank of Nepal known as Nepal Bank Limited in 1937 A.D. It was established with the joint ownership of government and general public of Nepal. Only after 19 years, the Central Bank of Nepal which is also known as Nepal Rasta Bank (NRB) was established. The establishment of Rastriya Banijya Bank under the ownership of Government of Nepal was followed after a decade (Nepal Rasta Bank, 2016).

In the development of banking sector, the major structural change were observed in financial sector regulations, policies and institutional developments during 1980s . The role of the private sector for the investment in the financial sector had been emphasized by the Government of Nepal with the adaptation of the financial sector liberalization policy. This leads to opportunities for the foreign banks to open Joint Venture Banks in the country. Thus, the first foreign joint venture bank, Nabil Bank Limited, was established and started its operation from July 1984 A.D along with other numerous banking and non-banking financial institutions. The last two decades witnessed the drastically increment in number of financial institutions with institutional diversification in larger geographical areas (Nepal Rasta Bank ,2016).

By the end of Mid July 2016, altogether 149 banks and non- bank financial institutions licensed by NRB were in operation. Among them, 28 are “A” class commercial banks, 40 “B” class development banks, 28 “C” class finance companies and 53 are “D” class micro-credit development banks. In addition to that, 14 saving and credit co-operatives and 25 NGOs are also in operation with the licence for limited banking operations. The total branches of all the banks and financial institutions has reached to the number of 5,068 (Nepal Rasta Bank, 2016

,2017).

Nepal Rastra Bank (NRB) regulates the national banking system and also functions as the government's central bank. As a regulator, NRB controls foreign exchange; supervises, monitors, and governs operations of banking and non -banking financial institutions; determines interest rates for commercial loans and deposits; and also determines exchange rates of foreign currencies (Export.gov, 2017).

#### **4.2 Nepal Rastra Bank as a regulator and supervisor**

With the adequate legislative provision, Nepal Rastra Bank (NRB ) as the central bank of Nepal has been authorized and entrusted with carrying out the duties of regulating and supervising banks and financial institutions The Nepal Rastra Bank Act, 2002 along with Bank and Financial Institutions Act, 2006 (BAFIA) have permitted the supervisory authority to the Nepal Rastra Bank (Nepal Rasta Bank , 2016 , 2017).

NRB has been continuously issuing various directives, guidelines, and policies to the licensed institutions based on the international base practices and banking condition of the nation.

For that, Bank and Financial Institutions Regulation Department with in the organizational structure of NRB is responsible for development and issuance of such regulations.

Thus, based on the major international guiding policies, existing legal framework, internal manuals and issued regulations, it supervises the activities of banks and financial institutions. For the effective supervision, it has four different supervision departments based on classification of banks and financial institutions. (Nepal Rasta Bank, 2017).

#### **4.3 Commercial Banks and their status**

“Commercial banks perform the act of financial intermediation that collect money from the surplus sector in the form of deposits and lend it to various sectors of the economy” (Timsina, 2017).

Culbertson (1958, p. 120) claimed that, “commercial banks are the only private institution whose debt serves as a generally acceptable medium of exchange, as money”. The main reason is that it creates money in a unique way which no other financial institutions can do. The feature of the banking system is that it can affect its liabilities volume and even can create or extinguish credit, or loan funds (Culbertson ,1958).

In the banking system of Nepal, commercial banks constitute a major chunk of total assets where the extension of credit is one of the major functions of banking institutions (Timsina, 2017).

Similarly , the secondary functions of the commercial banks are concern with overdraft facilities ,bills of exchange , agency functions , remittances , reserve of foreign exchange trustee and executors, act as tax consultant , letter of reference and acceptance and payments of different items such as cheque, dividends, bills, other periodical receipts, rents, exchange bill, discounting bills, offers letter etc. (Sahayogee , 2018).

There is a total of 28 commercial banks categorised as “A” class banks. Because of the size and importance of these banks, they have to follow more strict regulations compare to other class of banks. There was a dramatic increase in the number of private sector owned commercial banks. However, the three-public sector commercial banks still have a considerable market share in the industry because of their large geographical reach, government investments, loyal customers and high trust from public. Nevertheless, the share of private sector banks in terms of total deposits, loans, and assets has been gradually in increasing trend (Nepal Rasta Bank, 2017).

#### **4.4 Summary**

The banking sector of the Nepal consist of various numbers of banks and financial institutions, among which commercial banks plays the vital and dominant roles in the sector. In consideration of their importance and size of the business, the commercial banks are highly regulated by central banks of Nepal, known as Nepal Rasta Bank, with adequate legislative provision. Central bank has dedicated departments to monitor and supervise licensed institutions with issuing of various guidelines, directives, polices based on national and international practices.

## 5. Empirical Findings

The main objective of this chapter is to present the empirical finding based on the collected data. Both secondary and primary data has been presented related to the rules and regulations of credit department and their influence in management control system of bank.

Section 5.1 presents the empirical secondary data which are obtained from secondary sources such as government laws along with government and private studies, publications, reports and surveys etc about banks and its regulations in general, 5.2 presents the empirical primary data which are obtained from interview with various level of managers of different credit departments of three commercial banks of Nepal.

### 5.1 Laws related to Banking Sector

Banking industry is one of the highly regulated industry of Nepal. The Nepal Rasta Bank, the central bank of Nepal, is responsible for the regulating and supervising banks and financial institutions of Nepal (Nepal Rasta Bank, 2017).

The laws and acts related to banking sectors includes all those laws and acts which are prevailing in legislation related to financial sectors of the country. However, the prevailing version of acts, listed as following, plays important roles in the governing, supervising and monitoring the banking sectors of the Nepal:

- I. Nepal Rasta Bank Act 2002
- II. Bank and Financial Institutions Act, 2017 (BAFIA)
- III. Asset (Money) laundering Prevention Act, 2008
- IV. Banking Offence and Punishment Act, 2008

#### I. Nepal Rasta Bank Act 2002

This act is concern with establishment of Nepal Rasta Bank to carry out the function of the central bank. The preamble of Nepal Rasta Bank Act (2002, p.1) states:

‘Whereas, it is expedient to establish a Nepal Rastra Bank to function as the Central Bank to formulate necessary monetary and foreign exchange policies, to maintain the stability of price, to consolidate balance of payment for sustainable development of the economy of the Kingdom of Nepal, and to develop a secure, healthy and efficient system of payment; to appropriately regulate, inspect and supervise in order to maintain the

stability and healthy development of banking and financial system; and for the enhancement of public credibility towards the entire banking and financial system of the country.’

Similarly, as per the Section 84, subsection (2), of the Nepal Rastra Bank Act, 2002 states that Nepal Rasta Bank may at any time, inspect and supervise or cause to inspect and supervise any of the offices of commercial banks or financial institutions.

## **II. Bank and Financial Institutions Act, 2017 (BAFIA)**

The Banks and Financial Institutions Act (BAFIA), 2017 has replaced the previous version of the act i.e Banks and Financial Institutions Act 2006.

It is concern with laws and guidance for the establishment of banks and financial institutions having domestic or foreign ownership or branch of foreign BFIs. It is also concern with laws and guidance related to engage in trading of securities, appointment, functions and roles of board of directors, classification and paid up capital of BFIs and ultimately authority and roles of central bank on these matters. Banks and Financial Institutions Act (BAFIA), 2017

## **III. Asset (Money) laundering Prevention Act, 2008**

This act is responsible to prevent laundering of criminally earned assets and according to section 1, subsection (2) of Asset (Money) Laundering Prevention Act (2008, p.1),

‘The Act shall be applicable throughout Nepal and to any individual or corporate body, wherever may be residing, remitting, transferring or sending assets from Nepal to abroad or abroad to Nepal obtained by the act which is offence under this Act.’

## **IV. Banking Offence and Punishment Act, 2008**

This act provides legal provisions in relation to the banking offences and punishments. The preamble of Banking Offence and Punishment Act, (2008, p.1) states:

“Whereas it is expedient to provide legal provisions on banking offences and punishments with a view to promoting trust towards banking and financial system thereby mitigating the consequences and the risks that the banking and financial system may suffer on account of the offences may be occurred in course of transactions of Banks & Financial Institutions, the Legislative Parliament has formulated this Act.”

### **5.1.1 Rules and Regulations Relating to Commercial Banks**

All the banks and financial institutions (BFIs) are supervised and monitored by Nepal Rasta Bank (NRB) which also includes commercial banks.

The Nepal Rasta Bank (2017, p. 2) states that:

‘NRB supervises the activities of the banks and financial institutions based on the existing legal framework, regulations issued through its own Regulation Department, the internal manuals, and major international guiding policies such as those of BCBS (Basel Committee on Banking Supervision).’

The Nepal Rasta Bank, through its Bank and Financial Institutions Regulation Department, issues regulating policies, directives, guidelines, manuals and circulars as a regulator.

One of the major documents based on which the operations and functions of commercial banks are directed is called “Unified Directive” subject to be revised in yearly basis. It is issued by Banks and Financial Institutions Regulation Department of the Central Bank which contains rules and regulation, guidelines and provisions related to different subject matters of BFIs.

The latest unified directory contains twenty-three headings which contain all the provisions related to BFIs including guidance and criteria for the operations. Some of them which are concerned with credit facilities are provisions related to capital adequacy, classification of loans/advances and loan losses, single borrower and limitation of the sectoral credit and facilities, consortium financing, credit information and blacklisting, lending to deprived sector, know your customers etc.

In addition to this, banks and financial institutions also formulate internal rules and regulations within the threshold of NRB directives. They issue manuals, guidelines and product papers to facilitate the operations of the business. It can be supported with the statements included in respective annual reports of banks related to participants of interviews.

As per annual report of Bank A (2017), it has credit policies, guidelines and other product papers approved by The Board of Directors that are strictly followed during credit approval or disbursement. The bank A has further stated that the Bank has a very effective ‘Assets and Liabilities Management (ALM) Policy’ which defines procedures and authority including setting up various risk limits.

Bank B (2017) also stated that it sets out policies, procedures and standards covering the measurement and management of credit risk through a defined framework. The Bank C (2015) has developed written policies, manuals, standard operating procedures to conduct its business which covers all areas of banking operations.

### **5.1.2 Regulators' Rules Related to Credit Functions of Commercial Banks**

The unified directives issued by central bank of Nepal includes different rule and regulations or provisions related to various aspect and credit function of commercial banks. It is the basis for all other internal rules and regulation which are individually formulated by the individual banks for their credit operations.

The unified directives consist of laws and regulations under the heading of provisions related to capital adequacy, classification of loans/advances and loan losses, single borrower and limitation of the sectoral credit and facilities, consortium financing, credit information and blacklisting, lending to deprived sector etc. There are the provisions related to credit facility which should be followed by the banks and financial institutions. (Nepal Rasta Bank, 2018)

#### **A. Rules related to classification of loans/advances and loan losses**

This section of the directives consists the different classification of credit and advances and provisions to be made for its possible loss by commercial banks to carry out financial transactions.

It also contains directives under the sub heading of classification of loans and advances i.e pass, substandard, watch list, doubtful and loss, provision related to different types of loans such as term loan, grace period, rescheduling and restructuring of loans, trust receipt loan, bank guarantee etc.

#### **B. Rules related to single borrower and limitation of the sectoral credit and facilities**

This section of the directives is related to the advancing loans to the single person, firm, company or a group of customers which falls under mutual relationship and with regard to loans to be provided only in some area of economy.

It consists fixation of limit on credit and facilities to a single borrower or group of related borrowers both in terms of funded facilities and non-funded facilities. For example, a bank can only provide the total amount of fund-based loans and advances and non-fund-based like letters of credit, guarantees up to 25 percent of its core capital fund. Under no circumstances the investment in the group should exceed 25 percent of core capital of bank.

It also consists the different rules and regulations that the commercial banks have to follow to provide loan related to the different sector of economy. Under these rules, the commercial banks can only invest or provide the credit facilities up to the certain percentage of its loan portfolio in particular sector or certain percentage of collateral assets. For example, the bank can only provide real estate loan facility up to the 50% of fair market value of the assets under consideration.

