Participants’ Manual

Designing and Implementing Staff Incentive Schemes

A Toolkit for Designing and Implementing Staff Incentive Schemes

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Finally, we would like to thank Graham Wright of MicroSave who first had the idea for this toolkit. He successfully moved the production process along with the help of some old-fashioned but very effective incentives.1

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1 Hint (Those readers who have some experience in micro lending should already know this fact): If your borrowers don’t pay back their loans, just knock on their door at seven in the morning and remind them of their obligations. By the sixth or seventh time, if they have not run away, they will actually start repaying their loan.
Session One: Introduction and Design Process

1. Introduction to the MicroSave Approach

The MicroSave Approach

MicroSave generates and disseminates information through:
1. Practical Research
2. Action Research Partnerships with leading MFIs/Banks
3. Practical Toolkit development and testing
4. Training of consultants and practitioners

Evolution of Business

The microfinance industry is beginning to mature, and with maturity comes change. There are four alternative concepts on which organisations conduct their activities – these represent the development of marketing philosophy (see Exhibit 1.2.1). The concepts have characterised the maturation of most industries over time, and are also clearly discernable in the microfinance industry. The process of maturation has typically (but not always) been linear with the industry passing through each phase before moving to the next. These concepts for organisational activities are:
1. Production: which focuses on producing goods/services as cheaply as possible;
2. Product: which focuses on making the goods/services as high quality as possible;
3. Selling: which focuses on persuading potential customers to buy the goods/services being produced; and
4. Marketing: which focuses on understanding the target market(s) needs and responding to these in all aspects of the organisation’s operations.

This evolution is built on new business models which require developed branding, product and delivery mechanisms driven by motivated and committed staff.

Exhibit 1.2.1: Development of Marketing Philosophy

Staff Incentives as part of a Strategic Marketing Framework

MicroSave and TMS developed the following framework to assist MFIs thinking about strategic marketing and how it relates to their core business of providing financial services to poor people.
The framework is based on three 1st tier strategies and their 2nd tier sub-components and provides a comprehensive, all-embracing overview of how a market-led approach necessarily affects almost every aspect of an MFI’s business – from operations to human resource management, from IT to sales (see Exhibit 1.2.2). To make the market-led approach yield the full benefits of its potential, for the MFI and its clients, it will require support from the Board and top management. And the Marketing Director will need to be a master of developing collaborative working, team-based relationships.

Exhibit 1.2.2: Strategic Marketing Framework

A. Corporate Branding Strategy
Kotler (1999) defines a brand as “A name, term, symbol or design (or a combination of them) which is intended to signify the goods and services of one seller or group of sellers and to differentiate them from those of competitors.”

B. Product Strategy
Product strategy is a strategic approach to developing and enhancing products to fit the needs of the market and going about activities to optimise sustainable sales of the product in the most profitable manner.

C. Product Delivery and Customer Service Strategy
C.1 Personnel Training and Development Strategy
The fastest, cheapest, and best way to market an MFI’s service is through its employees. Every employee should know that every act is a marketing act upon which the success of the MFI depends. A market-led MFI needs to review every step, from how its receptionist answers the phone to its transaction forms, and ask what it could do differently to attract and keep more customers.

An MFI’s staff members define its corporate image, make or break its brand, ensure quality of service and commitment to client satisfaction (or otherwise) and deliver its products. A market-led MFI therefore has to focus particularly carefully on them and optimising their performance through:

- A well structured programme of human resource development;
- Attention to the process of team building and maintenance and
- The development and implementation of transparent and fair staff incentive schemes.

Perhaps the simplest framework for looking at human resource development is as follows:
1. Evaluate: the attitude, skills and knowledge required for a particular role or position;
2. Audit: existing staff’s competencies – usually through an appraisal system;
3. Gap Analysis: of the variation between two above to identify where additional training is required;
4. Implementation: of the identified training programme; and

MicroSave – Market-led solutions for financial services
5. Evaluation: of results of training programme.

Team building is essential for a market-led MFI. There is an almost universal acceptance in the management literature that high-quality, market-oriented organisations are invariably run by teams. Key factors for teams’ success (or otherwise) are broadly as follows:

- There must be tangible indications of team’s importance to the organisation;
- The group dynamics amongst the team members must “fit”;
- Personal characteristics and abilities of members contribute to, and are sufficient for, the task at hand;
- Effective leadership able to recognise significant gaps, which if are not recognised or go unfilled, will cause adverse effects on performance; and
- A recognition that teams need to be fostered, developed and assessed.

Please see the MicroSave/Aclaim “Institutional Culture Change Toolkit” (which is due to be updated in 2005) for more on these issues.

Well-designed staff incentive schemes can have positive and powerful effects on the productivity, efficiency and quality of MFI operations. Conversely poorly developed schemes can have serious detrimental effects. Incentive schemes must be transparent so that staff members affected should be able to easily understand the mechanics of the calculation. Thus the system should not be overly complex and should contain as many objective factors and as few subjective variables as possible. Furthermore, the “rules of the game” should be made known to everyone and should not be changed arbitrarily. In addition, it is essential that the incentive scheme be perceived as being fair, and thus the goals set out by the scheme must be attainable, and better performing staff members must indeed be rewarded with higher salaries. Finally, everyone must be able to achieve a higher compensation by working better and harder.

There are five compelling reasons why excellent customer service must be a “prime directive” for any market-led MFI:

1. Good service keeps customers;
2. Good service builds word-of-mouth business;
3. Good service can help you overcome competitive disadvantages;
4. Good service is easier than many parts of your business; and
5. Good service helps you work more efficiently.

C.2 Delivery Process Development

There is a growing recognition that some MFIs have not paid adequate attention to optimising the processes used to deliver their products and services. New focus on Activity Based Costing and risk analysis, as well as this important component of the Product Delivery & Customer Service Strategy, are all using process mapping as a tool to improve the efficiency of delivery processes. Process mapping involves the detailed analysis and recording of systems and procedures in the form of a flow chart to identify inefficient or redundant procedures.

C.3 Technology Strategy

With the growth of technology-based opportunities to enhance service standards and delivery processes, technology has to be an important part of any forward-thinking MFI’s strategy. MFIs should therefore constantly examine options for technology-based solutions but subject them all to rigorous cost/benefit and risk analysis. Furthermore, in many countries – particularly in rural areas, infrastructure issues need careful assessment since unreliable electrical supplies, high levels of dust or problems with availability of spare parts or rapid-response maintenance capability can turn a technology-based dream into a nightmare.

C.4 Infrastructure Development Strategy

This strategy refers to the development of infrastructure so that the target market can have access to the financial services offered by the MFI. This strategy is therefore an important component of any growing and expanding MFI’s business plan, and should outline proposals and rationale for the development and expansion of the MFI’s outreach infrastructure.
2. **Introduction to Designing Staff Incentives**

**What Are Staff Incentives?**

Staff incentives are designed to motivate staff to achieve high performance levels, change behaviours and/or change attitudes. Incentives are rewards for achieving certain targets or making a certain effort. Performance-based cash payouts are most frequently used, but non-monetary incentives are also possible.

**Why Staff Incentives?**

The provision of microfinance services is extremely labour-intensive. Typically, an MFI’s salary burden amounts to between 50% and 70%. This means that more than half of the total administrative expense is accounted for by direct and indirect labour costs. Any decision to alter compensation levels or salary structure may have important consequences for financial performance. It therefore deserves management’s full attention.

Furthermore, the selection and training of new staff members is costly, making experienced MFI employees a valuable resource. Management should be interested in anything that might improve employees’ motivation, including staff incentive schemes.

MFIs strive to improve institutional outreach and to deliver acceptable financial performances. Well-designed staff incentive schemes can have powerful effects on the performance and productivity of microfinance operations. So staff incentive schemes are a potential tool for boosting MFI performance. Smart managers should at least venture a closer look.
Case Study 1.3.1: BancoSol, Bolivia

BancoSol, one of the leading microfinance banks (not only) in Bolivia, has adjusted its staff incentive scheme for lending staff in response to the country’s financial crisis in 2002. The scheme focuses on the portfolio quality and the monthly bonuses of loan officers is determined by six performance indicators to which different weights are allocated (see Table 1.3.1).

Table 1.3.1: Performance indicators for loan officers at BancoSol

<table>
<thead>
<tr>
<th>Performance indicator</th>
<th>Weight in the “bonus formula”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio Stock</td>
<td>20%</td>
</tr>
<tr>
<td>Client Stock</td>
<td>20%</td>
</tr>
<tr>
<td>Provisions</td>
<td>15%</td>
</tr>
<tr>
<td>Past Due Loans</td>
<td>20%</td>
</tr>
<tr>
<td>Delinquent Loans</td>
<td>10%</td>
</tr>
<tr>
<td>Write Offs</td>
<td>15%</td>
</tr>
</tbody>
</table>

Exhibit 1.3.1 below shows the extent to which BancoSol could increase its loan portfolio quality. Surely, this achievement cannot only be attributed to the changes in the bank’s staff incentive scheme, but the incentive scheme has definitely supported this development significantly.

Exhibit 1.3.1 BancoSol’s performance in the turn of time

<table>
<thead>
<tr>
<th>Ago/02 - Jul/03</th>
<th>Jul 02</th>
<th>Jul 03</th>
<th>Jul 04</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ago/03 - Jul/04</td>
<td>70,050</td>
<td>29,215</td>
<td></td>
</tr>
<tr>
<td>Dif.</td>
<td>14,846</td>
<td>8,779</td>
<td></td>
</tr>
<tr>
<td>% growth</td>
<td>21%</td>
<td>30%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Jul 02</th>
<th>Jul 03</th>
<th>Jul 04</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Portfolio growth</td>
<td>9%</td>
<td>7%</td>
<td>20%</td>
</tr>
<tr>
<td>Portfolio at Risk</td>
<td>15%</td>
<td>9%</td>
<td>6%</td>
</tr>
<tr>
<td>% Provisions growth</td>
<td>2%</td>
<td>-2%</td>
<td>-3%</td>
</tr>
<tr>
<td>% Growth past due</td>
<td>8%</td>
<td>-34%</td>
<td>-15%</td>
</tr>
<tr>
<td>% Growth past due clients</td>
<td>4%</td>
<td>-49%</td>
<td>-27%</td>
</tr>
<tr>
<td>% Growth Writte Offs</td>
<td>3%</td>
<td>-32%</td>
<td>-57%</td>
</tr>
</tbody>
</table>
3. Who Should Think About Staff Incentives?

Who Should Think About Staff Incentives?

One can imagine several stakeholders in financial institutions who should find staff incentives important, and even exciting. Not only the “owners” or founders of an organization such as an MFI take an active interest in the performance and future path of “their” institution. Rather, there are many other interested parties, or stakeholders, such as employees, clients, creditors, and in some cases even the government (for instance when the financial institution is a licensed commercial bank, in which case the government is represented by the agency responsible for banking supervision).

Shareholders or “Owners”

To the extent that staff incentive schemes can help financial institutions to improve their performance, these schemes should be of considerable interest to owners.

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**Case Study 1.3.2: SafeSave, Bangladesh**

SafeSave is a rather small, but very innovative MFI in Bangladesh. It is also one of the few Bangladeshi institutions which successfully have implemented individual performance-based monetary staff incentive schemes. Until early 2003, SafeSave had employed a simple staff incentive scheme which considered only the number of active clients in the field officers’ (“collectors”) portfolio. To improve the portfolio quality, the organisation has introduced a second performance measurement parameter, namely the “fee collection” rate, which basically represents the repayment rate. Although the scheme was implemented in early 2003, it was very well communicated earlier – you may guess when by interpreting Exhibit 1.3.2 (the different colours represent the different branches)!

Exhibit 1.3.2: Effects of SafeSave’s staff incentive scheme on portfolio quality.
Who are these owners? In the case of NGOs, the “owners” might be the organisations’ founders. In commercial banks, owners usually are clearly defined – they might include private individuals or other organisations, such as firms. In credit unions, the owners are the member shareholders.

We will deal with the question of what constitutes “performance” in more detail later. Let us just say here that owners usually both want to achieve a certain degree of positive impact on the target group, and require minimal financial performance standards (for instance, not losing any money, and especially not their own).

Surely, if owners believe that staff incentive schemes can help them and “their” organisations to achieve two such broad goals, they should be keen to understand the mechanics of such schemes and to cooperate with management and others to design effective schemes.

What is more, staff incentive schemes are not limited to the level of staff members who are active in microfinance operations; owners should also be interested in their potential applications at the managerial level. Owners of financial institutions generally do not manage operations themselves. Instead, they hire managers and delegate day-to-day management to them. Credit unions, for instance, typically delegate management to a small group of shareholders or external managers. This separation between ownership and management (or control) can create a special set of challenges for the owners; if the managers generally know better than the owners what is really going on inside an financial institution (and not least in the financial institution’s accounts), how can the owners make sure that managers really do their best to achieve the owners’ goals and objectives? Here again, incentive schemes may have a role to play.

Managers

Managers of financial institutions should also be interested in staff incentive schemes. After all, managers bear the greatest responsibility for achieving the owners’ objectives and targets. All else being equal, a committed and productive staff will help the organisation to achieve both satisfactory outreach and financial performance. If incentive schemes can improve staff commitment and staff productivity, they surely deserve the attention of top managers.

Participants should also note that the fundamental problem of delegated authority applies to this level as well. Managers grant authority to their employees (branch managers and often loan officers) to make decisions and take actions (such as approving a loan in the local credit committee). These local staff and local managers always will know more about the specific details of a particular case or situation than upper management in the distant head office. As in the case of owners and managers, incentive schemes can be designed to help ensure that staff members of MFIs really act in the way that top managers want.

Employees

The purpose of staff incentive schemes is to improve employees’ efforts in their jobs. One major “lever” for increasing individual efforts is money. Monetary staff incentive schemes have a direct impact on employees’ income, regardless of the payout’s frequency (i.e. whether the incentive “package” is paid out monthly or quarterly or at other intervals). Therefore, the staff members targeted by an incentive scheme will feel a direct impact on their own incomes, and ultimately, on their livelihoods. It is only logical that a financial institution’s employees will take a keen interest in any staff incentive schemes that might be designed (or planned) for them. After all, they are the ones who are most directly affected by such schemes.

Clients

The ultimate goal of MFIs is to assist their clients in their economic endeavours by providing the clients with quality services, such as loans or deposit facilities. Despite all efforts (and progress) of automation, 2 In the language of economics, this is called an “agency problem”. The owners are the “principals” who delegate certain tasks to their hired “agents”, in this case MFI managers. There is a large – and quite technical – body of literature on this topic, which we will not discuss in this toolkit. We simply want to point out that our discussion of staff incentive schemes is well grounded in economic theory and has been applied to many industries other than microfinance.

2
microfinance essentially remains a “people business”: The quality of the relationship between MFI staff and their clients has a huge impact on client satisfaction. If staff incentive schemes affect the motivation and efforts of MFI employees (such as loan officers) then MFI clients inevitably will feel an impact as well. This suggests that clients should also be interested - at least in a general sense - in the staff incentive schemes that their counterparts in the MFI are subjected to. There is some empirical evidence to support this idea.

4. Introduction to a Step-by-Step Approach to the Design of Staff Incentive Schemes

A Step-By-Step Approach to the Design of Staff Incentive Schemes

We recommend completing Eight Steps to designing staff incentive schemes for financial institutions including:

**Step 1: Define the incentive scheme’s objectives.**
Defining the incentive scheme’s objectives is such a fundamental and important process that it requires the participation of management (and often also of the board of directors). We need to be crystal-clear about what we are trying to achieve with the scheme. The objectives of the incentive scheme must be in line both, with the strategic goals of the financial institution and its organisation culture.

**Step 2: Determine staff members to target and financial estimate**
Identify those staff members who contribute most to the achievement of the incentive scheme’s objectives. Often, the introduction of a scheme at one organisational level or function may create a need to implement schemes at other levels as well. Try to think comprehensively!

Roughly estimate how much you are willing to spend on staff incentives (you also could conduct cost-benefit analysis as described in Step 7).

**Step 3: Select the incentive mechanisms.**
Incentive schemes include: merit pay, incentive pay, perquisites, benefits, profit sharing, gain-sharing, ownership, Employee Relationship Marketing or a combination of these mechanisms. We further can distinguish between short-term and long-term schemes as well as between tournaments, individual and group based incentives.

**Step 4: Conduct the technical design work.**
This includes formula development and calibration, as well as spread-sheet testing. It is useful (and should be obligatory) to carry out sensitivity and scenario analyses. It helps to use a participatory process in designing the scheme.

**Step 5: Analyse the costs and benefits.**
This is the point where we need to conduct a proper cost-benefit analysis and to estimate the impact that the planned scheme will have on operating costs and the organisation’s financial performance. In the short run, a bonus scheme will increase total staff costs. If the system is well-designed, these costs will later be compensated by increased staff productivity and output.

**Step 6: Run a pilot test.**
Field testing the scheme in a controlled environment is very important. With all the financial models, scenarios and estimates, the only real test for our scheme is how it will be received in the field.

**Step 7: Sell the scheme to staff.**
The importance of the incentive scheme’s communication is frequently underestimated. Make sure that staff members understand the incentive schemes’ mechanics and the reasons for the scheme. If staff does not accept the scheme, it will have no or even counterproductive impacts on their motivation.
**Step 8: Monitor and adjust the scheme as necessary.**

Staff incentive schemes are of such critical importance in operations of financial institutions that senior management should regularly monitor and review the performance of the schemes utilised by the organisation. Are the objectives of the organisation still the same? And does the scheme in place still achieve the intended purpose(s)? Depending on the answers to such questions, it may be appropriate to make changes and adjustments.

**Who Should Be Involved in the Design?**

The implementation of monetary staff incentive schemes from scratch naturally implies changes in the organisation culture. Thus, the design of staff incentive schemes typically requires the committed participation of senior managers and sometimes of the board of directors. In order to assure that the incentive scheme is perceived as fair and leads towards the expected results, representatives of all functional levels of staff should participate in its design. This also helps to define the performance indicators adequately.

A small staff incentives team should be assigned to guide through the Eight Steps and organise and facilitate the implementation process. Ideally, this team consists of at least two staff members: one senior employee with expertise in operations and one staff member of the human resource department. However, the committed participation of other functional groups is essential:

- **Operations staff:** Designers need to know the processes, hardships, risks, and bottlenecks in the operations of their financial institution in detail. Furthermore, the staff incentives team should have a thorough knowledge of operational interdependencies between different functional groups of staff. Staff with extensive experience in operations will be able to predict expected increments in staff productivity as well as potential side effects of a planned (redesigned) incentive scheme. Operations staff should also identify the need for different incentive schemes for different local operational circumstances (e.g. urban branches and rural branches) or staff managing different products (e.g. loan officers managing micro loans and officers managing SME loans, or tellers who are in charge of savings products and employees managing a money transfer counter).

- **Human resource staff:** Staff incentives need to be incorporated in a wider HR policy. Before planning an incentive scheme, it is important to assess the potential effects and side-effects of various types of staff incentive schemes on the motivation of the employees. It is crucial to review the remuneration and incentives structure both, of the own institution and competitors, including: existing performance based and non-performance based incentives, the basic salaries, allowances and benefits (e.g. health insurance, pension fund). In addition, designers must be clear about legal aspects of monetary incentives (e.g. taxes, possible reactions of the labour union). If monetary staff incentives are designed from scratch, HR staff could explore the possibility of freezing the base salaries for a couple of years to finance a powerful bonus system. HR staff are also capable to predict whether or not the implementation of a performance based monetary incentive scheme will have effects on the attractiveness of the institution on certain segments of the labour market (e.g. a well designed staff incentive scheme with a significant variable portion in the remuneration is likely to attract those who are willing and capable to work hard; If the variable portion was too high, risks seekers may be employed).

- **Finance staff:** In order to calibrate the incentive scheme and to conduct the cost-benefit analysis (see Steps Four and Five), staff with significant knowledge in finance is needed. In particular, the cost-benefit analysis requires thorough financial projections of relevant parameters (e.g. the loan portfolio volume, the portfolio at risk rate or the savings balance) and their effects on the institution’s income for two different scenarios: if the incentive scheme was in place and if it was not in effect. These projections should also take seasonal factors into account.

- **IT staff:** At certain stages in the design process, IT staff needs to be involved. The team will have to analyse a well prepared report on the past performance of certain units in relevant areas (e.g. the number of loans disbursed to new customers by loan officer and month for the previous six months, or the portfolio at risk rate by branch for the last three months). Frequently, such reports need to be generated from different data sources which may require large amounts of time. The participation of IT staff is
further required to explore the possibility of including the calculation of a staff incentive scheme into the MIS or, at least, to assess if respective reports of relevant data can easily and reliably be generated regularly.

**Senior Management:** Senior managers should decide which type of staff incentive scheme should be employed. Although the staff incentives team may suggest respective schemes, designing or redesigning monetary staff incentive schemes can involve huge changes to the organisation culture. Senior managers should monitor the design process and finally need to approve the scheme.

**Design or Revision of Your Staff Incentive Scheme**

The next Session provides an overview of the basic principles of designing staff incentive schemes and a brief attempt to summarise the experience gathered by financial institutions to date. The eight consecutive sessions will then guide through the Eight Steps to designing staff incentive schemes. In each step, participants will reflect on their current scheme, or plan to design a staff incentive scheme using their Workbook. After the workshop, participants will continue this process in their institutions to finalise and pilot test their incentive scheme(s).
Session Two: Basic Principles for Staff Incentive Schemes

1. Introduction

Staff incentive schemes have been in use in a variety of industries for a considerable period of time. Examples include the sales compensation plans used by computer and software firms such as IBM. Procter and Gamble, now one of the largest consumer goods companies in the world, introduced a profit sharing plan for staff in 1887.