There are also some exceptional cases in terms of investment in hydropower, transmission line of electricity, agriculture sector etc. which are consider as the priority sectors for development.

#### C. Rules related to consortium financing

These directives have been issued in order for the effective managed of loans extended under the consortium finance by the bank or banks. It provides definition of consortium financing, necessary conditions for the participation in consortium financing, selection of lead bank and its functions, duties and rights. Similarly, it also consists the rule relates to the liabilities and duties of participating member banks of consortium along with provisions related to different aspect of consortium financing.

#### D. Rules and provisions related to credit information and blacklisting

It provides rules and regulation, procedures and guidelines in order to collect, maintain and submission of credit information of the debtors with Credit Information Bureau Ltd, an governmental organization. It also provides the detail procedures and criteria for the processing of blacklisting of those debtors who are not paying loan and credit facilities avail with any of the banks and financial institutions of Nepal.

It contains sub heading under the provisions related to credit information, obtaining details of customers, mandatory requirement of acquiring credit information, procedures of black listing etc. It also includes the rules related to special provision related to collateral valuers and arrangement of auditors etc. It consists detail information about rules and regulation regarding

blacklisting processes of default customers and removable of the process after clearance of all the loan facilities and all others matters of blacklisting. This section is mainly concern with information regarding past, current and future status of the customer who avail loan facilities with the bank and banks.

#### E. Rules related to lending to deprived sector

This section consists the rules and regulation with regards to the deprived sector lending to be provided by the banks.

It consists of all the rules and regulation related to micro credits to low income, socially backward women, tribal people, physically incapacitated persons, marginalized and small farmers, craft-men, labour and landless squatters' families. Its main aim is to improve the economic and social status of deprived sector through the operation of self-employment oriented micro-enterprises.

The unified directives contain 23 sections or chapters under which various sub sectors are listed as a rules, regulations, guidelines and provision for the smooth operations of the banking sector with minimum risk. Based on these rules and regulations, individual commercial banks also formulate and issued their respective policies and product papers which contains the guideline and rules that should be followed at the time of operations of banking activities.

### **5.2. Structure of Management Control System of Commercial Banks**

As per the annual reports of the banks, it has been stated that the bank has standard control system which is designed to provide reasonable assurance regarding the achievement of efficient and effective operations, compliance with applicable regulatory laws and regulations, and internal documents of the bank, reliability of financial and other reporting and lastly risk minimization by introducing and maintaining an adequate risk management system.

Under this structure, the board of directors along with senior management create control environment to demonstrate importance of control and to observance of ethical norms to the employees.

Directors of board are responsible for the establishment of overall control system. They take measures for the improvement of control system and to regularly monitor its efficiency. Thus, as per the approval of board of directors, senior management is responsible for implementation of the policies related to control system, improvement of control processes and procedures, and

monitoring the function of control system towards the set goals or behaviours. Heads of the functional departments are responsible for development, documentation, maintenance, monitoring and improvement of control procedures (Bank A, 2017; Bank C, 2015).

The Bank has effective committees comprises of senior managers who meets periodically and reviews operations and performance of the employees and takes necessary decision as well as circulates various guidelines to concerned departments for effective management (Bank B, 2017).

The internal audit department also plays the role of control department to ensure that the rules and regulations, policies, procedures and manuals are followed strictly at the time of operations of the function and report directly to the audit committee (Bank A, 2017).

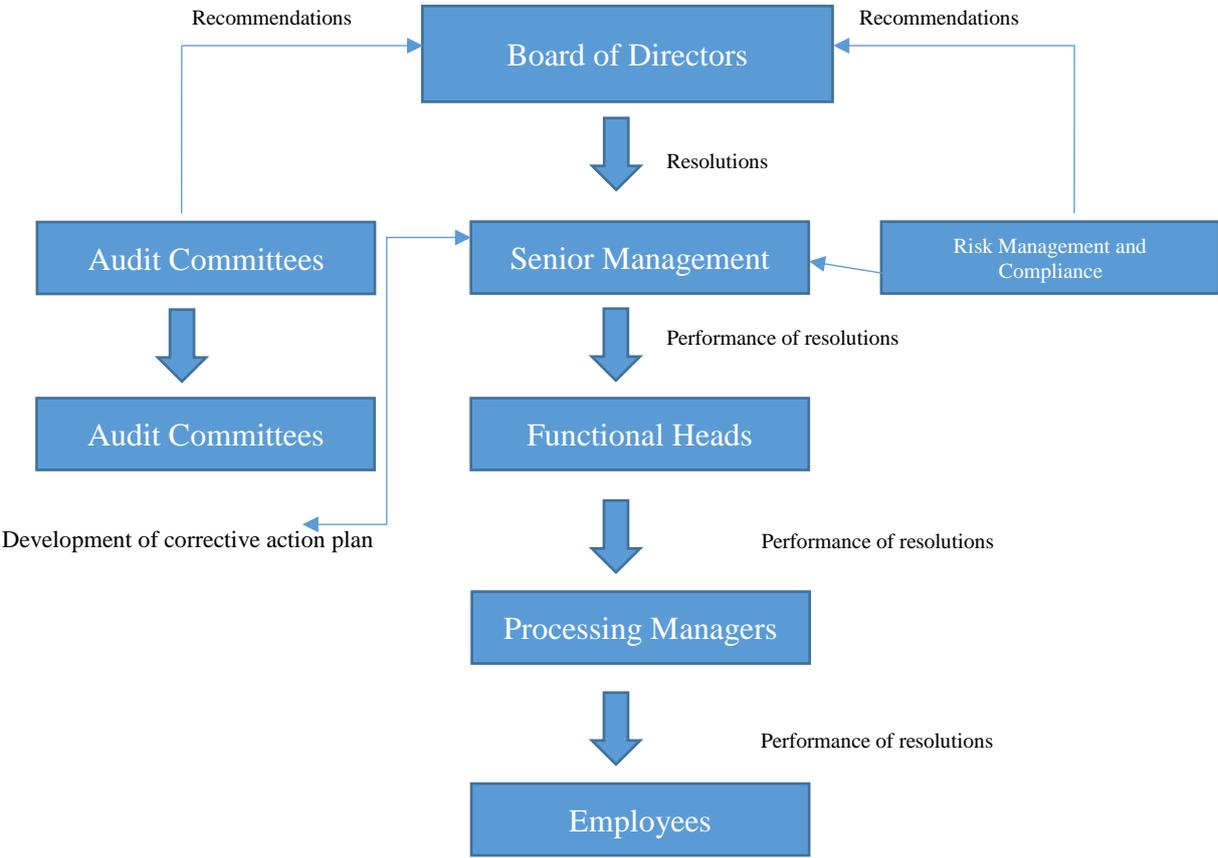


Figure 5. Structure of Control System  
 Source: Summary based on the Annual Reports of Bank A, Bank B, Bank C<sup>1</sup>

<sup>1</sup> The annual reports of banks have not been included in reference list to keep their names confidential

### **5.2.1 Credit Processing and Control System**

Credit is managed through a defined framework which sets out policies, procedures and standards covering the measurement and management of credit risk. The board of directors formulate and approved credit policies guidelines and other product papers which should be strictly followed during the credit approval and disbursement. To ensure this the bank has established a credit appraisal system.

Similarly, the bank segregates the duty of the employees based in their respective functions and designations to maintain and check the control system. One of the approach is to distinct three functions under respective functional departments, namely relationship management, credit risk assessment and credit administration.

There is a clear segregation of duties between transaction originators in the businesses and the approvers in the risk functions. All credit exposure limits are approved within a defined credit approval authority framework. There are also provision or policy to consider as security for pledge, hypothecated or mortgage which have value considering physical control and legal title. Chief Credit Officer heads the credit risk assessment which is an independent department. He is also the member secretary of credit risk management committee. They meet and discuss overall credit process and associated risk in quarterly basis and provide guidelines as per necessity and requirement.

Similarly, the internal audit department, as a control department, is responsible to carry out review of control system of the bank and ensure that the rules and regulations, policies, procedures and manuals are strictly followed. It generates the report and directly submitted to the audit committee which is headed by the non-executive director (Bank A, 2017; Bank B, 2017 and Bank C ,2015).

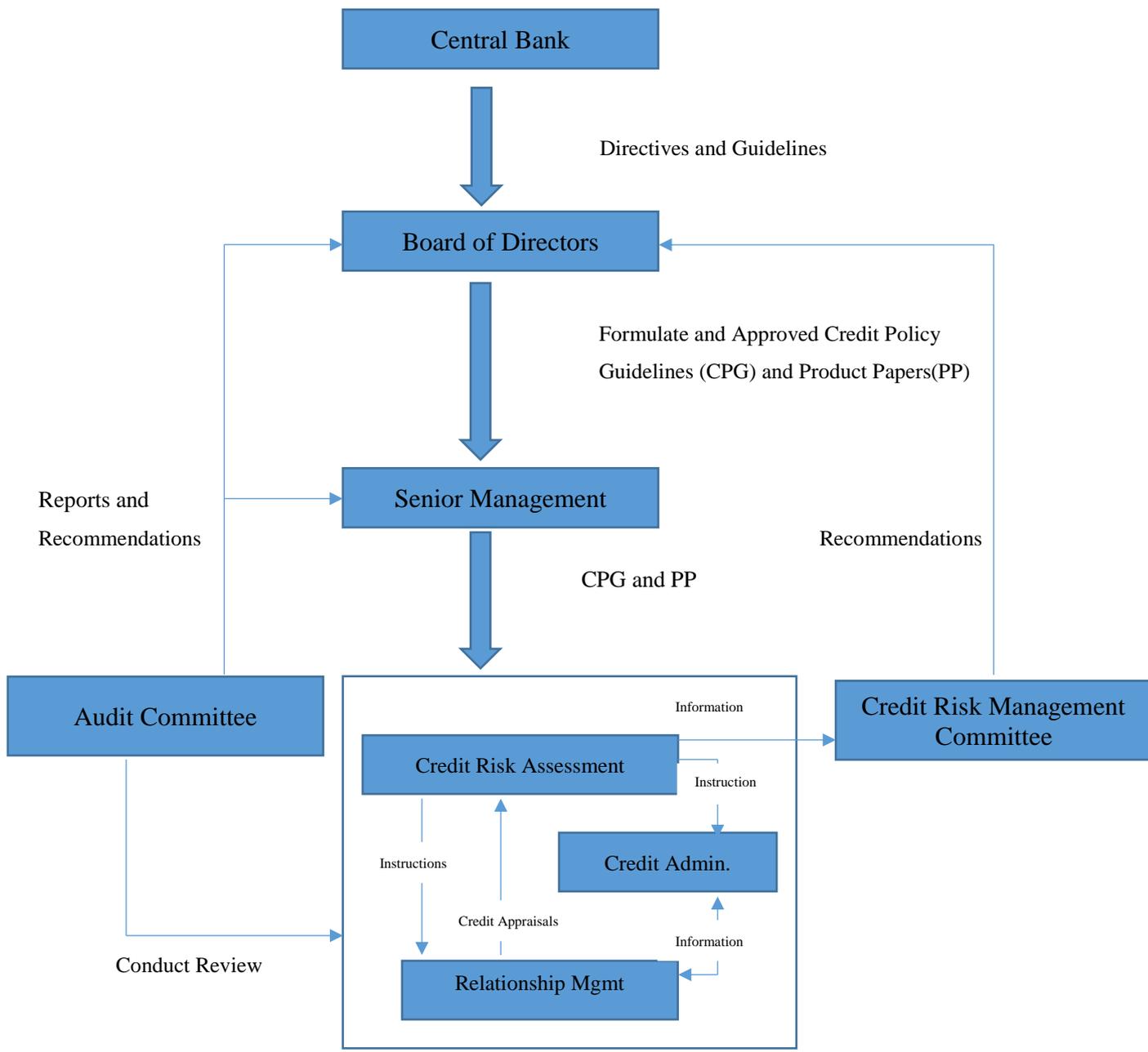


Figure 6. Credit Processing system and its control  
 Source: Annual Report of Bank A, B and C<sup>2</sup>

<sup>2</sup> The Annual reports of banks have not been included in reference list to keep their names confidential

### 5.3 Credit Related Rules and Regulations in Commercial Banks

This section contains the empirical findings about rules and regulations related to credit departments which are collected through interviews with number of managers who works in various levels of commercial banks.