But for every good staff incentive scheme, there is also an example of one that failed. For instance, Sears Auto Centers (a division of Sears, Roebuck & Company) was forced to change its incentive compensation program in 1992, after it led to an avalanche of customer complaints. Employee compensation had been based on the repairs that customers authorised. The staff became quite adept at “detecting” new problems, and many unnecessary repairs were carried out as a result.

How Do Employees Judge Their Remuneration?

If incentive schemes are to be effective, they must be accepted by those they target. To assure acceptance, they should be in line with four principles according to which employees judge their remuneration:

1. **Equity Principle:** This principle states that employees would like their compensation to reflect their contributions to the organisation. Those who contribute more to the success of the organisation would (and should) expect a higher compensation than those who contribute less. If outstanding performance of individuals was not acknowledged, high performing staff are likely to become unmotivated. Of course, this raises the question of how to measure these contributions properly. We will come back to this concern later.

2. **Status Consistency:** Status can be as powerful a motivating force as monetary compensation or intrinsic factors. Status is usually linked to an employee’s position within the organisation’s hierarchy, and it is not usually correlated with income between different organisations. For instance, teachers or university professors may enjoy a relatively high status in society despite receiving small salaries. Sales representatives, on the other hand, may make much bigger salaries, but they do not enjoy the same high status. However, the monetary compensation within organisations should be widely status consistent. In a number of institutions, for example, branch managers frequently complain that their total remuneration is lower than that of high performing loan officers.

However, within an organisation the principle of status consistency demands that salaries reflect staff members’ positions within the organisational hierarchy. Thus, superiors expect to earn (at least somewhat) more than their subordinates. Returning to our example above, a school's headmaster typically earns a higher salary than the teachers do; this reflects the difference in their status.

3. **Distributive Fairness:** Staff members look at what kind of salary they receive for their efforts and compare this with their peers’ salaries. Note that this concern is directly related to the equity principle mentioned above. In one East African organisation, e.g. loan officers considered themselves as peers of tellers. When the institution replaced a bonus scheme for tellers by a higher base salary, loan officers became dissatisfied because their basic salary was lower than that of the tellers (although there was a likelihood for high performing loan officers to earn a higher total remuneration than tellers).

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3 The point is not that superiors *always* should receive a higher remuneration than all the staff they supervise, but that they have a fair chance to receive higher payouts.
4. **Procedural Fairness:** Employees are not only interested in the outcome of the “salary distribution”, but also in the process itself. They might ask: What is the process that was used in order to decide who gets how much? Staff members wish to understand the mechanism that was used to determine their individual salaries, and this mechanism should be acceptable to them. E.g., staff frequently do not accept supervisors’, subordinates’ or peers’ performance assessments as a basis for bonus rewards. We will discuss this further at a later stage in this course.

**Minimum Requirements for Staff Incentive Schemes**

Let us now apply these principles to the specific case of staff incentive schemes in financial organisations. The two most important minimum requirements for such schemes are fairness and transparency.

**Fairness**

- The goals or reference standards set out for employees must be attainable. Otherwise, rather than motivating staff, the incentive scheme will have a detrimental effect on their motivation and performance.

- Staff members who perform better than others should receive higher compensation. This fact should be understood by everyone in the organisation.

- When staff members work harder and produce better results, they should receive a higher compensation.

- The compensation system should reflect the hierarchical levels within the organisation.

**Transparency**

- Staff incentive schemes should be kept simple enough that they can be understood by all who are affected by them. If a scheme resembles a “black box”, where it is impossible to determine the mechanics or algorithm of arriving at individual payouts, employees will neither accept nor embrace the scheme.

- As much as possible, incentive schemes should be based on measurable, “objective”, variables rather than subjective performance indicators. As we will see, this goal may sometimes be difficult to accomplish, but the use of subjective variables automatically reduces the system's transparency.

- It is important that the “rules of the game” be known to everyone affected by the scheme. The rules of the game are constituted by such things as performance measurements, minimum requirements, and any formulae used for calculating individual payouts. They should be communicated clearly and posted on the notice board or in the computer system. In addition, the scheme should not be changed too frequently – otherwise the organisation risks making the relationship between performance and compensation unpredictable for staff members.
Examples of Poorly Designed Staff Incentives

There are many examples of deficient incentive schemes in financial institutions, including:

- A number of lending organisations that were facing arrears problems decided to introduce very strong disincentives for allowing client delinquency. Two things happened. Firstly, some loan officers began to manipulate their statistics by reporting clients as “current” when the clients were actually overdue. Secondly, most of the loan officers concentrated so much on recovering funds from delinquent borrowers that they almost stopped granting new loans – which compounded the arrears problem even more.

- An MFI in Latin America introduced a staff incentive scheme that heavily focused on loan officer productivity. In order to earn a (substantial) bonus, loan officers had to disburse more than a certain minimum number of credits per month. Two types of problems were discovered during a subsequent audit: Firstly, loan portfolio quality generally suffered because lending staff had disbursed dubious loans in order to fulfil their targets. The second problem was even more
worrying – some loan officers had engaged in fraudulent behaviour by granting loans to “fictitious” clients (i.e. customers who did not exist). Again, there had been a strong temptation to do so since loan officers only received a reward if they surpassed the critical number of loan disbursements.

- The management of a credit-granting NGO in Asia wondered why the organisation was experiencing such a high turnover rate among the loan officers. The NGO's loan officers would leave, typically after about two years of service. These loan officers were paid only a commission, which was based entirely on their ability to lend and on their loan recovery. They received no base salary at all.

- One MFI made heavy use of incentive pay. Good loan officers received fat monthly bonuses. In fact, some loan officers earned so much that they refused to apply for more senior jobs in the same organisation (such as branch manager) since this would have meant accepting a lower salary.

Invariably, the question arises whether there aren’t any examples of well-designed incentive schemes in financial institutions. As the next section highlights, some of the world’s leading MFIs successfully utilise staff incentive schemes that enhance outreach and productivity. Then, why do the flawed schemes seem to be more prominent than the well-designed mechanisms? Perhaps industry participants and observers find such negative stories to be more “newsworthy”. And perhaps some of the organisations that have developed particularly good incentive schemes are reluctant to share this “success factor” with potential competitors.

2. The International Experience

Diagnostic Reviews

MicroSave and the MicroFinance Network conducted in-depth diagnostic reviews of the staff incentive schemes of 18 MFIs worldwide including:

1. Acleda Bank, Cambodia
2. Alexandria Business Association, Egypt
3. BancoSol, Bolivia
4. BRAC, Bangladesh
5. BURO, Tangail, Bangladesh
6. Centenary Bank, Uganda
7. Commercial Microfinance, Uganda
8. Compartamos, Mexico
9. Credit Indemnity, South Africa
10. Equity Building Society, Kenya
11. Finca-Uganda, Uganda
13. Prodem, Bolivia
14. SafeSave, Bangladesh
15. SHARE, India
16. Tanzania Postal Bank, Tanzania
17. Teba Bank, South Africa
18. Uganda Microfinance Union, Uganda

In addition, we were able to review the staff incentive schemes of Financiera Calpiá (now Banco ProCredit) in El Salvador and Los Andes in Bolivia.

Results of these reviews suggest that **well-designed monetary SIS can have very powerful effects on staff performance.** The design of staff incentives largely depends both, on the organisation culture and the culture of the MFI.
In Central and South America, staff incentives are typically designed for individuals, measure and reward performance in the short-term, focus on lending operations, and bonuses make a significant difference to the loan officers’ remuneration. Not very surprisingly, these staff incentives have a high and direct impact on staff performance. In comparison to the other cultural regions in which the diagnostic reviews took place, Central and South American MFIs have the largest technical expertise in the design of incentive schemes.

In contrast, most Asian MFIs are rather reluctant to employ monetary staff incentive schemes. It may be possible that money is not the best driver to improve staff performance in the Asian culture. However, the experience of two South Asian MFIs, namely Share and SafeSave suggest that monetary incentives can have powerful effects on performance. More research is needed to explore this question.

There is a wide heterogeneity in the design of the staff incentive schemes in East Africa. Some MFIs, such as Centenary Bank or Finca-Uganda, utilise similar schemes to those employed in Latin America – and do not want to miss their staff incentive schemes. Others seem to prefer group-based staff incentives with a lower variable part in the total remuneration or focus on long-term or non-performance-based incentive mechanisms. Such schemes typically have a very indirect impact on performance because individual employees do not perceive that they can significantly influence their payroll by working better and harder. However, we can assume that long-term and group-based incentives indirectly contribute to staff motivation, loyalty and long-term commitment.

Technically speaking, staff incentives transform best into improved performance if …

1. Staff perceive a strong link between their individual effort and the reward;
   a. Performance is measured and rewarded in the short term (monthly or quarterly);
   b. The performance of individual employees is measured and rewarded;
2. Rewards are monetary and make a significant change to the employees’ total remuneration;
   a. Bonuses are not capped;
3. Being applied to loan officers;
4. Staff accept them.

Employees accept staff incentives best, if they are both, transparent and fair. This implies that:

1. Employees understand the mechanics of the SIS;
2. Objective performance measurement parameters are used and supervisors’ assessments are avoided;
3. Eligibility requirements are easily achievable;
4. Incentives are based on individual performance.

When the performance of groups is measured and rewarded, free-rider behaviour is likely to reduce the scheme’s impact on performance. In contrast, individual staff incentive schemes can reduce team-spirit and team-work. However, the diagnostic reviews clearly suggest that individual incentive schemes have a higher overall impact on staff performance than group-based schemes.

Survey on Staff Incentives

The MicroFinance Network, CGAP and MicroSave have been conducting a large-scale survey on the use, design and effects of staff incentive schemes in different organisational structures.

Preliminary results from 86 MFIs have uncovered the following insights into the design and effectiveness of the staff incentive schemes that MFIs around the world are using. Of the MFIs that responded to each particular question:

- 86% indicated that they have monetary individual schemes in place for credit officers, making this by far the most popular scheme.
- 98% responded that their staff incentive schemes had a medium to very high effect on improving financial performance.
- 83% said that incentive schemes had a high or very high effect on increasing the productivity of credit officers (measured by number of clients and size of portfolio).
• 47% responded that the effect of staff incentives schemes on increasing staff loyalty was high or very high.
• 62% said that their staff incentives schemes had a medium to high effect on reducing staff turnover.
• 81% said that their staff incentive schemes had a medium to very high impact on improving client satisfaction.
• 76% indicated that staff incentive schemes had a high or very high impact on increasing staff motivation.

3. Building Blocks for Staff Incentives

Why is Human Resource Management Important for MFIs?

Financial institutions provide their services to thousands (and in some cases millions) of clients, both in urban and rural areas. Interacting with clients usually requires direct human involvement, especially when it comes to such tasks as assessing potential clients’ ability and willingness to repay a loan (in other words: credit risk) or customer service. MFIs share this basic characteristic with all retail financial institutions, including commercial banks, credit unions, and savings banks. It is fair to say that the staff members are the most important “factor of production” in microfinance. As was pointed out in Session Two, salaries and other personnel costs account for the lion’s share of total administrative expenses.

What is more, the quality and dedication of staff members have an enormous impact on an MFI’s ability to provide the best possible service to as many customers as possible (in other words: to achieve outreach). Regardless of an organisation’s staff size, whether it is an NGO with fewer than 100 employees or the BRI-UD with more than 20,000, the human resource function is an integral part of MFI management:

1. Many MFIs operate in environments where it is difficult to find well-educated graduates who are also socially motivated and willing to work with the informal sector.
2. Whatever new skills staff members already bring to the job, there is always a need for considerable additional training – and training is expensive. Training activities typically include basic training in the form of introductory courses as well as special training in needed skills like loan analysis. Training can take place in the classroom (theoretical instruction, role-playing) and in the field (“on-the-job” training). In addition to transferring the necessary skills, training also helps to socialise new staff members in the organisation. That is, training helps newcomers to understand and to assimilate the organisation’s basic values as well as its mission. Training also helps them to define and to find their particular position within the group.
3. MFI staff members are on a steep “learning curve”. Loan officers and other professional staff become more productive as they gather experience. Typically, loan officers reach their productivity “peak” after about two years of experience. By this time, they have become very valuable within their organisation. In order to become middle level managers (such as branch managers), staff members need to accumulate even more experience.
4. In urban areas, and especially in capital cities, there is often a gruelling competition among banks and international organisations for first-rate staff with practical experience in (micro) finance. As a result, excellent MFI staff members often have the option of moving elsewhere.
5. Good teamwork is an essential requirement for the delivery of quality services in microfinance. Building up teams with a common mission requires time and effort.
6. For an MFI to be successful, it requires excellent leadership skills at the middle and top levels of the organisation.

**Human Resource Management**

Staff incentive schemes always must be integrated into an organisation’s overall human resource function. For example, the best staff incentive scheme will be rendered useless if an MFI does not properly train its employees. Although we will not deal with the other elements of human resource management in this course, participants are strongly urged to keep the “bigger picture” in mind.

According to one influential text on the management of human resources, the field includes these areas:

1. Recruitment and placement (job analysis, personnel planning and recruiting, employee testing and selection).
2. Training and development (determining training needs, training and developing employees, managing organisational renewal).
3. Compensation (establishing pay plans, pay-for-performance and financial incentives, benefits and services).
4. Labour relations and employee security (collective bargaining, employee safety and health).

As can be seen from the list above, incentive schemes make up only a small part of the total area of human resources in microfinance.

**Compensation, Intrinsic and Extrinsic Motivation**

Essentially, someone is **extrinsically motivated** if she or he worked to achieve something that is not directly related to the work itself. In most cases this means to earn money. We all need an income in order to fulfil our basic needs such as food, shelter, and so on. All other things being equal, most of us would prefer to earn more rather than less, and the promise to be paid more money generally will make us work a little bit harder. In other words, money is a motivating factor for most humans. This is exactly the point of departure for monetary staff incentive schemes: Money can motivate people to increase their efforts and to produce better results. Specifically, staff incentive schemes often use the promise of higher compensation to influence individual behaviour. In this respect, staff incentive schemes belong to the “compensation” function of human resource management.

In contrast, some people derive their motivation for work from many factors other than “just” money. There are people who study medicine because they want to help others (one would like to think that this is generally the main motivation for becoming a doctor). Others work without receiving any monetary compensation at all (just think of all the volunteers in relief organisations and other NGOs). These types of phenomena highlight the fact that there is always some form of **intrinsic motivation** for human activities. The term “intrinsic” refers to the fact that this type of motivation comes from “within” and has nothing to do with the other benefits that are attached to the specific activity or job, such as prestige, power, or monetary compensation.

So, money is only one motivation for employees to do their job well. We already mentioned status as another motivating factor. The opportunity for promotion is yet another powerful motive for good performance. Most people will work harder if they have the prospect of moving on to a higher rank within the organisation. For this reason, some institutions have a policy of filling all vacant managerial positions from within the company; they do not hire outsiders. This is intended as a signal to employees that it pays to work well since the best employees can move up through the ranks.

While intrinsic factors also are powerful motivators, the level and composition of employee compensation have undeniable effects on the efforts that staff members invest in their jobs. Money is a powerful extrinsic factor that influences employee behaviour. We can expect that the degree to which

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people are motivated by money depends on individual as well as cultural factors. But we can also expect that, all else being equal, the promise of more money (i.e. a higher compensation) will make most people work a bit harder. This is exactly where staff incentive schemes enter the stage.
Session Three: Defining the Incentive Schemes’ Objectives (Step One)

1. Introduction

Introduction

The definition of the incentive scheme’s objectives is a critical step in the incentive scheme’s design. They must be in line both with the strategic goals and the culture of the organisation. The objectives of the scheme and the organisation culture then determine the type of incentive scheme that we want to employ (see Step Three). When the institution’s strategic goals change significantly, staff incentives have to be adjusted. Exhibit 3.1.1 illustrates these relationships.

Exhibit 3.1.1: Overview: defining the incentive scheme’s objectives
Defining the Organisations’ Strategic Goals

Where Are We Heading?

The definition and clarification of the institution’s strategic goals is such a fundamental and important process that it requires the participation of management (and often even the board of directors). Of course, clarity and agreement about the major goals of the organisation are important requirements not only for the design of appropriate incentive schemes. They form the basis for strategy formulation in all business areas.

The more we know about such strategic directives, the better we can adjust our incentive scheme.

In any case, it helps those designing staff incentive schemes if there is agreement on what the organisation wants to achieve. Perhaps there is a process of normalisation and conversion into a bank. Or perhaps management and the board have decided that for the next few years the overarching goal is to increase outreach.

Example: What Are Our Goals?

To start with, we could identify our position in the financial market from a client’s perspective. Typically, financial institutions compete on three levels, namely their prices, the quality of their product design and the quality of their customer service (see Exhibit 3.2.1). Since there are obviously trade-offs between these three factors, successful financial institutions usually have their competitive advantages in only one or two of these factors.

Exhibit 3.2.1: A perceptual map to categorise competitive advantages of financial institutions
Designers of staff incentives must know where their organisation is positioned (and if this position is desirable). They should anticipate how customers would react on the impact of certain types of staff incentive schemes. If, e.g., our competitive advantages included high quality customer service and quality products, we should be careful in designing staff incentive schemes focusing on productivity – because staff productivity may come at the expense of the delivered customer service quality.

**Example: Ranking Strategic Goals**

To define our strategic goals as detailed as possible, we could categorise them by their importance and terming, e.g. as demonstrated in the example of Table 3.2.1.

<table>
<thead>
<tr>
<th>Rank (according to importance)</th>
<th>Goal</th>
<th>Terming (long-term, medium-term, short-term)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Increase outreach</td>
<td>Medium-term</td>
</tr>
<tr>
<td>2</td>
<td>Implement a new banking software</td>
<td>Short-term</td>
</tr>
<tr>
<td>3</td>
<td>Market a new savings product</td>
<td>Short-term</td>
</tr>
<tr>
<td>4</td>
<td>Mobilise local funds</td>
<td>Long-term</td>
</tr>
</tbody>
</table>

**3. Analysing the Organisation Culture**

**Organisation Culture**

In order to be effective, staff incentive schemes have to fit into the organisation culture of the financial institution. The more we know about our institution’s organisation culture, the better the incentive scheme can be designed. The organisation culture of financial institutions includes:

- Commonly shared values
- Traditions, history, experience
- Policies and guidelines
- Strategies
- Formal and informal agreements
- Tools, processes and techniques
- Clientele
- Products
- Staff incentives
Typically, senior staff members who have been working in the organisation for a long time have a good idea about the relevant aspects of the financial institution’s organisation culture. It is neither feasible nor practical to develop a formal tool for the comprehensive analysis of the financial institution’s organisation culture. However, designers should at least:

- Anticipate how clients would react on staff incentive schemes.
- Appraise how staff incentives fit into the human resource strategy of their organisations and how staff would react to (redesigned) incentive schemes.
- Be clear about the organisation’s practices, procedures and processes.

**Staff Mentality, Motivation and Compensation**

Monetary staff incentive schemes can have different impacts on staff performance. The case of Prodem (see below) illustrates how the intrinsic motivation of employees was undermined by such types of incentives. Other institutions, such as the Alexandria Business Association (Egypt), attribute large parts of their success to the use of monetary staff incentives. Well designed incentives can have significant influence on staff performance (e.g. at Banco Procredit in El Salvador, Banco Los Andes in Bolivia, BancoSol in Bolivia or Compartamos in Mexico). However, they must fit into the institutions’ organisation culture. In particular, we can avoid detrimental impacts if we carefully predicted the effects of staff incentives on

- staff productivity and performance,
- intrinsic motivation,
- staff commitment,
- staff loyalty,
- staff turnover, and
- staff recruitment

before implementing or redesigning incentive schemes.

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**Case Study 3.2.1: Detrimental Effects of Staff Incentive Schemes at PRODEM (Bolivia)**

Prodem belongs to Bolivia’s leading MFIs. It focuses on delivering a wide range of financial services to rural customers and is well known for its innovations such as a “speaking” ATM which is capable to serve illiterates or its biometric client identification system.

In the early 90’s, just after having founded BancoSol, Prodem has implemented a monthly monetary staff incentive scheme for its loan officers to enhance productivity. While the scheme achieved its objective during the first years, the institution recognised some detrimental effects of the bonus scheme: staff turnover increased and cases of fraud and other irregularities in processes and procedures were observed. Simultaneously, staff demanded higher bonuses. In other words, the incentive scheme has undermined the loyalty and commitment of Prodem’s employees.

Consequently, Prodem replaced its monthly individual incentive scheme by an annual branch-based incentive scheme in which branch staff could earn up to one monthly salary. The scheme enhanced teamwork and the annual payments stipulated a longer term perspective of the employees. Nevertheless, it discouraged staff to work at weaker branches (where lower bonuses were earned) and reduced the cooperation between branches.

Thus, Prodem decided to align the incentive schemes for all staff fully with Prodem’s goals by providing staff with annual bonuses which are determined by the performance of the entire institution. In addition, Prodem focused on the development of non financial incentives and non performance based incentives such as training opportunities, health benefits or job enrichment to promote a culture of commitment, trust excellence.

*See Eduardo Bazoberry 2001: We Aren’t Selling Vacuum Cleaners. In: MicroBanking Bulletin 6 (Handout 3.2).
**Human Resources**

Designers should analyse the human resource policy of their institution. They could ask:

- What kind of staff do we attract?
- Why do staff leave?
- What motivates our staff at present?
- How would (monetary) staff incentive schemes change the compensation policy of the MFI?
- How would our staff react on staff incentives? What effects would staff incentive schemes have on the intrinsic motivation, turnover, productivity, commitment, loyalty of our staff? Would we attract different staff if we implemented monetary incentive schemes (e.g. more committed staff or risk-seekers)?