The initial document that is referred by the employees of the credit department is product papers of their respective banks. The product papers are formed by the board of directors and communicated to all the employees.

According to respondent 7 from Bank C, a relationship manager,

*‘The bank has its own different product papers. Without thoroughly going with product paper and without reading NRB directives, if you randomly process file then firstly I don’t think that even risk department or signing authority will sign for the sanction of the loan.’*

Similarly, according to respondent 1 from Bank A, Chief Risk Officer and Head-Credit and Risk Department, mentioned that the internal documents are one of the major documents that govern the credit processing. He stated that,

*‘... another major document is the credit policy guidelines of the bank. We call it CPG. CPG is approved by the Board, of course. Further we have product papers, guidelines, procedures. Individual product papers for example if we want to extend SME loan, we have a separate SME loan product paper and if we want to extend sort of Retail loan, then we have separate product paper for that. So, Nepal Rasta Bank, the regulator’s guidelines and then credit processing guidelines of the bank, individual product papers, so these are the governing documents for any sort of lending’*

Respondent 5 from Bank B, Head Credit Approval also put some light on this matter, He mentioned,

*‘Board of director formulates the rules and regulations of overall banking system specially to credit and bank’s management is responsible to comply with those rules and regulations. The rules are set based on bank’s strategy, regulatory guideline, lending climate etc’*

He further added that credit sales strategy of the bank, regulatory provisions, economy of the country and lending climate of various sectors are other parameters that are considered at the time of formulating rules and regulations associated with the respective bank.

Similarly, all the product papers and internal rules and regulations are formed within the boundary of rules, guidelines and directives of central bank i.e Nepal Rasta Bank (NRB) in the case of Nepal. The NRB directives are the main reference that guide the credit functions of all the banks in Nepal. It has more significance than even the product papers of the bank. According to Respondent 1,

*‘The rules and regulations for granting credit is governed by the central bank of the country, Nepal Rasta Bank. Nepal Rasta Bank is the governing body and that basically formulates the rules and regulations, limitations and all’*

Similarly, respondent 3 has also stated that central bank governs all the banks and is also responsible to formulate the policies for all the commercial banks.

During his interview of respondent 7, he mentioned in many answers that rules of NRB are the ultimate one. He stated that,

*“Rules are followed as per the directives of NRB, we cannot go elsewhere. Rules are made by NRB...”; “I think as a relationship manager (RM), without following rules of NRB you cannot do any any processing...”; “We always do work as per the rules of NRB ... even with the pressure of top level management, we cannot conduct the loan processing for those which shouldn’t be done as per the rules”.*

He further stated that they can easily change the rules related to internal policies but have to ultimately follow central bank’s rules and its cap size.

It is not only the relationship managers; the employees of other departments also make sure that the rules and regulations of central bank are always followed. Respondent 7 mentioned that the risk analyst, who is a member of credit risk assessment department, is responsible to check and comment on the proposed facilities according to rules and regulations of central bank. It is then

forwarded to higher authorities who also perform such functions while taking decisions for approval and disapproval of proposed facility.

During the course of operation of credit functions, the employees follow various rules mentioned in its internal product papers, guidelines, manuals etc along with directives and guidelines by Central Bank or NRB.

Respondent 7 has mentioned various rules related to credit during the course of interview. He has mentioned that the one of the main rules is to collect credit information from “Credit Information Bureau” to look whether proposed customers are availing any loan facilities or not. Similarly, in case of overdue of the loan facility, the bank has to request for internal credit information along with no objection letter with the concern bank where the overdue has been observed in credit information. He has also mentioned that they prefer to invest in old companies rather than new one. The reason is that the central bank has general rules, with some exception, that the proposed company should have completed the two years of operations. Respondent 7 has stated that some of the rules related to the limitation of amount of loan in certain categories and sectors. He continued that as per the updated guidelines in case of purchase of land, only 50% is permitted to invest for inside capital city. Likewise, only 65% can be financed in vehicle loan category.

The rules regarding this has also been mentioned by respondent 3. He has stated that there is ceiling in real estate, home loan and vehicle loan financing and they can only invest up to the 65% in home loan and vehicle loan.

The respondent 2 from Bank A, a branch manager, has also support the above-mentioned statements. The respondent 2 stated,

*‘The central bank sets the rule. The synopsis related to the monetary policies, which are for all financial institutions, from the central bank gives the things the bank should look out and follow the rules. These things are set and circulated by the central bank. We are all the time following the rules of Nepal Rasta Bank. For example, inside Kathmandu, we cannot provide more than 50% of loan for real estate loan. We cannot give 60% for this. If it was home loan, its fine which is not the case in real estate like loan from mortgaging the land..... Apart from that we also have CPG-Credit Policy Guidelines*

*which is in very detail in more than 100 pages. We also integrate CPG while following the rules. I am not in position to say those by hard right now but we do look into all of these, as per the issues we encounter’.*

All the respondents mentioned that central bank is responsible for the formulation of rules and regulation related to banks and financial institutions of Nepal, as a whole, in accordance with monetary policies and current external environment of the country. After that, the board of directors of respective banks formulate rules and regulation in the form of product papers, guidelines, procedures etc based on bank’s strategy, regulatory guidelines and lending situation and circulate it for the processing of the credit operations.

#### **5.4 Credit Processing System in Commercial Banks**

The credit processing system starts when the potential customer made contact with the relationship manager of the credit department for the initial screening. The customer either contacted the bank or the bank on-board the customer.

According to respondent 1, *“Either we go to the customer, market them and bring them into our book or the customer comes with their request for the loan...”*.

The relationship manager interviews the customer and identify their requirements and ask for the necessary documents for the initial screening.

*‘First of all, we see the agendas of client, what the client wants. There are different kind of clients.... Some clients want non-funded facilities such as letter of credit (LC), bank guarantee and some needs funded facilities like overdraft, demand loan etc.... we collect entire documents need for credit facilities starting from photo, citizenship card for account opening, documents related to their family background, work experience etc and move ahead for the process.’ Respondent 7*

The relationship manager then analyse the documents and prepare the credit appraisal or credit proposal. Prevailing rules and regulations, guidelines, procedures etc are considered while writing proposals or appraisals. The statement of respondent 2 stated that the bank assesses the income and repayment capacity of customer, other sources of income such as house rent,

background of customer and family along with criteria mentioned in following response of different respondent can be taken as examples of required documents and analysis process,  
“... his repayment capacity, security i.e collateral and his character, qualification. All are analysed.” Respondent 3

“...we verify the documents, we try to analyse the end use of the fund, where the loan going to be used, the purpose of the loans. These are the basics things and document we validate.”  
Respondent 1

During the process of analysis, the bank uses different tools and techniques for the validation of the documents and needs of the customer.

According to respondent 1,

*‘If we are satisfied with those sorts of documents then we go to the field, visit the business, see how business is doing, what sort of stock or what sort of sales volume are routing. We verify them in the field and if we are satisfied with that then we follow the normal processing of loan processing.’*

Then the proposal or appraisal is forwarded to head of the department for extra screening.

“After that other prospect is that the file is analysed by department head, he analysed whether the loan file should be forwarded or not”. Respondent 7

In some banks based on their sizes, either there are some extra layers on the structure which consists of regional credit office and regional heads. Similarly, some banks have segregated the credit files based on the purpose of the loan. They are retail loan, mid-size business loan or small and medium sized enterprise (SME) loan and corporate loan. Retail loan are individual customer related loan for the purpose of consumptions such as vehicle loan, house loan etc. Mid-size business loan or small and medium sized enterprise (SME) loan are the loan for the mid-size business and corporate loans are the high or big amount loan such as project loan. To process each type of loan they have separate heads and all credit proposals should go through the respective heads.

As per respondent 3 from Bank A,

*'To talk about loan facilities, I refer to my line manager. We have three heads related to credit i.e. corporate, mid-sized or SME and retail. Huge amount loan falls under corporate loan, mid-sized consists business loan, retail loan means home loan, house loan, car loan etc. My branch falls under corporate loan.'*

After the approval of the department heads, the risk analyst analyses the file who checks and commented the proposal based on the rules and regulations of internal and central banks said respondent 7.

However, as per respondent 3, the credit proposal first forwarded to department called credit risk assessments where relationship managers of that departments check and review the proposals based on their pre-assigned branches and after their reviews they are forward to respective heads of credit categories. He further stated that if the appraisal has to be forwarded to the higher authority, it will be then routed through Chief Risk Officer (CRO), Chief Business Officer (CBO), Deputy general manager and then Chief Executive Officer for the approval. Each have their own independent authority and power to approve or reject the credit appraisal. The approval and rejection are based on assessment, financial figures that customer has submitted, predetermined rules and regulations, the knowledge of reviewers etc.

Respondent 7 has also presented the similar structure of credit processing system and stated that,

*'... our risk managers who are in credit chain, who even have limited authority to sanction loan, look after it or sanction the loan. If it's beyond their sanction authority, it will be forwarded to upper level of authority, i.e CCO (Chief Credit Officer), beyond him is Deputy CEO and then CEO. Ultimately, if loan is of big cap size and have group credit structure then it will be forwarded to board for approval. It is how our processing system flows'.*

Similar process has also been presented by respondent 5 from bank A, who stated,

*'Relationship Manager, Branch Manager, Regional Credit Office, Regional Head, Business Head, Credit Head, Credit Committee, Board are the key authorities involved in credit process. Relationship managers solicit credit clients and make credit proposal after collecting required documents from customer then forward to higher chain for credit approval through online credit approval system developed by bank named OCAS.'*

*Each authority of credit chain independently reviews the proposal and approve/ support as per their delegated credit approval discretion.'*

The respondent 5 has mentioned in above statement that online credit approval system has been developed and use by the bank to review, support and approve the credit proposal or appraisal by the related approval authority.

Respondent 4 from Bank A, a relationship manager of credit risk assessment department also mentions the use of intranet system for the processing of the credit appraisals. She has mentioned that the credit appraisal is submitted by the branches using intranet. She further stated that they have CPG , product papers and NRB guidelines etc. in their intranet and she works as a corrector in the credit process. She plays the role of mediator before forwarding those appraisals to higher authority. She has mentioned the process which they used to process the credit appraisal in their department. The process uses email and telephone calls as a communication medium.

First, the relationship managers of branch inform the risk analyst or relationship manager of credit assessment departments about the credit appraisal or proposal which will be uploaded in the specific drive in the bank's intranet. In some cases, appraisal is directly send through email if it is relatively small in both size and credit. The risk analysist or relationship manager of the credit risk assessment department access it, print the hard copy, review it then provide corrective suggestions or take corrective actions before forwarding it to high authority in credit chain.

After approval, the hard copy of approved credit appraisal is scanned and uploaded again in the special drive. Then she communicates through email to respective branch to access approved file in the specific drive. The branches then communicate with another credit processing department called Credit Administrative Department (CAD) for further processing which includes preparation of legal documents, mortgage of collateral etc. before disbursement of fund in the account of loan customer.