To address these questions, designers should know their organisation well and critically compare themselves with their competition in certain areas including:

- Competitiveness of salaries and benefits including the determination of the basic salaries and benefits as well as the types of monetary staff incentive schemes which are in effect;
- Working environment (e.g. workspace, equipment and overall environment);
- Status of the MFI as employer and in public;
- Chances for promotions and organisation hierarchies (both, formal and informal);
- Social commitment, overall motivation, mentality and turnover of staff.

Designers should use such assessments to anticipate the effects of staff incentives on staff recruitment, satisfaction and turnover.

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**Case Study 3.2.2: Automated Promotions at the Alexandria Business Association, Egypt**

The Alexandria Business Association (ABA), an NGO in Egypt with a strong social commitment, has a long-lasting experience with staff incentive schemes and attributes large parts of their success to these.

Staff earn basic salaries which are determined by the pay grades of civil servants in Egypt. These salaries are not sufficient to make a living and, thus, civil servants have frequently additional income sources. In ABA, all staff can earn very lucrative monthly, performance based incentives instead. However, poor performance is not rewarded and, hence, weak loan officers are likely to resign.

Besides its powerful bonus system ABA has implemented a widely automated and transparent promotion scheme for its loan officers. Loan officers receive monthly scores according to their performance in certain areas. These scores are accumulated during the year, and junior loan officers who have achieved a minimum accumulated score within one year automatically get promoted to senior loan officers if their tenure was at least two years. Likewise, senior loan officers can be promoted to “group leaders” which serve also as trainers for new loan officers.

In addition, the scores earned throughout the year belong to the key criteria to promote group leaders to deputy branch managers and those to branch managers.

ABA has made very good experiences with its incentive scheme. It not only enhances staff productivity but also assures that staff can largely forecast their career path within the institution – which definitely motivates high performers to retain in the institution while poor performers are discouraged to stay.

In Case Study #5.5.1, we will outline further technical aspects of ABA’s staff incentive scheme for loan officers.

Analysing Staff Productivity

In most cases, staff incentive schemes are employed to enhance productivity. To analyse the present staff productivity, and, thus, to appraise the potential for improvement, we could compare our staff in terms of productivity (e.g. in the number of transactions of tellers or in the number of outstanding loans of loan officers, or in the capacity of branch managers to develop their branch and staff). If there were high disparities, which can at least partly be explained by disparities in staff motivation, we could further ask how staff incentives would contribute to a higher overall performance of staff.

Analysing Practices and Processes

We should review practices, procedures and processes to identify:

- Responsibilities;
- Dependencies between different functional levels of staff;
- The level of required team-work;
- Bottlenecks;
- Risks.

Interviews with staff, a review of relevant documents such as job descriptions or training and product manuals and observations in the “field” are useful tools for designers. Costing and process mapping exercises are valuable, but rather complex tools. While it may not be essential to conduct them to design staff incentives, they are useful tools to identify areas where processes can be improved altogether. Based on such assessments, potential areas where staff incentives can contribute to enhance the overall performance of the organisation can be identified.

4. Defining the Incentive Scheme’s Objectives

Defining the Incentive Scheme’s Objectives

The definition of the incentive scheme’s objectives is a critical step in the design process. We need to be crystal-clear about what we are trying to achieve with the scheme. The objectives of the incentive scheme must be in line both, with the strategic goals and the organisation culture of the institution. Of course, staff incentive schemes cannot contribute to all of the organisation’s strategic goals. However, staff incentives can be powerful tools to increase overall staff loyalty and commitment, increase staff productivity or to fix some of the organisations’ problems.

Designers may want to use the format of Table 3.4.1 to define what you are trying to achieve and what problems you are trying to fix with the scheme. To be more concrete, designers could also define the results, which they expect from the staff incentive scheme.

Table 3.4.1: Suggested format to define the staff incentive scheme’s goals

<table>
<thead>
<tr>
<th>Rank (according to importance)</th>
<th>Objectives (be as precise as possible)</th>
<th>Expected Results</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

For instance, the goal might be to increase overall staff motivation and long-term commitment. Or the objective could be to increase loan officer productivity in the branches or to improve portfolio quality. Be as precise as possible at this stage.

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5 See the MicroSave Toolkits “Process Mapping” and “Costing and Pricing” and the CGAP “Microfinance Product Costing Tool”.
As indicated earlier, the definition and clarification of the staff incentive scheme’s goals naturally require the participation of senior management and eventually the board of directors. Hence, this is the point where the staff incentives team should discuss (and, eventually revise) the results of their analysis with senior management before proceeding to the Second Step.
Session Four: Determine Staff Members to Target and Financial Estimation (Step Two)

1. Whom Do We Want to Target With The Incentive Scheme?

Whom Do We Want to Target With Our Incentive Scheme?

Different functional levels of staff have different tasks, which have a different impact on the achievement of the staff incentive scheme’s goals. The incentive scheme needs to target these employees who contribute most to the achievement of the scheme’s objectives. If our main objective was e.g. to increase the loan portfolio quality, our incentive scheme should rather focus on loan officers than on savings mobilisation staff.

In determining whom our scheme will cover, we need to have a clear understanding about how the different occupational areas of the organisation are linked and depend on one another.

Often, the introduction of an incentive scheme at one organisational level or function creates a demand for schemes at other levels as well. Try to think comprehensively! On the other hand, we should not attempt to design one scheme that will apply to everyone in the organisation – such attempts are doomed to failure!

Thus, we should identify three groups of employees:
1. Those whom we want to target with our scheme
2. Those whose (work-) load is directly linked to these.
3. Those whom we do not want to target but who are likely to demand a staff incentive scheme if other employees, with whom they compare themselves, participated in a staff incentive scheme.

What about Other Staff Members?

Although the third group is not targeted by the incentive scheme, you should think about designing a simple staff incentive scheme for them as well to avoid that they feel neglected and become unmotivated.

Comprehensiveness of Staff Incentives

An incentive scheme’s “comprehensiveness” refers to whether the scheme is designed for only one level of the organisation (or one occupational group) or whether it encompasses several levels or groups. There are several arguments in favour of maintaining a narrow focus:

- Typically, a financial institution will experience problems in only certain departments or functions (for instance insufficient productivity among the field staff or elevated arrears levels), while other areas continue to perform well. So why not focus on those areas that need to be fixed?
- From a practical point of view, it is not possible to design and implement one, single, incentive scheme to cover all levels of the organisation. This would be an extraordinarily complex task that would go beyond the planning and management capacities of most financial institutions.

On the other hand, it may be useful to design incentive schemes to be more comprehensive from the outset:

- Many of the functions in a financial institution are interdependent. If loan officers work harder because they receive a special incentive such as a monthly bonus, other staff members will also need to work harder (we already looked at the examples of data typists and accountants). If the incentive scheme neglects these types of support functions, this might negatively influence the performance of the targeted staff members.
• Even when tasks are completely independent, it may be useful to consider introducing some kind of incentive scheme for all organisational groups. The implementation of incentives for operational staff (which is typically where incentives are most appropriate and most effective) can create the expectation at all levels of the financial institution that exceptional performance deserves special gains. If the other, non-operational, staff members are not covered by some kind of incentive scheme within a reasonable time frame, after some time they may simply stop working as hard. To the extent that organisations thrive on excellent performance in all departments and units, managers are well advised to consider more comprehensive incentive schemes.

In practice, it is probably not necessary to design incentive schemes for all organisational units at the same time. Rather, managers should concentrate on those areas that are most in need of “fixing”. They can then plan and implement schemes for the other units and departments at a later time. The second point to keep in mind is that the schemes for the “non-operational” units may be kept more simple, or fundamental, than those for operational staff.

**Organisational Hierarchies and Perceptions of Staff Incentives**

As discussed in Session Two, the salary of staff should be somehow consistent with their status in the organisation. Since monetary staff incentive schemes are naturally change the total remuneration of the employees, we should assure that those having a higher status have at least a good likelihood to earn more than the staff they supervise. Informal organisational hierarchies may or may not exist between staff of different functional groups of staff (e.g. between loan officers and tellers, or between department heads and branch managers). If members of such functional groups compare their remuneration among themselves, care should be taken when changing the remuneration system to avoid that some functional groups become demotivated. This problem is exacerbated if staff do not know to which position they are assigned before being employed. The point is not, that the relative remuneration cannot be changed. However, such changes to the organisation culture need to be well communicated to staff.

Conversely, monetary staff incentive schemes can contribute to reduce undesired salary gaps. Such differences typically arise in the long-term when merit pay schemes or tenure based salary increments are employed. If employees of the same level have the same likelihood to earn the same bonus, the relative salary gap can be reduced.

### Case Study 4.1.1: The Need to Think Comprehensively: Staff Incentives at an MFI in East Africa

An MFI in East Africa (East Africa Finance, EAF) employs multi skilled staff who can work as tellers, loan officers or back office staff. Occasionally, EAF rotated their branch staff between these different functions.

To boost loan officer performance, EAF implemented a very well designed monthly incentive scheme for them. Soon, other branch staff started to demand staff incentives as well.

Being aware of the fact that the performance of tellers and back office staff cannot be measured easily, EAF decided to base the rewards on supervisors’ assessments. Although great care was taken to make the scheme as transparent and objective as possible, e.g. by using a number of supervisors and standardised appraisal forms, some back office staff and tellers suspected that supervisors use subjective criteria in their performance assessments. Not feeling to be treated fairly, they became demotivated.

Hence, EAF eliminated the incentive scheme and offered tellers and back office staff higher basic salaries instead. While most of the banking staff members were satisfied with this change, loan officers felt neglected and demanded an increment in their base salaries or, in some cases, higher bonuses.
Checklist for Designers

1. First, focus on those areas and units that need improvement (in most cases, this will be some kind of operational department). Don’t attempt to design one single incentive scheme to apply to all staff members at the same time!

2. Set up a clear schedule for including other groups in an incentive scheme as well. Keep these schemes as simple as possible.

3. Try to align support staff’s incentives as closely as possible with those of the operational employees whom they support.

Designers may want to use the format of Table 4.1.1 to determine staff to target and appraise the size of incentive payments (see below).

<table>
<thead>
<tr>
<th>Functional group of staff</th>
<th>Importance of consideration</th>
<th>Interdependencies (indicate functional group)</th>
<th>Targeted size of incentives (e.g. in percent of base salary)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 = are targeted by the scheme</td>
<td>2 = are not targeted, but need to be considered immediately</td>
<td>3 = Could be considered later (or not at all)</td>
</tr>
</tbody>
</table>

2. How Much Are We Willing to Spend?

How Much Are We Willing to Invest?

To assure that staff incentives are investments and not costs, we will conduct a cost-benefit analysis in Step Five (Session Seven) for our planned incentive scheme. However, before selecting the incentive mechanism, we should have a very rough, tentative, idea on how much we are willing to spend on staff incentives.

Weight of Monetary Incentives in Total Pay

One fundamental question is to what extent the affected staff members’ total income will be fixed rather than variable. In other words, how much weight should the incentive component have in total employee remuneration?

In practice, the variable part of the remuneration in total pay varies. Some examples are included in Table 4.2.1.

Table 4.2.1: Monthly salary composition of loan officers in selected MFIs (estimates)

<table>
<thead>
<tr>
<th>MFI</th>
<th>Variable portion of total monthly compensation</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alexandria Business Association, Egypt</td>
<td>65%</td>
<td>Most loan officers earn incentives. The highest performers earn up to 5 times their basic pay as incentives</td>
</tr>
<tr>
<td>Centenary Bank, Uganda</td>
<td>30%</td>
<td>Most loan officers earn incentives</td>
</tr>
<tr>
<td>BancoSol, Bolivia</td>
<td>30%</td>
<td>Around 50% of the loan officers earn incentives</td>
</tr>
<tr>
<td>BURO, Tangail</td>
<td>10%</td>
<td>All loan officers earn incentives</td>
</tr>
</tbody>
</table>

The variable portion of the remuneration of other functional levels of staff is usually lower – we come back to this later.

6 Considered are only these loan officers who earn incentives. Values represent rough appraisals and are calculated by: bonus/(bonus + basic salary).
Too Low Incentives

If incentive pays were too low, staff may not increase their performance.

To explain this point better, let us look at a simple example. Imagine a situation where employees could earn an additional 5% of their total remuneration if they doubled their productivity. Such a small “carrot” is unlikely to motivate most employees to work much harder.

Our simple example highlights the fact that a variable incentive must be of a certain minimum size to be effective. Those who are targeted by an incentive scheme should have the feeling that it “really makes a difference” – otherwise they are unlikely to change their behaviour. Or, to continue the carrot analogy, the potential carrot has to be sufficiently large to warrant increased effort.

Too low incentives may even have detrimental effects on staff motivation if employees do not perceive that their efforts were acknowledged altogether – then, the incentive scheme may reduce their intrinsic motivation.

Too High Incentives

Conversely, if the variable portion of total compensation becomes too large, the job might only attract those who enjoy risk. Let us imagine the extreme case where an employee’s compensation depends entirely on the output that he or she can produce during a month or day. While such “piece rate” systems are quite common in industrial production, they would mean high risks for the employees of financial institutions. Moreover, financial institutions might not want risk seekers (people with a high affinity to risk) as their loan officers.

Basic Salaries

To avoid subjecting their staff members to excessively high degrees of risk, MFIs should calibrate base salaries in such a way that the “typical” employee (for instance a married loan officer with two children) can cover his/her basic monthly needs from this source of income. “Basic needs” comprise at least housing and food, plus normal medical and educational expenses.

If base salaries fall significantly below this level, employees will be subjected to considerable financial risk. This almost certainly would lead to low morale and increase staff turnover. For the same reason, it probably does not make sense to use “negative” bonuses (i.e. penalties). In the worst case, the bonus earned should be zero, and if a staff member never earns any bonuses then his/her poor performance may eventually be reason for dismissal.

Local Culture

Depending on which region or country the MFI operates in, there may be different “trigger points” for what employees perceive as real incentives. Some cultures are perhaps more sensitive to monetary rewards than others, and managers need to think about this before they create or change incentives. There is some evidence that high monetary incentives work best on the American continent. In contrast, the fact that monetary incentives are rarely used in Asia may indicate that other motivational forces are more adequate in this cultural background (see Session Two).

Organisation Culture

The “organisational culture” should also be taken into account: To what extent do we as an organisation want our staff to be motivated by money? Perhaps there are other, more important values that all members of the organisation have traditionally shared. By making it possible to earn relatively large monetary awards through bonuses or other incentives, management might jeopardise the role of these other values. The intrinsic motivation of staff members may suffer if too much attention is paid to extrinsic factors such as salary and monthly bonus entitlements. Eduardo Bazoberry provides a good case
study of such a situation in his account of the introduction of a monetary incentive scheme at Prodem in Bolivia. (See Handout 3.2).

As we look at higher levels in the organisational hierarchy, we might expect monetary incentives to be less powerful than at the lower levels. Managers usually have high intrinsic motivations and derive benefits from such things as status, responsibility, and power. Also, managers generally receive substantially higher salaries than other employees, which may limit the motivational effect of any given monetary bonus. Finally, given the long-term outlook of managerial work (the owners would prefer managers to maximise institutional performance and profits not only for the next two months but also over the course of several years or perhaps even decades), it might be counterproductive to offer large monetary rewards to managers over the short term. We will revisit this topic when we look at incentive schemes for different occupational groups at a later stage of the course.

**In Numbers …**

As a general guideline, try to use the following ideas:

- For loan officers, the variable, performance-related, portion should account for between 20% and 50% of total compensation. Levels much below 20% probably will not have much effect on behaviour, while levels above 50% may attract risk-seeking individuals to the job.

- For other staff members, such as those engaged in savings mobilisation and back-office work, it may be more appropriate to let the variable (incentive) portion of compensation vary between 15% and 30% of total pay. Staff in these occupational categories would probably find variable pay accounting for 50% of total compensation unduly harsh.

**A Rough Cost-Benefit Appraisal**

In the Fifth Step, we need to conduct a proper cost-benefit analysis and to estimate the impact that the planned scheme will have on operating costs and the organisation’s financial performance. However, to select the incentive mechanism, we need to determine how much we are willing to invest on incentives at this stage. If your MFI was, e.g., among the few which did not expect staff to increase their performance under a bonus scheme, we may opt for a less expensive profit sharing scheme which may support the existing motivation of staff. Based upon the predicted benefits which are related to the planned staff incentive scheme, we can determine the maximum amount which we could spend on staff incentives without risking losses. Based on such an appraisal, we could decide how much we are willing to spend on incentives.

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7 As we will discuss in Session Seven, a bonus scheme will increase total staff costs in the short-run. If the system is well-designed, these costs will later be compensated by increased staff productivity and output.
Session Five: Select the Staff Incentive Mechanisms (Step Three)

1. Performance Based and Non-performance Based Incentives

**Performance Based and Non-Performance Based Incentives**

Performance-based incentive schemes link the employees’ rewards directly to their performance (either their individual performance or to the performance of a group). Thus, poor performance is not rewarded and well-designed staff incentives assure that staff can benefit by working better and harder.

Non-performance based incentives include all kind of benefits which staff receive – regardless of their performance. They include e.g. pension funds, insurances and most kinds of allowances. Although they may support the intrinsic motivation of staff, their impact on performance is usually low. Despite the fact that non-performance based incentives are important for financial institutions, we will not consider them further in this course.

**Examples of Performance Based and Non-Performance Based Incentives**

Among the performance based incentives are:
- Bonus schemes
- Profit-sharing plans
- Gain-sharing plans
- Merit pay plans
- ESOPs
- Prices for best performers
- ERM
- Commendation letters
- Promotion

Among the non-performance based incentives are:
- Health insurance
- Pension fund
- Allowances (e.g. leave, transfer, lunch, cash loss allowance)
- Good working environment
2. Performance Measurement Techniques

**What Do We Want to Measure?**

Staff incentive schemes are supposed to reward good performance and to make employees increase their level of effort. But if performance is to be rewarded, it must first be measured. In most cases, it is easiest to measure the work results (in which we are finally interested). However, there are many factors which lead towards work results and staff cannot be accountable for all of these factors. Exhibit 5.2.1 distinguishes between four types of inputs which lead towards the work result including:

1. Staff effort
2. Staff skills
3. Operational circumstances (e.g. urban vs. rural branch, computerised branch vs. manual branch)
4. “State of the World” (e.g. economic crisis, earthquakes, floods, etc.).
Exhibit 5.2.1: Factors which determine work results

Designers of staff incentive schemes are mainly interested to measure staff performance which includes both, staff effort and staff skills. It does not include operational circumstances or the “state of the world”. The point is that there are a number of factors which contribute to institutional performance but are out of the control of staff. We should bear this in mind when attempting to measure staff performance.

In some cases, it is impossible to measure work results for individual staff members or certain functional groups of staff. If, e.g. there is a high degree of teamwork, it may be difficult to attribute work results to individual employees. For designers of staff incentives, there are two possibilities to cope with such operational circumstances.

Firstly, the unit for which work results are assessed could be increased. For instance, if it was impossible to measure the performance of individual branch employees, the performance of a branch could be measured and a group incentive scheme could be designed. As we will discuss later in this section, this approach has some drawbacks since free rider behaviour is likely to reduce the impact the incentive scheme as the size of groups increase.

Secondly, designers could give up the idea of measuring work results and assess the performance of processes alternatively. For instance, instead of measuring the portfolio at risk of loan officers, we may gauge the reduction of the portfolio at risk during a specified period of time. Or we may assess the number of customers visited in order to recover loans in arrears. Obviously, this technique cannot reflect managements’ goals as well as the measurement of work results but may still lead to better incentive effects than increasing the unit of measurement.
In rare cases, institutions decide to include the compliance with processes and procedures into a wider set of performance measurement parameters although work results can be measured. Clearly, if processes are designed well\(^8\), staff who comply with them are more likely to generate better work results. However, if staff are not aware of this relationship (e.g. because they are not very experienced), it may help to design staff incentives also around the level of the compliance with processes.

But be aware, that such a technique may also have some drawbacks: as discussed earlier, staff incentives should foster and reward outstanding performance. Usually, the compliance with policies is expected from employees. Awarding employees for expected behaviour may send the wrong signal because staff may start to believe that everything they do should be acknowledged and rewarded – while in fact they should be punished for not complying with certain institutional norms such as showing up in time or keeping files neatly. Hence, as a general rule, we suggest to avoid rewards for expected behaviour. Good managers should be capable to assure that policies are followed, and staff should understand the reasons for policies (e.g. that maintaining a neat file for each borrower is crucial to manage a high loan portfolio quality).

Institutions which historically face problems with adherences to processes and procedures, may reward for the compliance with these processes temporarily. Respective performance measurement parameters could then be phased out once the problem is fixed. Even better, such institutions may implement disincentives, such as deductions from bonuses earned in other areas, for not complying with certain policies.

### Qualitative Assessments

The supervisor evaluation is a commonly used instrument for assessing performance. This is a structured process in which superiors are asked to rate their subordinates regularly on a number of performance criteria. The idea behind this instrument is that direct superiors usually have a clear impression of the quality of their own staff’s work.

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\(^8\) See the “MicroSave Toolkit on Process Mapping” to evaluate and improve processes.
The criteria used in these evaluations consist of objective and measurable items (such as whether someone always arrived at work on time) as well as more subjective items requiring a certain degree of judgement on the supervisors’ part.

**Drawbacks of Qualitative Assessments and Possible Solutions**

The main drawback to supervisor evaluations is that staff members often suspect that these assessments are completely subjective. Indeed it is almost impossible to exclude subjectivity from the rating process. However, one way to mitigate the danger of the evaluation becoming a “popularity contest” is to assign two supervisors to the task and to ask them to develop a common rating.