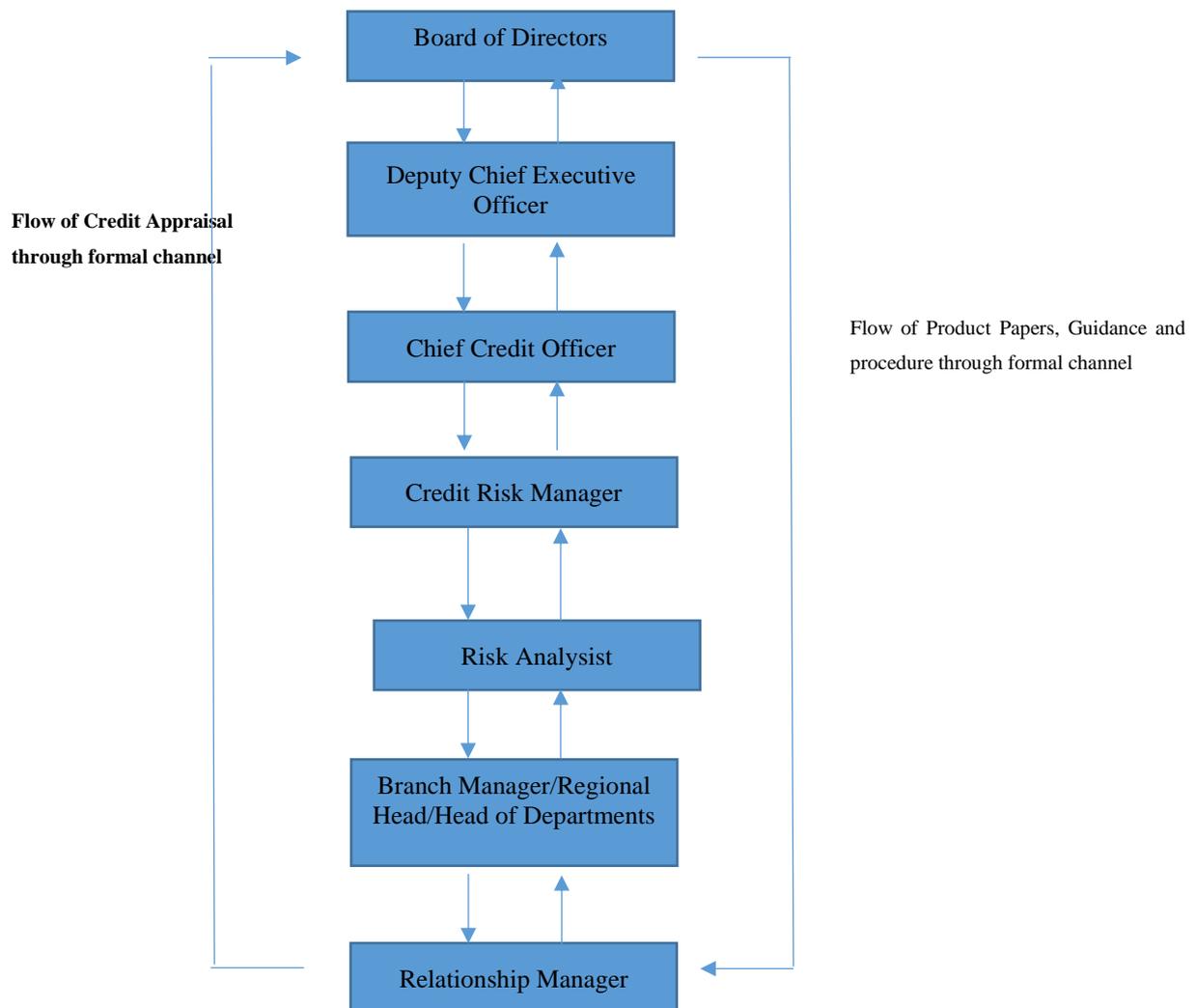


Figure 7. Employees involve in Credit Processing System

Source: Summary based on the results of interviews

#### 5.4.1 Structure of Credit Processing and Control system

The credit appraisal process through different departments where each department act as both processing and control departments simultaneously. The major concern is the compliance of rules and regulation, guidelines which are provided by Central banks and Board of Directors.

##### I. Branch / Credit Processing Unit/ Credit Department

It is the first line of credit processing which make contact with the potential customers and analyse it as per the belief, strategies and rules and regulations of regulators. It also acts as the

control unit where the relationship managers control the processing of the facility by analysing documents provided by the customers in line with prevailing rules and regulations. Branch manager play the major role for the control of the processing of the desirable appraisals and behaviour of the subordinates towards attainment of the organizational goals. The branch manager in some extent analyse, scrutinize, accept or reject the appraisal prepared by the relationship managers. In some banks, department heads of related credit such as corporate, mid-sized or SME and retail, play the role similar to branch managers (figure 8).

The statement of respondent 2, a branch manager, highlights the responsibilities of the branch manager as, “Basic responsibility is branch management, credit appraisal, deposit marketing, staff management, other controlling function, decision making, planning for this branch”. Similarly, the statement of respondent 7, a relationship manager of credit department situated at head office of Bank C, also highlights the control role of the head of the departments.

*‘...the file is analysed by department head, he analysed where the loan file should be forwarded or not. After department head decides “to go ahead”, it goes to our other department i.e. risk department’.* Respondent 7

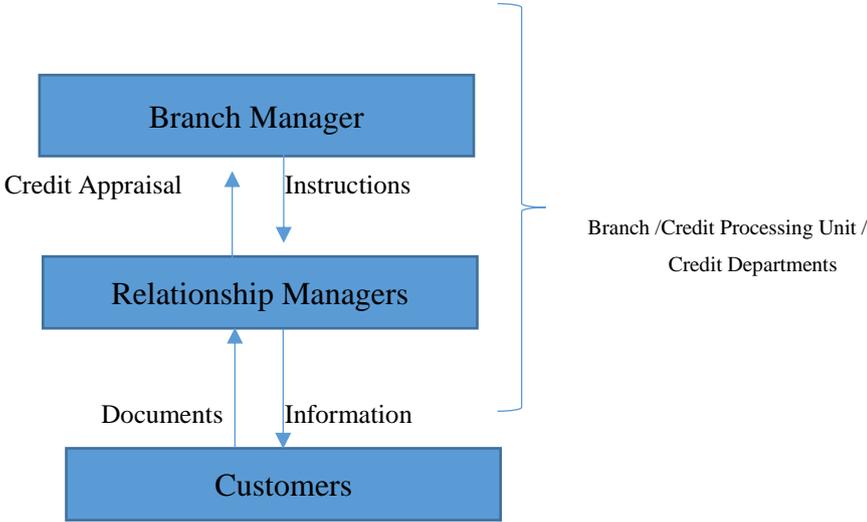


Figure 8. Structure of Processing Unit or Branch of the bank A, B or C

Source: Summary based on the results of interviews

II. Credit Risk Assessment Department

This department plays the mediator role between branch /credit department/credit processing unit to higher authority. The relationship manager of this department or risk analyst are

responsible to check, ask for explanation, clarification and rectification of content of the credit appraisal as per the CPG, circulars, product papers, directives. They guide and plays the role of control unit before sending the credit appraisal to the higher authority for the approval. They are responsible to enforce the rules and regulations related to the credit processing (figure 9).

The respondent 4, a risk analyst of credit assessment department of Bank A, said that the bank has standard format for the credit appraisal related to each type of credit facilities and the branch has to prepared based on that. She further said that the details should match with their guidelines which are accessed by all in bank’s intranet. She demanded that it should be as per the rules and regulations and it is always followed in practice. She further clarifies that her responsibility starts form receiving of credit appraisals to the sending back the approved one.

The risk analyst or relationship managers forwarded the rectified credit appraisal to relative department heads of credit or risk managers which ultimately forwarded it to the chief credit officer who is the head of the credit risk assessment department for the approval or further checking process.

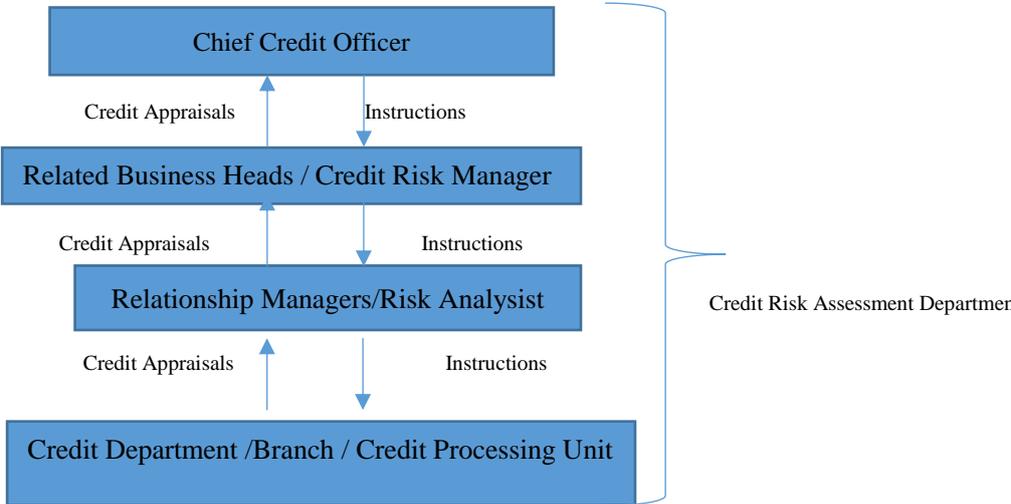


Figure 9. Structure of Credit Risk Assessment Unit in bank A, B and C

Source: Summary based on the results of interviews

### III. Senior managers and Top-level managers

The senior and top-level managers consist of chief credit officer along with chief business officers, deputy general managers, deputy chief executive managers and chief executive managers in most of the commercial banks, who look into the credit appraisal based on their categories and amount of proposed loan facilities.

As per respondent 7 of Bank C, all those credit appraisals which are beyond the sanction authority of risk managers are forwarded to upper level of authority which are Chief Credit Officer, beyond him is deputy CEO and then CEO.

Respondent 3 of Bank A also mentioned that the appraisal will be forwarded to the higher authority routed through Chief Risk Officer, Chief Business Officer, Deputy General Manager and then Chief Executive Officer for the approval.

Respondent 5 of Bank B also support the statement as he also mentioned that each authority of credit chain independently reviews the proposal and either approve or support as per their delegated credit approval discretion.

The number of senior and top-level managers in credit chain can be different along with their designations and roles, however all of them has similarly structure of forwarding credit appraisal for the approval from the higher authority based on their internal credit sanction mechanism for the purpose of risk management, proper control and compliance of both internal and regulators rules and regulations.

### IV. Board of Directors

The Board of directors of the commercial banks is the group of directors of the bank lead by chairman of the bank who formulate internal rules and regulation and also in the top of the structure for the sanctions of the loan facilities. As per Nepal Rasta Bank ( p. 31), it has been stated that,

*‘The bank’s board of directors has a responsibility to ensure that management establishes a system for assessing the various risks, develops a system to relate risk*

*to the bank's capital level, and establishes a method for monitoring compliance with internal policies. The board should regularly verify whether its system of internal controls is adequate to ensure well-ordered and prudent conduct of business'.*

Similarly, as per the interview data, all of the respondent has motioned Board as a final authority for approval. As one of the respondent said, "Ultimately, if loan is of big cap size and have high group credit structure then it will be forwarded to board for approval". Respondent 7

Thus, board has the ultimate power for any sort of amendments, changes and modification of product papers, the internal control system, policies and producers of credit system along with credit sanction authority. However, it should also follow all the rules and regulations and its designated responsibilities mentioned in NRB directives for commercial banks and financial institutions.

#### V. Internal Audit Department and Committee

The internal audit department is responsible to carry out review of the credit file to ensure whether the internal rules and regulations, policies, procedures, instruction of product papers etc. and NRB directives are properly followed or not in the operation of the credit functions. They issue the repots and forwarded to audit committee for the review and corrective actions.

#### **5.4.2 Control system and Communication system**

The banks use different communication system, control mechanism and tools for the follow of operations as per the proposed rules and regulations, policies, procedure etc which can be identified based on the interviews.

The rules and regulations are formulated by the central bank and based on which board of directors of the commercial banks formulate the respective rules and regulations, policies and procedures, organizational beliefs, targets, etc to guide the day to day operations of the bank. The rules are set based on bank's strategy, regulatory guideline, lending climate etc (Respondent 5 ; Respondent 6).

The formulation of rules and regulations is more clarified by respondent 1,

*'The rules and regulations for granting credit is govern by the central bank of the country, Nepal Rasta Bank. Nepal Rasta Bank is governing body and that basically formulate the rules and regulations, limitations and all. After that, another major*

*document is the credit policy guidelines of the bank. We call it CPG. CPG is approved by the Board, of course. Further we have product papers guidelines, procedures. Individual product papers for example if we want to extend SME loan, we have a separate SME loan product paper and if we want to extend sort of Retail loan, then we have separate product paper for that. So, Nepal Rasta Bank, the regulator's guidelines and then credit processing guidelines of the bank, individual product papers, so these are the governing documents for any sort of lending.'*

In relations to belief systems and values of the banks, the respondent 2 stated that ,

*'Previously, our moto is "service with a personal touch". We give our personal touch to customer with bank's vision to focus on service. So, it is how the bank function. Later, "to become bank of first choice of people". With focus in service, bank will ultimately become people's first choice.'*

Respondent 7 also stated his bank's values and beliefs with,

*'In my view, in this banking industry, C bank's priority is customer satisfaction starting from easy account opening. ... management has targeted for customer oriented process. As we have traditional banking system, we focus on meeting deposit target with maximum focus to open accounts in each home, to provide home loan, auto loan etc. from capital to remote areas of Nepal. So, I think, it is the target of the bank.'*

The respondent 2 also gives the examples which they follow to ensure the activates towards its belief and values and stated,

*'...Communicating information through jingles in local language, conduct financial literacy programs, providing knowledge about bank; with these kind of proactive medium, bank is trying and currently providing its service to all niche and corner. With the help of all our 62 branches, we go door to door to provide information about bank A. We talk with local people of communities and get information regarding what kind of service they expect from the banks and they are in need of. We also involve in CSR activates and what we can give to the community.'*

The bank's management is responsible to comply with those rules and regulations as per respondent 4. Thus, senior managers control the flow of the information and make necessary system for the compliance of them. For this, they use different types of communication tools. Out of which, uses of bank's intranet is highly popular among the commercial banks along with use of email to provide instructions and guidance. The bank also uses the paper base system (respondent 6) and communicated through emails, memo in written form and record it and use filling (Respondent 3).

*'... we formulate policy approved by board or whoever is the competent authority. We put them in bank's intranet so that everybody can read it because everybody has access to computer. So, they can read it.'* Respondent 1

As per respondent 6, a senior manager of Bank C, the central compliance department of the bank is also responsible for the communication of policies, manuals etc of banks along with NRB directives and rules to all the staff using intranet through circulars and manuals.

Similarly, they conduct necessary training program in different level of the bank to clarify the contains of those documents. To make sure the understanding and smooth flow of the operations, the senior managers conducted training programs up to the operational level of the organization.

Respondent 1, a senior manager of Bank A stated that,

*'Even going further in order to ensure that those documents are actually read by people we go to the different regions, different branches and interact with them, conduct training session and we check their understanding on the paper, documents that have been uploaded or are in place.'*

Training programs is also used to make sure that the employee is responsible to follow the instructions written in the documents and get the intended outcomes from the operations such as minimizing risk. They also communicate the importance of procedures and documents and the consequences and risk associated with them in case of non-compliance. Respondent 1 emphasised that,

*'To ensure that, those things that are written down are followed, we conduct training across the country, down even to the junior assistant level through continuous training. Training is a continuous process and we make sure that whatever is written down in documents, they are followed. People understand it, implement it... we have been insuring that the employees that are working in the bank, they really understand the importance of control function, the risk function ... We have been trying to ensure through continuous training, making them aware the importance of the documents and importance of procedures and sort of risk we might be exposes if we don't follow it.'*

Respondent 1

The bank uses formal structure and different credit processing departments as a major control mechanism to make sure that the communicated information is followed, implemented and comply in the operations.

*'One of the very simple techniques to ensure that whether the things that has been communicated written down in the papers, guidelines and procedures and that are actually been followed or not people really understood it or not. For example, when a credit proposal comes, initially credit procedure comes directly to risk department for the initial screening and we check whether the things the mechanism that we have set, the procedure that we have set are been followed or not.'* Respondent 1

The respondent 5 also claimed that even after loan approval, there is mechanism to cross verify the compliance status through independent control function of the bank. It is also supported by respondent 4 and respondent 7 who stated that there is presence of internal audit department which is responsible for the review of existing credit files in line with internal and regulators rules and regulation of the banks and provide necessary suggestions for the compliance of them.

There are severe consequences that the employees have to face in the event of non-compliance of the rules and regulations and necessary documents in credit processing. The respondent 1 mentioned that, *"not following the instructions of Nepal Rasta Bank, NRB, or the bank, the consequences would be very severed also"*.

The bank also uses the severe punishment technique to discourage the use of activities and behaviour for the non-compliance of the rules, regulations, policies and procedures that are

communicated to the employees. The punishment can be in terms of both monetary and non-monetary in nature based on the degree of the subject matters.

In the same context respondent 3 has mentioned that there will be punishment and penalties and claimed that in case of staff, promotion will be hold, there will be disciplinary action and in case of bank, there will be certain capital charges, monetary fines will be charge as well from central bank.

Similar negative consequences have been mentioned by respondent 6 and 7 from Bank C where they claim that intentional cheating and major non-compliance of Nepal Rasta Bank's rules will lead to punishment according to prevailing laws. The partial or even the whole credit chain can be punished which may contains the prison sentences of 2 to 10 years and large amount of monetary compensations in case of such cheating and fraud.

Similarly, according to respondent 1 regarding non-compliance of internal rules and polices,

*'If the regulations or procedures are not followed, we initially caution the related person. If they continuously make those sort of mistakes, we even caution them in writing also that goes to the personal file. It has a sever implication on the promotions etc'.*

Respondent 6 also mentioned the mechanism called incident reporting. He claimed that harmful incidents, major mistakes, lapses in compliance of policies etc whether that is intentional or unintentional are analysed, screened and evaluated. Then the details of the incidents, consequences and their corrective actions are circulated among employees to make sure that they are not repeated in future operations.

Thus because of the above reasons, regarding the compliance of the directives of NRB and respective bank are taken very serious. All respondents believe that such control is necessary for the better performance of the bank and its overall development which can observed in following statements of some of the respondents.

*'What we believe is that, if we have strong procedures and documents and once they are implemented, the compliance that regulator wants, even we have our own standard benchmarking that are made. Compliance are made, risks are minimized i.e. reflected*

*in the lower NP level, lower loan loss provisions and other operation areas’.*

Respondent 1

*‘If the bank invests in risky sector and if policies control it then risk assets are better. Ultimately, they don’t discourage to do business but they control it to minimize the risk. Policies, disciplines are for good’.* Respondent 3

The control mechanism encourages performance of department and bank. (Respondent 5)

The bank also has systems that allow them to amend, change and modify the rules, regulations, policies and other matters whether that is from regulator or from the internal sources. They take them very seriously and take necessary actions. The instructions for the regulator has been immediately applied or comply as per the instruction.

According to Respondent 1,

*‘If there is certain amendments or changes in the regulations by the regulator itself- Nepal Rasta Bank, that comes with immediate effect, there is no time line for that unless the NRB comes up with guidelines stating giving us the time lines. If circular comes without any timeline, it means that it is effective immediately. So, we don’t have any options. We have to implement that from day one, with immediate effect. So, there is no discussion on this.’*

The similar statement has been presented by the respondent 6 where he said that if there are certain changes from NRB or regulator, it is immediately complied.

Similarly, according to respondent 1, there are necessary procedures to incorporate changes, modifications and amendments of the internal policies as per the required of the boards and other related conditions. They investigate, research and identify necessary ground and reasons for the modifications and changes and proposed them to the board for the approval and then recommunicate them to employees for taking necessary actions for the implementation in the process.

*‘During the course of business, if we feel the internal policies are not very conducive to business, that our policies are hindering the level of business we want to do. Then we make changes accordingly with substantiate ground that these policies are hampering*

*our business to this level, so we need some amendments in the policy. We put them to the board or competent authority like CEO or Board. Get it approved and change it. We do it anytime whenever we feel like doing that.* Respondent 1

Along with top down approach in the banking control system, the bank also practices the bottom up approach for the continuous improvement of the system and the function. The bank has the interactive communication function which takes regular feedback from the operational managers and incorporate them in the system for the betterment of the bank. The bank needs number of valid and substantiating ground to put up any changes in the board for the approval.

*'We do receive such suggestions or the amendment that are required in policy documents or the procedure that we follow, very frequently... We need to have very strong ground, substantiating ground to justify the change. We have to put it up to the board level. In order to put up the changes up to the board level we need to have substantiating ground, valid ground, numbers, we need to have all those things'.*

Respondent 1

However, with the valid argument and proof, the bank has the mechanism to modify, change and rectify those internal rules and regulations, procedure, policies etc as per the suggestions of the operational level of staffs and managers. Those change should always be within the guidelines and directives of the central banks and approved by board of directors.

As per the respondent 2 and 3, there is a system which also allow them to provide necessary information to regulator through banks and its association called Bankers Association of Nepal. They claim that all the information associated with the existing problems are accumulated and forwarded to top level for discussion. CEOs discussed them in the banker's association and if they found out that it is the common problem faces by all the banks then they requested the regulator or the central bank to investigation and consider necessary amendment in the polices. Thus, almost all the respondent claims that it is the common and continues process where they review the internal policies continuously and take corrective actions.

However, respondent 7, who is a relationship manager and works in the bottom level of management has some different prospective compare to others. He has highlighted that in

current situation, there is lack of interaction with middle and top level of management because of absence of the two-way communication mechanism.

*'No, we don't have it in our bank. It might have been there in past but nowadays, we don't have any mechanism of two-way communication and interaction between loan processing level and top-level management in our bank.'* Respondent 7

He then mentions the role of top level managers with other related departments to make some improvement in this issue. He further stated the importance of training program among relationship managers and risk analyst and suggest for better interaction and collective work. He also suggested that for implementation of effective two-way communication human resource department and management have to work collectively.

## **5.5 Summary of empirical findings**

The major laws and acts in legislation related to financial and banking sectors of the country can be mainly summarised as Nepal Rasta Bank Act 2002, Revised Bank and Financial Institutions Act (BAFIA) 2017, Asset (Money) laundering Prevention Act 2008, Banking Offence and Punishment Act 2008.

All the banks and financial institutions are supervised and monitored by central bank, known as Nepal Rasta Bank, through its Bank and Financial Institutions Regulation Department and issues regulating policies, directives, guidelines, manuals and circulars as a regulator.

The major documents base on which the operations and functions of commercial banks are directed is called "Unified Directive" contains rules and regulation, guidelines and provisions related to different subject matters of banks which is revised yearly as per the requirements.

It also contains all the provision concern with credit facilities, some of them are; provisions related to capital adequacy, classification of loans/advances and loan losses, single borrower and limitation of the sectoral credit and facilities, consortium financing, credit information and blacklisting, lending to deprived sector, know your customers etc.

In addition to this, board of directors of banks formulate internal rules and regulation, policies

manuals, guidelines and product papers to facilities the operations of the business in line with credit sales strategy of the bank, economy of the country, lending climate of various sectors and most importantly central bank's directives. They are also responsible for the establishment of overall control system with the help of senior management. Senior management implements the policies related to control system, improvement of control processes and procedures, and monitoring the function of control system towards the set goals or behaviours. Heads of the functional departments are responsible for development, documentation, maintenance, monitoring and improvement of control procedures.

Regarding the credit processing system of banks, it starts with contact between potential customer and relationship manager of the credit department for the initial screening, collection and analysis of submitted documents under various parameters as per guidelines and preparation of credit appraisal to forward it to higher authority for approval of credit facility. The credit departments are segregated based on the purpose of the loan i.e retail loan, mid-size business or small and medium sized enterprise (SME) loan and corporate loan. Each type of loan department has separate head and all credit appraisal should go through the respective heads.

The credit appraisal passes through formal structure which contains different credit processing functional departments namely credit departments, credit risk assessment department and credit administration department. In some banks based on their sizes, either there are some extra layers on the structure which consists of regional credit office and regional heads. Similarly, there can be different roles allocated to different functional designation, however all of them follow the respective hierarchical structure of credit approval before forwarding it to higher authority or senior managers base on the proposed amount.

If the appraisal has to be forwarded to the higher authority, it will be then routed through chief risk officer or chief credit officer, chief business officer, deputy general manager and then chief executive officer for the approval. However, the structure of senior management can also depend on respective credit approval authority framework of bank. All credit exposure limits are approved within a defined credit approval authority framework having respective authority and accountability. After approval of the credit facility, credit administrative department is responsible for preparation of legal documents, mortgage of collateral etc. before disbursement of fund in the account of loan customer.