Some institutions (e.g. Teba Bank) utilise a “360 degree” performance appraisal in which the employee’s performance is assessed “from all sides” of the functional hierarchy: by superiors, peers and subordinates.

While all the techniques mentioned above can be powerful methods to monitor staff performance or to identify candidates for promotions, they are rarely accepted as tools to determine the size of rewards or bonuses by staff. If it comes worse, staff even may collude to maximise their payoffs. The authors know a case in Africa where the supervisors “charged” for good performance appraisals (which, in that case, directly were transformed into bonuses). So be aware!

Yet whether or not an individual’s output can be properly measured depends mostly on the way in which a service or activity is performed, or, in the terminology of economics, on the “production technology” employed. Generally speaking, if tasks can be broken down into smaller and clearly identifiable sub-tasks, it should be easier to measure individual output. But in the context of finance, this can be a rather difficult undertaking.

Consider these typical occupations and activities:
1. Loan officers
2. Other credit staff (support staff)
3. Savings mobilisation staff
4. Back office and administration staff
5. Management

**Loan Officers**

The performance of loan officers (or credit officers and field agents) is relatively easy to define and measure. Loan officers are expected to produce and control as many loans as possible (this is the outreach aspect), to build up large portfolios (which is related to the sustainability aspect), and to maintain excellent portfolio quality. All of these performance criteria can be easily measured, both in individual and in group lending.

More performance standards could easily be added to the ones that we have already mentioned. For instance, it would be possible to measure client retention – after all, microlending organisations would like to keep their best clients as active borrowers. Likewise, it would be possible to measure (and to emphasise through the bonus system) the extent to which loan officers manage to attract new customers to the institution. This point is related again to the outreach objective; if loan officers only work with their repeat customers, the MFI will not be able to grow into new market segments. Additional performance criteria can be measured and included in an incentive scheme: client gender, client activity (for instance rural versus urban, or trade versus production), or any other client characteristic that management deems relevant.

The main reason that loan officers’ performance is easy to measure is the production technology of micro lending. Loan officers have direct contact with their individual clients or groups, and most of the data that are needed for performance evaluation are already collected as part of the loan evaluation process.
**Other Credit Staff (Support Staff)**

It is relatively simple to measure the output and productivity of cashiers, tellers, and desk officers who process particular transactions (such as payments and inter-branch or international transfers). A good management information system (MIS) will help to count numbers of payments or other transactions. Quality may also be measured, for instance by counting the percentage of faulty transactions (transactions that needed corrections or other follow-up work). It is useful to remember that service quality also comprises such elements as friendliness to clients, which is more difficult to measure.

**Savings Mobilisation Staff**

Mobilisation of savings is not quite as straightforward to measure as lending. If savings are collected by branch outlets, several staff members must work well together in order to entice customers to deposit their funds with the organisation. The receptionist may have to help illiterate customers to fill out the necessary forms and the deposit or withdrawal slips. Cashiers need to be efficient and friendly so that customers feel they are being well treated. It is not so easy to determine the various employees’ contributions to the collection of deposits since the whole team must work well.

Moreover, it is not only the quality and hard work of the staff members in the savings department or general banking hall that determine the success of deposit mobilisation. Other factors, such as the general image of the organisation in the market, also play an important role. So the “production” of savings is relatively complex and is conducted over longer periods of time. Also, it depends in part on good cooperation within a (branch) team rather than on individual effort alone.

**Back Office and Administration Staff**

Most front-office activities require additional work in the back office and in various administrative departments. Typical examples include:

- Data entry by typists (e.g. for transferring the loan analyses conducted by the loan officers to the loan accounting module).
- Legal due diligence and drafting of loan agreements (e.g. for loans to small and medium sized businesses).
- Processing of information for financial and management accounting purposes (e.g. entries into the general ledger and preparation of management reports and statistics).

For most of these functions it is not too difficult to develop objective performance criteria, such as “the number of transactions processed” or “the number of contracts drafted”. Note, however, that the workload for back office staff often is related directly to that of the front office: If the loan officers analyse more clients, staff members in the legal department must screen more documents, and data typists must enter more data into the loan accounting system. Likewise, an increase in the number of deposits or money transfers made automatically increases the amount of information being processed by the MIS and accounting departments. What performance-based incentives make sense under these circumstances?

Staff members engaged in back-office transactions and supportive administrative departments usually cannot control their workload; rather, this workload is produced by other staff members in the field and in the front office. While this is the subject of later sessions, we can already see here that a different approach is needed. It might thus be an idea to let back office personnel participate in the monetary incentives earned by front-office staff or to use a group-based incentive scheme.

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9 In the Southern Albanian city of Fier, some local residents made their first deposit on the exact day of the branch's first anniversary. These customers had waited a full year to see if the newly established branch of a microfinance bank was “trustworthy”.

10 An exception to this rule occurs when staff members go out into the field in order to mobilize savings from potential customers. In such cases it would be possible to collect data on who “recruited” a certain customer and to pay out individual incentives.
Management

We should also note that performance measurement becomes increasingly complex for the upper levels of the organisational hierarchy. There are two main reasons for this challenge.

- The first complicating factor is that managers typically are responsible for producing more than one output at the same time. Branch managers and other senior staff have multiple tasks, and in some cases there may even be conflicts between these tasks (e.g. “maximising market share” and “improving profitability”).
- Another issue is that high level managers’ decisions and actions often affect the “bottom line” only in the longer term. Consider, for instance: How long will it take until a new head office building (or new MIS) will boost productivity enough to improve the MFI’s financial performance?

To sum up this section, we can state that it is useful to measure employee performance whenever this is possible. But there are situations where objective performance measurement is impossible and might even be counterproductive. Whether individual performance measurement is possible depends mostly on the production technology and the nature of the task.

General Guidelines

It is useful to measure the individual performance of employees wherever possible. Good performance measurement techniques measure the performance of staff, are objective and are exhaustive (which means that they include all tasks of staff). Whether such techniques can be employed depends on the production technology and the nature of work.

3. Individual Incentives, Group Incentives and Tournaments

Individual Incentive Schemes

In individual incentive schemes, there is a direct relationship between individual staff member’s performance and their remuneration. Note that the form and frequency of payouts might vary. The key point is that each employee is compensated according to his/her performance.

While individual incentive schemes are designed precisely in order to enhance individual performance, they also have some potential drawbacks:

- Individual schemes can lead to a rather narrow focus; the affected staff members will tend to maximise their own output with the aim of increasing their income. Such self-interested behaviour may negatively affect the common goals of the organisation, thereby reducing the overall performance of the group or unit.
- The focus on individual income (maximisation) may reduce staff members’ intrinsic motivation. That is, once money takes over as the main motivator, other values may be reduced—to the detriment of the organisation.
- It is often difficult to distinguish properly between individual and group performance. This difficulty can be compounded by problems with measuring performance. In such cases the incentive scheme may turn into a “black box”.
- There is some evidence that merit pay (in which the best performers receive a pay raise) is often linked to staff members’ position within the organisational hierarchy. Those on the higher levels may receive bigger salary increases simply because of their position and not necessarily because they have contributed more to the overall company or unit results. The credibility of such systems is at risk since the affected staff members perceive them as unfair.

Despite their potential drawbacks, individual incentive schemes are widely used in financial institutions since they are quite well-suited to the tasks and workflows especially of microcredit operations.
When Choosing Individual Incentives?

Individual-based incentive schemes are appropriate if\(^{11}\):

1. Individual output is easy to measure.
2. Employees have enough autonomy that they can decide themselves how much effort they will put into their job.
3. There is no need for close cooperation among staff members, and competition between them is even beneficial for the whole organisation.
4. The organisational culture favours individual achievement.

Group Incentive Schemes

As opposed to individual incentive schemes, group incentive schemes look at the output of the whole group in order to determine staff rewards. The main benefit of such schemes is to foster teamwork and cohesiveness within the group or unit.

The biggest danger of group incentive schemes is a phenomenon called “free-rider” behaviour. If the group is large enough, it becomes very difficult for the group members to monitor each other and to ensure that everyone gives his/her best effort. This creates opportunities for some of the members to shirk their responsibilities; they reduce their individual efforts without getting punished. If the other group members anticipate such behaviour, there may be a noticeable decline in the group’s output – clearly not a desirable outcome for the organisation. So the main task for those who operate group incentive schemes is to control and prevent free-rider behaviour.

When Choosing Group Incentives?

Conversely, group-based incentive schemes can be very useful under the following circumstances\(^{12}\):

1. It is difficult to identify individual outputs.
2. The organisational structure lends itself to the measurement of group outputs (e.g. a branch system).
3. Technology and workflows make it simple to identify groups (e.g. savings mobilisation in a branch).
4. The MFI wants to stress the importance of cooperation and teamwork.
5. The MFI wants to set a common goal (goal setting can enhance performance).
6. Free riding problems are relatively small or can be controlled.

Three Core Questions to Address

1. Is it possible to measure individual effort and output? (If not, opt for a group-based scheme instead of an individual incentive scheme.)
2. What is the main purpose of the incentive scheme: to maximise individual performance or to improve cooperation and teamwork in the group/branch/unit?
3. Investigate the possibility of combining both individual and group schemes.

Tournaments

Tournaments are regular or occasional contests between individual staff members or between units. Provided the organisation’s MIS is capable of collecting the relevant information, managers and especially public sector managers can conduct regular rankings within the branch network and thus create a sense of competition between the different branches. Criteria for rankings can include: productivity, outreach (e.g. growth in deposits), customer satisfaction, etc. The best branches are then recognised and

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commended both on public occasions and within the organisation’s internal communications infrastructure (black boards, newspaper, etc.).

**Case Study 5.3.1: Tournaments at Acleda Bank (Cambodia)**

A number of branch managers at Acleda Bank conduct regular non-monetary tournaments among credit officers. Under that scheme, loan officers are ranked according to selected criteria among which are the number and volume of disbursed loans, the volume or growth of the outstanding loans and the portfolio at risk rate. The ranking is an ongoing process and the credit officers’ results are almost daily updated. In some branches, monthly, quarterly and annual winners are identified and their names and pictures are pinned at the notice board. Although there are no monetary rewards, the Cambodian bank has made very good experience with its scheme: being honoured for outstanding performance is a high motivational force in the Cambodian culture.

**When Choosing Tournaments?**

Tournaments can be supplementary tools to individual or team incentives. They not only help to identify good performers but also to identify (and punish) free-riders when group-based incentives are employed. In environments were monetary incentives cannot be used, e.g. in public sector organisations, tournaments are the best alternative.