Regarding the management control system of the bank, board of directors also formulate organizational beliefs, values and targets, etc. to guide the day to day operations of the bank and the senior managers control the flow of the information and make necessary system for the compliance of them. Different types of communication tools are used to provide instructions and guidance among which bank's intranet is highly effective. The central compliance department of the bank is also responsible for the communication of policies, manuals etc of banks along with regulators directives to all the staff using intranet through circulars and manuals.

The senior managers also conducted training programs to all related employees to make sure that the employee is responsible to follow the instructions and direct its behaviour towards intended outcomes from the operations. As mentioned earlier, the bank uses formal structure with various credit processing departments as a major control mechanism to make sure that the communicated information is followed, implemented and complied.

The presence of the internal audit department, as an independent control department, is responsible to carry out review of credit appraisals and control system of the bank and ensure that the rules and regulations, policies, procedures and manuals are strictly followed at the time of operations of the function. Then it gives report directly to the audit committee who then provide necessary recommendation to non-executive directors of board.

The bank also uses the severe punishment technique to discourage the use of activities and behaviour for the non-compliance of the rules, regulations, policies and procedures that are communicated to the employees. The punishment can be in terms of both monetary and non-monetary in nature. Hold in promotion in case of employees and certain capital charges, and monetary fines in case of banks are some of the example of punishment techniques. The major non-compliance of regulators rules with intentional to cheat will lead to the prison sentences of 2 to 10 years and large amount of monetary compensations to partial or even the whole credit chain.

The bank also has systems that allow them to amend, change and modify the rules, regulations, policies and other matters whether that is from regulator or from the internal sources. They take them very seriously and take necessary actions. The instructions for the regulator has been immediately applied or comply as per the instruction.

There are necessary procedures to incorporate changes, modifications and amendments of the internal policies as per the required of the boards and other related conditions. They investigate, research and identify necessary ground and reasons for the modifications and changes and proposed them to the board for the approval and then recommunicate them to employees for taking necessary actions for the implementation in the process.

The bank has the interactive communication function which takes regular feedback from the operational managers in the form of meetings, half yearly budget conferences etc. to collect information and suggestions that can be used to incorporate changes, modifications and amendments of the internal policies, if any, with valid and substantiating ground for board's approval which should be within the guidelines of central bank. All the respondent claims that it is the common and continues process where they review the internal policies continuously and take corrective actions.

There is a system which also allow them to provide necessary information to regulator through commercial bank's association called Bankers Association of Nepal. The common problem faces by all the banks are accumulated and discussion by representative of each bank i.e chief executive officer and then requested the regulator or the central bank to investigation and consider necessary amendment in the polices.

However, one of the operational level manager has highlighted that in current situation, there is lack of interaction among different level of management because of absence of effective two-way communication mechanism in one of the bank.

He then mentions the importance of role of top level managers to make some improvement in this issue. He further emphasis on effective training program, better interaction and collective work among all level of banks.

## **6. Analysis**

The main objective of this chapter is to analyse collected empirical data that are presented in the empirical finding chapter and relate them with the theoretical framework of this thesis. This chapter will help to understand the data and to present findings and conclusion related to research questions.

In this chapter, the empirical data will be analysed based on the theories that I have explained in chapter two i.e. administrative controls and simons four levers of control. This chapter is also used to identify the rules and regulations that are present in the banking system of Nepal and how those are related to management control system of banks to perform its credit processing function.

Section 6.1 provides the analysis on the administrative controls of the banks base on empirical data collected from Bank A, Bank B and Bank C. Section 6.2 present the analysis on management control system of the bank base on the Simons four levers of control framework. Section 6.3 presents the analysis on how rules and regulation are incorporated in banks presented management control system of banks.

### **6.1 Administrative control system of Commercial Banks**

Administrative control systems direct employee's behaviour by organizing individuals and groups, monitoring behaviours and make them accountable for their behaviours. It also includes the process of specifying how those behaviour and task are to be performed or how those behaviours and tasks should not be performed (Malmi and Brown, 2008). The empirical data that are presented in chapter 5, highlight the presence of administrative control system in all the three banks which are taken into consideration for the research. The following sections consist the related analysis based on those empirical data under different groups of administrative control systems.

#### **6.1.1 Rule, Policies and Procedures of commercial banks and their credit departments**

The empirical data suggest that central bank plays the prominent role in almost all aspects of the banking sectors. The initial rules, policies, constraints, parameters etc are formulated by the central bank and banks take them as the ultimate sources and formulate their respective policies and procedures for overall operations. They are the main sources and targets of the banks and

under no circumstance they violate the constraints mentioned in the directives of the central bank.

As Malmi and Brown (2008) stated that policies and procedures includes standard operating procedures and practices along with rules and policies, the empirical data also present the similar traits in the context of banking system of the Nepal. The unified directives presented by the central bank act as rules and policies document that should be used by the banks to formulate its internal rules and policies for the operations. The internal rules and regulations, policies etc are present in the bank in the form of credit policy guidelines (CPG), product papers related to each categories of loan portfolio, memos and circulars etc.

The empirical findings also highlight the existing rules and regulations, procedures, policies and directives which govern the banking sector of Nepal. The major rules related to the banking sector are formulated as per the prevailing laws and acts in legislation of financial sector of country. Nepal Rasta Bank Act 2002, Revised Bank and Financial Institutional act 2017 (BAFIA), Asses(Money) laundering prevention act 2008, banking offence and punishment act 2008 are among the important ones that shape the unified directives of the central bank.

The unified directives include all those rules, procedures and directives which are compulsory for the operation of the banking business in Nepal. It's also includes all those rules that are related to credit processing system and parameters for the sanction of any kinds of credit facilities from banks. Rules related to classification of loans/advances and loan losses, rules related to single borrower and limitation of the sectoral credit and facilities, rules related to consortium financing, rules and provisions related to credit information and blacklisting, rules related to lending to deprived sector and many other related rules are there base on which any credit facilities are processed in the bank. Thus, central bank governs and controls the credit operations of business with its unified directives that all banks have to follow without any exceptions.

Malmi and Brown's concept of administrative tools that managers use to control behaviour, in line with Merchant and Van der Stede's call action control i.e. behaviour constraints, pre-action reviews and action accountability, also seems applicable in the context of banking system of Nepal. As per empirical data, management use different control tools which include branch credit targets, regular meetings, budget conferences, training etc to control the behaviour of

employees. Review of credit appraisals and proposals by each level of managers of different departments before the sanction of the credit facilities are also present which can be linked to the concept of pre-action reviews. There is also presence of action accountability where each employee is accountable for their targets, behaviour and actions which are controlled by existing reward and punishment systems.

The empirical findings provide a ground to support Malmi and Brown's claim of use of policies as a bureaucratic approach to specifying the process and behaviour within an organization. Thus, it further strengthens their claim and presented that it is also applicable in context of developing countries despite of possibility of different uncertain factors in the context of Nepalese banking sector.

### **6.1.2 Organizational design and structure of commercial banks**

Organization design can encourage certain types of contact and relationships by using a particular structure and it can be act as an important control device (Malmi and Brown, 2008). Similar, phenomenon has been observed for the empirical data presented in findings.

The empirical data suggest that the central bank plays the prominent role on the formulation of both administrative structure and control structure of banks and financial institutions which also includes the commercial banks. The central bank instructs the board of directors to formulate and develop overall system of the bank, with the coordination with management team of bank, which is best suited to ensure smooth operations of business. The system needs to include method of monitoring compliance with internal policies.

Board of directors appoint management team and provide responsibilities to control behaviour of the employees and to make sure to comply with regulator's requirements. Top and senior managers instruct department heads to monitor and control the behaviour of employees, which uses different tools such as meetings, half yearly budgets conference etc. They also provide instructions and take inputs through telephone and emails to maintain the close relationship with departments heads and branch managers. It helps them to understand the progress of the work, behaviour of the employees and enforce certain kind of control over their behaviour.

The top managers also play the roles of the controller where they also involve in the process of checking and controlling the work and behaviours of the employees of all level. They are the one who provides direct training to different level of employees with the assistance of middle managers like department heads and branch managers. The training programs are taken as the one of major tools that influence the behaviour of the employees.

Department heads and operation mangers are responsible to check and control the behaviour of the employees and report it to the top managers. They play as the role of immediate supervisions and even role of operational level controllers for the top managers.

The control systems highly applicable to the credit processing system of the bank where there is presence of makers and checker mechanism. The flow of credit appraisal and proposal go through hierarchical structure where each level works as a control level to influence and check the behaviour towards predetermined process. Rules and regulations, policies and procedures of banks along with directives of central banks are the control parameters for the behaviours.

The existence of formal structure of the credit processing mechanism through different departments i.e. credit processing departments base on loan categories, credit risk assessments department and credit administration department encourage the control of the credit appraisal. Similarly, direct involvement of different level of middle and senior managers in the credit processing and sanction of credit facility is definitely act as a control device as suggested by Malmi and Brown (2008).

The empirical data highlights the use of functional structure of the banks which are used to flow the instructions and guidance from the top level and flow of credit appraisal from operation level to sanction the loan facilities. The same organizational structure is used for the communications as well as control of the behaviours by acceptance or rejection of the appraisal or the modification and rectification as per the policies set by the top level. This leads to the control of the behaviour of the employees. This provides the evidence that the Nepalese banking sectors is in consistence with views of Malmi and Brown (2008) where he claimed that the organization structure is a form of control which works through functional specification and contributes to control through refusing the variability of behaviour and increase its predictability.

However, empirical findings also present existence of informal communication and control system in the bank. As per some of the respondents specially relationship managers and branch managers, there is existence of informal communication system specially through telephonic conversation and unscheduled branch visit, which influence the behaviour of the employees. Most of the time, the employees follow the formal structure of the banks but the informal system also takes places in some occasions. The empirical data reassure the claim of Rijal (2007) who concluded the existence of informal organizational and communication system in his examination of application of management control system in Nepalese commercial banks.

The existence of informal system has not been mentioned by the Malmi and Brown (2008) in its administrative control systems. But it is identified and presented by Rijal (2007) in the context of Nepalese banking system and also supported by my empirical data, which can be identified that the despite of having formal structure of the system, there is also use of informal structure and communication system which influence the behaviours of employees. The reason of informal communication is highlighted by respondent 2 as less frequent and on urgency basis, the further study can be conducted in this subject as it might have significant impact in behaviour of the employees. The empirical data from respondent 7 highlight such issues where he feels uncomfortable to comply with such instruction from higher authority who is somehow contradict with directives presented by central bank. As per Allen and Cohen (1969), the informal organization is far less influential in determining the flow of critical ideas, or of ideas for new work in comparison to formal organization in their study of information flow in research and development laboratories, however, the effect of the similar informal structure and communication in the case of banking sector might be different.

### **6.1.3 Governance structure of commercial banks**

The presence of internal audit department also suggests that there are other control departments as well as number of control systems that controls the behaviours of the employees with different approaches. In addition to multi-layer direct control system in the form of organizational structure and formal structure of credit processing, the presence of internal audit department of the bank presented the constant control of the behaviour even after completion of one set of activities. It also makes sure that there is coordination of activities among different credit processing departments and units as per view of Malmi and Brown (2008). So, it implies that there is the presence of some form of governance structure. However, the functions of the

internal audit department and their structure to report directly to top and board level implies the different system of control mechanism which even control the regular controllers of the formal structure and make them accountable for their actions.

The empirical data also suggest that there are presence of external control factors and control mechanism. The high importance of rules and regulations of central bank and their yearly involvement in auditing and inspection of the files, documents and operations of commercial banks highlight the existence of external control system or systems. The conclusion of Alaudin et al. (2010) of having other control mechanisms and practices at work in implementing bank's strategy at operation level can be relate with Nepalese banking sectors as well, based on existence of external and internal audit systems.

Both the internal and external audit systems check the compliance of the banks and regulators requirements in the form of rules, regulations and polices backed by certain consequences and punishments. So, the banking system of the Nepal also have a reward and punishment system as one kinds control tools. They are applicable for both employees of the banks as well as banks themselves. In banks both reward and punishment system exist where there is more emphasis on punishment to employees who don't comply with policies and other procedures of bank. This is in terms of both monetary and non-monetary in nature and ranges from simple to severe. So, bank's management emphasis this tool to all level of employees and central bank emphasis it to banks as well as its all level of employees. As per the empirical data, the action accountability is more associated with punishment rather than motivational factors and reward. Employees are more concern with bad consequences that might follow if they don't comply with the procedures and policies. Thus, it can be emphasised that employees are more driven by punishment then its rewards.

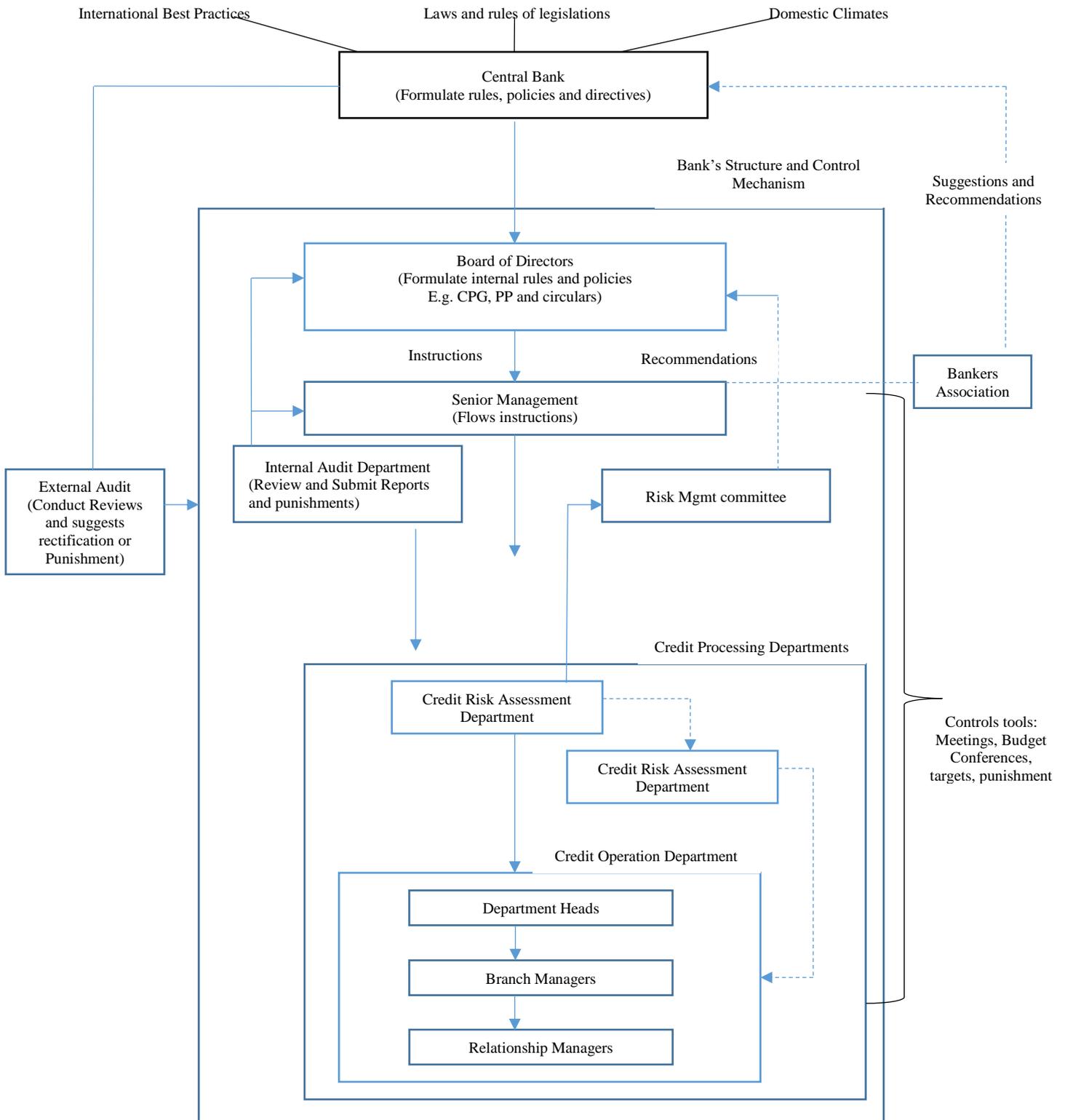


Figure 10. Bank's Structure and Control Systems  
 Source: Primary and Secondary data

## **6.2 Levers of control in commercial banks**

According to Simon (1995), the management control system framework consists of four control levers where beliefs control systems empower and encourage employees to search for new opportunities, boundary control system establish rules and actions that employee must avoid, diagnostic control system ensure important goals are achieved efficiently and effectively and interactive control system enable top level managers to focus on strategic uncertainty and learn about threats and opportunities and respond proactively. The empirical data shows the use of all these levers of control systems to direct the behaviour in credit processing functions of the employees towards attainment of its strategic goals with strict compliance of the regulators directives.

### **6.2.1 Diagnostic Control System**

Simons state that diagnostic control system helps managers to track the progress of individuals, departments or production facilities towards strategically important goals (Simons, 1995).The some empirical findings presented the existence of credit target in terms of figure that are allocated to the branches and use of different control tools such as emails , town hall meetings , branch meetings and half yearly budget conference to check the progress of individuals or branches to predetermined target. These implies that there is existence of diagnostic control system in the banks control systems. However, they are not widely discussed by the respondents.

The empirical data highlights the reward and punishment system that are prevail in the bank. The information provided by respondents mostly focuses on the punishments that are used when there is non-compliance of behaviours in relation to both internal and regulator's rules, policies, procedures and directives.

They have also highlighted the control mechanism of credit processing system which constantly check and modify the behaviours of employees and standard of work they have performed toward the predetermined values and beliefs of the bank.

The empirical data shows contradict information in relation to Simons view of the purpose of diagnostic system to eliminate the burden of mangers of constant monitoring. In one hand, the

data don't support his statement as both board of directors and top managements involve in credit sanction even that is for high amount of credit facilities which takes their both time and efforts. In other hands, presence of set of credit targets, rules and regulations in the form of credit policy guidelines, product papers guidelines etc implies the employee's performance targets. Complemented by the related reward and punishment system, do act as a tools of diagnostic control systems which definitely helps management to looks after other important aspect of the business.

### **6.2.2 Beliefs System**

As per Simons, the belief system is the explicit set of organizational definitions which are communicate formally by senior managers that reinforce systematically to provide basic values, purpose and directions (as cited in Widener, 2007, p. 759). The empirical data shows that the board of directors formulate the belief system of their respective bank. It contains mission and vision statements along with its values and targets which are then communicated to all the employees. The top managers are the one who communicate through formal communication systems comprise of banks intranet and email services. They also provide training facilities to all level of employees to direct their activities towards the attainment of those values and beliefs.

The empirical data highlights use of different programs and approaches such as door to door campaigning, financial literacy programmes to local public along with use of audio media and jingles by Bank A for creating value of customer satisfaction. The customer oriented process of Bank C, to fulfil their value of maximum satisfaction of customer, with the target to open account in each home and provide individual loan from capital to remote areas of Nepal are the examples to create new opportunities and search for new ways of creating value as per their respective beliefs and values. These insights the Simons belief systems views of communication of core values for the inspiration and motivation to explore, search, expand and create effort in order to engage in appropriate actions (as cited in Widener, 2007, p. 759).

### **6.2.3 Boundary System**

The empirical data shows that the rules and regulations in the form of unified directives from central bank act as an ultimate document to be followed and under no circumstances those rules

are to be ignore. It acts as a reference as well as the boundary of the activates that should not be crossed by the banks and its employees at any cost. In the view of Simons, the boundary systems are an organizational break and for the banks unified directives act as an organizational break.

Base on the unified directives, the banks formulate its own policies and guidance. The empirical data present the internal documents that are credit policy guidelines, product papers, circulars etc which act as a boundary for the behaviour of the employees of respective bank.

The board of directors and top managers use the formal structure of the banks to assure that those rules and regulations which are set as a boundary are compiled by the employees in its operations. They have development the control systems where each credit proposal or appraisal is checked and rectified towards the desirable behaviours with the use of functional hierarchy and credit processing departments. Windener (2007 p. 782) statement of boundary systems provide structure through delineating the areas of-limit to employees highlights the findings of empirical data.

As per Simons, the boundary system is more important to those organizations which are heavily depend on trust to maintain their reputation and image (as cited in Tessier and Otley, 2012, p. 172) which is applicable to banks as they collect money from the surplus sector in the form of deposits and lend it to various sectors of the economy” (Timsina, 2017).

#### **6.2.4 Interactive Control System**

The empirical findings show the existence of two-way communications mechanism where there is constant communication between different level of employees through formal channels. The different formal tools like emails, town hall meetings, branch meetings and half yearly budget conference are present in the system where top-level managers are in contact with its subordinates. The top-level managers provide instructions to its immediate lower level managers and the respective managers follow the same mechanism with its immediate subordinates.

In addition to that, the subordinates who are working in the operational level has opportunities to provide information and suggestions from their sides. They can be either related to identification of new opportunities or the problem associated with existing rules, regulation and

policies that need amendment for the achievement of goals and strategies. The empirical data shows the presence interactive control systems in the bank which is used by the top-level managers to influence the behaviour of the employees and along with taking feedbacks which helps them to take corrective actions. The system also helps the operating level employees to present their problems and insight related to operations of the business.

The four characteristics that are associated with interactive control systems are presented by the empirical data and it is also the key to identify the issues related to overall banking systems of the Nepal and helps the banks to communicate them to the central banks. This mechanism seems effective for the overall development of the banking system of Nepal with collective efforts.

### **6.3 Rules and Regulations and Management Control System of Commercial Banks**

The managers can control the behaviour of the employees by using administrative tools which includes rules, policies, procedures and practices (Malmi and Brown, 2008). The majority of empirical data is gathered with the target to identify existing rules and regulations and their relationship with the management control system of the banks. To understand the relationship the credit processing system or departments are selected as it is one of the most important functions of the bank.

The both secondary and primary data that are gathered and presented in empirical findings chapter emphasised that banks are highly governed with different forms of rules and regulations, policies, procedures, directives etc. by internal and external forces. Banks are highly regulated and supervised by the central bank with the issuance of unified directives and constant supervision by their dedicated departments in the form of constant reporting and audit system (Nepal Rasta Bank, 2017).

The board of directors also formulate internal rules and regulations, policies and guidelines based on the unified directives of central banks to control the behaviour of employees towards their strategic achievements. Those rules and regulations are widely spread among employees with the help of management and formal structure of the organization. Different communication tools such as email, intranet, telephone, direct training etc are used to communicate those rules to the employees. Along with this, the constant monitoring and control systems are placed in

the organization with both formal and informal structure and control mechanism to ensure that employees are complying with existing rules and regulations and their behaviours are directed towards predetermined manner.

The empirical data also present the management use of different control tools such as credit sales target, regular meeting with head of departments, branch managers and half yearly budget conferences, reward and punishment systems etc. They are the integrated part of the control system which are exercise with the help of formal credit processing and reporting structure.

The management uses the hierarchical structure of control mechanism in the credit processing system of the credit departments. The processing departments have both authority and accountability over their activities. The activities are concern with identifying potential customers, gathering necessary documents, preparation of credit appraisals, sanction of the credit facilities and maintaining of those relationships independently. To make sure that the rules and regulations are followed, they perform different activities such as visit the business site, monitoring business activates and processes, inspection of stocks and sales volume etc. All these have to be reported in credit appraisal and based on which each department and individual at functional level accept, reject or ask for rectification and modification as per the requirements. These decisions are independent decision which cannot be influence by others. Thus, there is presence of direct control in each level of formal structure secure by both authority and accountability. The focus area of the control in these departments are concern with compliance of wide range of management and regulators requirements in the form of rules, regulation, policies etc.

The presence of reward and punishment systems where there is high influence of punishment as an effective control tool is presented by the empirical data. Both central bank and top management have clearly communicated the consequences that employees have to bear for non-compliance of the rules, regulations, policies and procedure backed by legislation of country, which is one of the effective control tools used in management control system of Nepalese banking sector.

The empirical data highlight the presence of different levers of control presented by Simons (1995) base on previously presented data. In the control system, rules and regulations and their compliance are the integrated part of each levers of control. Management presented their beliefs

and values through communication channels and to direct the activities of the employees towards those they formulate rules, regulations, policies and guidelines. With the formal organizational structure and use of different diagnostic control tools such as credit sales targets, meetings, budget conference etc. they enforce the control over employees and their behaviours. The boundary system which is mainly concern with what not to do (Simons, 1995), is directly associated with rules and regulations. The constrains and what the employees should not do while performing its activities are presented in the form of rules, regulations, polices etc. of the bank (Nepal Rasta Bank, 2010). This implies that the boundary control system and different form of rules and regulations have integrated relationship with each other.

The interactive control system is concern with encouragement of flow of information among all the levels of organization to enable managements to participate in decisions of the employees (Tessier and Otley, 2012, p. 172). The senior management focus on constantly changing information for potentially organizational strategic is one of the characteristics of interactive control system presented by Simons (1995). The empirical data shows management seeks the information related to the effective application of existing rules and regulations, their impact in performance of the branch and bank along with suggestion to adjusting those rules in the favour of the organizational goals from operational managers and employees. Thus, the management takes inputs in the form of information and suggestion using interactive control tools about the effectiveness of rules, policies etc. base on substantiating grounds and how they are modified for the betterment of the performance of bank.

The information gather from the operation level are also used by the top management of the bank as the inputs to influence the market conditions, external environment and regulators. The rules and polices that act as problems for overall banking sector are discussed in the welfare organization of all the commercial banks which is known as Bankers Association of Nepal under sufficient ground. Upon collective discussion on them, it highlights the problem associated with specific polices to the central bank, as a regulator, to consider for further investigation, amendment and modification.

#### **6.4 Summary**

On the basis of empirical data, it has been identified that there is existence of various rules and regulations that govern the overall banking system of the Nepal, in particular credit processing functions. The presence of legislative laws and acts lead to the formation and issuance of unified

directives by central bank, as a regulator's guidelines, which contains all the rules that should be followed by the banks for the operations of their business. It is the ultimate rule book for the banks and financial institutions of Nepal and all the operations of the banks should comply with it at all times.

There is also presence of documents related to internal rules, policies, guidelines and procedures namely credit policy guidelines, product paper guidelines, risk management guidelines, credit risk management procedures etc. They are documents which contain the rules related to the credit processing functions of respective commercial bank in addition to unified directives of central bank. They act as the boundary and organization's break in the activities that should not be crossed by employees at any cost.

The central bank plays the prominent role on the formulation of administrative control system of commercial banks. The board of directors formulate monitoring and control system of bank with the coordination of management team. Senior managers, head of credit departments and operational managers are responsible for the control of behaviours of their respective subordinates under the formal organizational structure.

The empirical data also show that the board of directors formulate the belief system of their respective bank. It contains mission and vision statements along with its values and targets which are then communicated to all the employees. Along with that there are use of different control tools; credit sales target, meetings, half yearly budgets conference, continuous training etc. and communication tools; email, intranet, telephone are performed to control the behaviour of employees towards desirable outcomes by management.

In the context of credit processing, credit appraisals are forwarded through formal organizational structure which contains different credit departments with hierarchical function having both authority and accountability over their respective activities. The same organizational structure is used for the communication and control of the behaviours as per the policies set by the top level.

The existence of other control systems is also present which includes internal audit system, and external audit by central bank or regulator. The purpose of them is to examine the operation of credit processing and control the undesirable behaviour of the employees or banks by

implementing punishment against the non-compliance of internal and regulatory requirements. During the operation of credit function employees are more concern about bad consequences that comes in the form of punishments.

The empirical findings show the existence of two-way communications mechanism where there is constant communication between different level of employees through formal channels. In addition to that, the subordinates who are working in the operational level has opportunities to provide information and suggestions about problems, threats etc that exist in the market due to certain rules and polices. If presented with sufficient evidence and ground the top management presented, discussed and take collective decisions in association of commercial banks. Then the association request and forward them to regulator, the central bank, for the consideration of amendment and modification.

The empirical findings also present the existence of informal communication and control system in the bank which are exercise by top level managers base on time and situational factors to influence the behaviour of the employees.

## **7. Conclusion**

The main objective of this chapter is to present the findings of this master thesis. It provides the important aspect of empirical findings, contribution of the research provided as practical implications and limitation and ideas for future research.

### **7.1 Important aspect of findings**

The commercial banks of the Nepal are highly regulated by the central bank, as a representative of government, with the issuance of various rules and regulations along with direct supervision of banks using physical audit mechanism. The presence of unified directives along with internal policies and guidelines collectively drives credit function of the bank. The day to day operations of the credit function continuously remind the employees about the regulators requirement as the processing system itself is based on the compliance of it. The presence of formal organizational structure constantly monitors the credit appraisal and check, modify and approve it in accordance to the presented regulations and policies.

The study also shows that management and employees are highly aware about the regulators rules, regulations, guidelines and requirements which leads as the effective control factors of commercial banks. The management effectively communicate the consequences of non-compliance of the banks and regulators requirement backed by punishment and penalties. Thus, employees are more driven towards avoidance of punishments while performing credit operations.

The empirical data highlight the presence of different levers of control presented by Simons (1995) in management control systems of bank related to credit processing. In the control system, rules and regulations and their compliance are the integrated part of each levers of control. The Nepalese commercial banks used diagnostic tools ; credit sales targets, meetings, budget conference , interactive tools ; two way communication systems, boundary system; rules and regulations etc to control its credit functions of the bank. These assure that the Simons levers of controls are applicable in the service sectors of developing countries as well. However, the direct involvement of top-level managers in credit sanctions authority of bank take huge amount of managers time which is somehow opposite to the concept of use of diagnostic tools to save monitoring of time of managers.

The study also shows that the commercial banks of Nepal use many aspect of administrative control system to maintain the control over the behaviour of the employees for credit function. The full reliability of top level management in policies and procedures, presence of formal organizational design and governance structure in the form of hierarchical credit approval structure can be taken as evidence of it. The management uses combination of rules, regulations and policies as a control parameter and placed the monitoring mechanism as a formal organizational structure to control the behaviour of the employees. This implies that there is existence of different group of administrative control systems in the control system of Nepalese lending structure of bank.

The study also shows that there is existence of different control system in the bank credit processing. Along with multi layered formal control systems, there are independent control systems in the form of internal audit and regulators audit which not only control the activities of the employees and the whole business but even monitors and controls the activities of formal controllers towards the full compliance of rules set by the regulators.

The study also shows that despite of high supervisions and control by central banks, the banking system of Nepal also facilitates commercial banks to present their information, problems, suggestions to regulators which can be an effective tool for the mutual cooperation and overall development of banking sector of Nepal.

## **7.2 Some suggestions of practical implications of findings**

The study highlighted the importance of rules and regulations presented by central bank as a regulator or representative of government and how control systems has been developed in credit function. The insights provided by the study can be used for the continuous improvement of the system and formation of regulations that suited the changing environment and development of different business sectors.

The research shows the existence of informal communication and control system that is prevailing in the bank at the time of urgency and to handle serious subject matters. The importance of informal system can also be highlighted by it. By studying this and their use to handle the crisis can be initiated. There can be formulation of special communication and control system which is applicable to handle urgent and important matters and can be part of

the main control system. It can also be used for the timely identification, communication and solving of the problems and can also use to grab the opportunities in the market. Thus, the informal control systems can also be incorporated in the formal structure by formalizing it as a system to handle the urgent and important matters, for either to gain absolute control or to utilise its potential in management control system of bank.

The research shows that there is high influence of punishment mechanism in the credit processing system of the bank. The effect of this has to be properly studied. The reliabilities of control system in a single factor cannot be able to help management for the achievement of desirable goals in the competitive market. This can also direct them toward more rigid system which will be very harmful for the beliefs and value of the organizations.

### **7.3 Limitations and ideas for future research**

During the course of research, I have found number of limitations and suggestions for the future research. As a research for the master thesis, there is always limitation related to allocation of time for the research, number of respondents for the data etc. For the research, I have considered interview related to limited number of the respondents of three commercial banks in limited time which are not sufficient for the analysis of management control system of credit facilities of the bank or entire banking system. Similarly, the data have been collected in very short period due to pre-determine time frame of research and distance that I have to travel to collect the data. It decreases the possibly of follow up interviews for more quality data. As the study is based on the collective interviews of both top and operational level of managers, the further research can be done as the comparative study between top level and operation levels, between two banks or between two departments of same bank etc.

The study also highlights the possibilities of research related to effect of informal communication and control system. It also highlights the possibilities of research related to different aspect of reward systems specially effect of punishment mechanism in the performance of employees or overall bank. There is wide range of opportunities to research on banking sectors of developing countries as highlighted by review of literatures.

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## **Appendix 1**

### Interview Questions

#### Set 1 Questions

Questions especially for middle and processing managers

General Questions:

1. Can you briefly present yourself?
2. What are your responsibilities and tasks?

Questions related to Diagnostic Control and Belief Systems

1. Can you introduce the organization you are working at?
2. Can you describe the beliefs of your organization?
3. How do these things are communicated to employees and in what ways they are incorporated in its operations?
4. In what ways these beliefs are incorporated in the operations of the business especially in credit operations?
5. Can you describe how credit file has been processed?
6. What are the mechanism and in what ways they are used to control credit files in connection with organizational beliefs and goals?

Questions related to Boundary Systems

1. Can you describe, what are the major rules and parameters related to providing credit facility or facilities in general? Can you provide some examples?
2. Who is in charge to formulate the constraints? How do they do it?
3. In what ways are these constraints formulated at other organizations or departments?
4. What tools and techniques do managers use to follow these rules and regulations or parameters? Can you give some examples of exceptions or flexibilities?
5. Can you describe the consequences if these parameters are not complied?
6. How does this control system have some impacts on the performance?
7. What do you think about cost and benefits of this system? Can you give some examples related to these?
8. In what ways this control system can be adjusted if new or modification on rules or parameters is taken place?

### Questions related to Interactive Control System

1. Can you describe how the information related to the operations is processed to you especially in the case of crisis or problems?
2. Can you describe any mechanisms related to the interaction between you and top or senior level managers? Can you give some examples?
3. What kind of role this mechanism or system has for the control of the process especially in the context of following rules and regulations in Credit function?
4. In what ways the system work/function is able to include necessary changes?

### Set 2 Questions

#### Question for Senior and Top-Level managers

1. Can you briefly present yourself ?
2. What are the responsibilities and tasks you are assigned with?
3. Can you tell me, who is in charge to formulate your responsibilities? How it is decided and what grounds are used for it?
4. Can you describe credit processing system of the bank in brief and describe your responsibilities related to it in details?
5. Who are responsible to set the rules and regulations related to overall banking system specially rules related to credit processing function of bank or banks? On what basis they do that and what are the procedures that they follow and under what circumstances?
6. What are other parameters/circumstances that has to be considered for formulating rules and regulations?
7. How these rules and parameters are incorporated in credit processing function of bank?
8. How do you communicate these rules or parameters to the responsible persons/employees within your bank?
9. What kind of mechanisms do you use for this communication? Can you describe it in detail?
10. Can you describe how you make sure that these parameters are followed or meet as per the instructions? What are the control mechanism that are used?
11. How this control process/system/mechanism is appropriate for these kinds of functions?

12. What do you think about cost and benefits of this system? Can you give some examples related to these?
13. Can you describe, what are the consequences if there are not followed properly?
14. How do you think that this control system/mechanism will have affect the performance of department and bank?
15. How existing rules, regulations and parameters related to credit functions are revised, in case of necessity, and how frequently they have been revised?
16. How do you incorporate them in existing system or mechanism if there are certain changes?
17. How do you process and consider information and suggestions that are forwarded by operational managers which they have experienced at the time of compliance of rules and regulations? In what ways they are communicated to formulator for taking corrective actions?
18. Lastly, can you summarized existing control system related to compliance of rules and regulations on credit function and how they can be improved in coming years.