**4. Short-term and Long-term Incentives**

**Short-Term vs. Long-Term Incentives**

While short-term incentives are accrued in the short-term (e.g. monthly or quarterly), long-term incentives are accrued in the long-term (e.g. semi-annually or annually). The architect of an incentive scheme must make decisions regarding the term for which the incentives will be structured. But the term is only one of the relevant dimensions that need to be addressed. Much more fundamentally, we should ask what kind of behaviour we want to encourage with the help of the incentive scheme:

**Reduce and/or Control Client Delinquency**

While delinquency control is both a short- and long-term goal, portfolio dynamics direct us to concentrate on the short term. Since portfolios of small and micro-loans typically rotate very quickly, the trick is to defend portfolio quality rigorously and not to allow any slack to enter into the system. Once a loan officer has neglected his/her portfolio quality for a few months, the negative impact is enormous. Thus, incentive schemes that are geared towards portfolio quality usually measure and reward performance at short intervals, such as a monthly basis. If quality is maintained at these short intervals, longer-term delinquency should not become a problem.

**Boost Staff Productivity**

Staff productivity is one of the most important drivers of MFI performance. Many managers use incentive schemes to try to improve that productivity.

The most commonly used measure of productivity in lending is the number of outstanding loans per loan officer (or staff member). Given the nature of micro and small business lending, high productivity is the result of a high output of loans per loan officer. In many of the most productive MFIs, loan officers disburse two to three loans per working day (i.e. 40-50 loans per month). As with the example of maintaining portfolio quality, it probably makes most sense to provide short-term incentives to all staff engaged in lending; their productivity over the longer term is directly related to their monthly and quarterly output.

Does this mean that all productivity-related incentives should be geared towards the short-term? There are at least two caveats:
• Not all types of finance activities are characterised by such simple and straightforward mechanics as microlending. Consider, for example, the case of deposit mobilisation. This can be a tedious activity, where individual staff members (such as the tellers in the branch) exercise very little control over the inflow of new clients. What is more, mobilising deposits requires trust, and trust takes a notoriously long time to build. Therefore, it might be more appropriate in such cases to use incentives that work over the medium or long-term.

• We must never forget that we want to provide excellent services to our clients over the long-term, year after year. Short-term productivity must not come at the expense of long-term performance.

If financial institution’s staff members such as loan officers are constantly subjected to significant short-term oriented productivity incentives, they may “burn-out” and stop responding to the bonus system. This phenomenon is likely to be even more pronounced if there are system-wide crises such as in Bolivia during the late 1990s. Employees may start feeling that they have been running the “treadmill” for too long and that it is time to move on to another job. Supplementing short-term incentives with longer-term ones might be useful to avoid such problems.

### Increase Staff Loyalty

Another common goal with staff incentive schemes is to foster loyalty among the employees. Staff members who feel like they are part of the organisation, who identify with their bank or program, tend to be more productive and to produce higher quality output. Older, more experienced staff members hold valuable skills that would be difficult to replace if they moved on to another organisation. Since employee loyalty evolves over time, fostering loyalty fits into long-term incentives such as profit-sharing plans or ESOPs.

In practice, most organisations opt for a combination of long- and short-term incentives. MFIs that place a high value on productivity and portfolio quality are bound to make greater use of short-term incentives. However, in order to maintain key staff and to avoid an excessive focus on short-term thinking, longer-term incentives also have their use.

### Payout Frequency

The term “payout frequency” relates to how often an incentive is distributed among the employees. What might be the arguments for more or less frequent payment intervals?

#### Arguments for Short Intervals

On the one hand, we might expect that shorter payment intervals provide more direct feedback to the employees and will therefore have a stronger positive effect on productivity. Spreading out the payment intervals obscures the relationship between an employee’s actual performance and the award he or she receives. This, in turn, makes it more difficult for managers to change employees’ behaviour by making adjustments to the incentive scheme.

#### Arguments against Short Intervals

The main argument against short payment intervals runs as follows: If monetary incentives are paid out frequently (such as monthly), staff members may develop an “entitlement” mentality. In other words, they may perceive the incentive payments as part of their regular compensation. If this were to happen, the scheme would no longer affect employee performance; it would only increase the MFI’s wage bill.

Furthermore, it may be simply difficult or even counterproductive to determine performance at short intervals for some activities and groups of employees. Certain employees, such as department heads and branch managers, are expected to optimise their units’ performance over the medium to long term. In these cases, very frequent payment intervals might provide the wrong signal. In other cases, the tasks are complex, and performance cannot be measured easily or may depend more on qualitative factors.
Another potential argument against frequent payment intervals is the administrative cost of gathering the necessary information, making the relevant calculations, and managing the payroll. This problem may be mitigated by the increasing use of information technology.

**Guidelines**

In conclusion, we might say that more frequent payment intervals make sense where the following conditions exist:

1. Short-term productivity is important for overall organisational performance.
2. Individual performance can be measured accurately and at reasonable cost.
3. It is possible to avoid an “entitlement mentality” by making the incentive awards very reactive to changes in performance.

**5. Forms of Incentives**

**Introduction: Typology of Staff Incentives**

There are several types of staff incentive schemes. We can distinguish between:

1. Cash incentives
   a. Bonus schemes
   b. Profit-sharing plans
   c. Gain-sharing plans
   d. Merit pay plans
2. Symbolic rewards
3. Employee Stock Ownership Plans (ESOPs)
4. Delayed benefits
5. Perks

**Bonus Schemes**

Bonus schemes are the most common form of cash incentive. Bonuses can be accrued and paid out at different intervals, such as monthly, quarterly, or annually. Monthly bonus payments are very common for loan officers. Bonus sizes vary between 10% and 50% of the total pay. Managers sometimes pay spot bonuses to some staff members for having made special efforts in their work. Typically, the spot bonus is awarded for an achievement that is not measured by any regular performance standard.
**Case Study 5.5.1: The Bonus Scheme of the Alexandria Business Association, Egypt***

As already mentioned in Case Study 3.2.2, the Alexandria Business Association (ABA) has a long-lasting experience with staff incentive schemes and attributes large parts of their success to these. In ABA, all employees are eligible for incentives. Credit officers can earn up to five times their basic salary as bonuses. Bonuses are paid monthly and are determined by the credit officers’ individual performance in three areas including the number of disbursed loans, the portfolio quality and the number of active clients in the loan officers’ portfolio. The staff incentive scheme is staged, which means that credit officers have to meet certain benchmarks in order to increase their bonuses. The Tables 5.5.1 and 5.5.2 demonstrate how the bonuses are accrued.

<table>
<thead>
<tr>
<th>Number of disbursed loans in the month</th>
<th>Bonus in USD</th>
</tr>
</thead>
<tbody>
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</tr>
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<table>
<thead>
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<th>Repayment rate</th>
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<th>70-90</th>
<th>91-120</th>
<th>121-150</th>
<th>&gt;150</th>
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<td>$82</td>
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<td>$100</td>
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</tbody>
</table>


**Profit-Sharing Plans**

Profit-sharing plans are another widely used form of cash incentive. Under such plans, employees receive a certain percentage of the annual (or semi-annual) profit. The profit pool allocated to the employees is then distributed equally between all staff members, or according to some form of allocation criteria (base salary, individual performance, etc.).

**Gain-sharing Plans**

Gain-sharing plans are similar to profit sharing plans, but here the basis for the distribution pool is different. Typically, under gain-sharing plans, employees are entitled to a certain percentage of the productivity gains that are achieved over a given period. Payout intervals are typically shorter than under profit-sharing plans.
Case Study 5.5.2: The Gain-sharing Plan of Teba Bank, South Africa

Among other staff incentive schemes, Teba Bank has a profit-sharing plan in effect. Except for top-managers, all employees participate in that scheme.

However, until recently, the Bank had employed a gain-sharing plan under which staff were eligible for semi-annual bonuses. The total staff bonus pool consisted of 50% of the Bank’s gain and was distributed among the employees as indicated in Exhibit 5.5.1 below.

Exhibit 5.5.1: The gain-sharing plan of Teba Bank

Example: Company profit: R40 Million, Budgeted profits R30 Million.
Excess pool = R10 Million

The main challenge of the scheme was the budgeting process. If profits were budgeted too challenging, staff obviously would not have been able to receive significant bonuses. If profits were budgeted too low, staff would have easily been able to receive high awards. To overcome this weakness, Teba Bank replaced the scheme by a profit-sharing plan. Under that scheme, the staff bonus pool is calculated as a function of the Bank’s return on equity as demonstrated in Exhibit 5.5.2.

Exhibit 5.5.2: The profit sharing scheme of Teba Bank

Essentially, the technique of Exhibit 5.5.1 is used to distribute the bonus pool among the staff members.

**Merit Pay Plans**

Merit pay plans involve salary increases for those employees who have produced the best performance during a certain period of time (often one year). Annual salary increases might range from 0% for weaker performers and 5% for average performers to 10% for strong performers. While most of the other incentives assure that staff always have to work hard in order to receive the reward, employees will feel the merit pay forever. Hence, merit pay schemes are not only performance based, but also (and, maybe, mainly) tenure based. While they can contribute to low staff turnover rates, they can cause high disparities in the salaries of junior and senior staff because of the past performance of senior staff. Despite their drawbacks, merit pay schemes are widely used in practice.

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**Case Study 5.5.3: The Merit Pay Scheme of Acleda Bank, Cambodia**

Acleda, a fully fledged bank in Cambodia with more than 2,000 employees has developed a remarkable merit pay scheme. At the end of each year, the organisation conducts an employee evaluation for all staff members. This evaluation contains both quantitative achievement based variables and qualitative parameters. Staff performance is mainly appraised by direct superiors.

For credit officers, for example, quantitative parameters include the amount and number of loans disbursed as well as portfolio at risk. The evaluation is enriched by qualitative criteria such as: general knowledge, degree to which the policy is followed, feedback from customers, responsibility, degree to which internal regulations are adhered to, sincerity and planning skills.

For each function the evaluation form has the same structure. Achievement targets are set separately for each branch, and in exceptional cases even individually according to circumstances. For each parameter performance scores are given which are then added up.

Depending on the results, the salary for the next year can increase by 0-3 steps, where each step refers to a salary increase of a certain percentage. Low performers receive no salary increment, can receive warnings or get transferred to different functions of the same level or lower levels.

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**Symbolic Rewards**

Symbolic rewards are of small monetary value and emphasise the recognition of the employee’s work effort. Examples of such rewards include commendation letters, branded gifts, trophies, joint dinners (on unit level) or trips. While the monetary value of this reward is not likely to enhance staff performance, the provision of such rewards can be valuable supplementary tools to support staff motivation. However, staff usually prefer cash payouts as the financial value of these rewards becomes significant.

**Employee Stock Ownership Plans (ESOPs)**

Another monetary incentive, called Employee Stock Ownership Plans, or ESOPs, involves the participation of employees in the MFI’s share capital.

Through an ESOP, employees become co-owners of the organisation. They can increase their wealth and income if the MFI makes profits, which would tend to increase the value of the shares and make it possible to pay out dividends. Although ESOPs are a relatively new phenomenon in microfinance, they have become more common, especially in Latin America and in some African MFIs.

One difference between a cash payout and an ESOP is that the former has a short-term impact while the latter is felt more over the long term. Also, cash is “real” – employees can take their bonuses and spend them. The value (and, perhaps more importantly, the purchasing power) of an ESOP is contingent upon such factors as future profitability and the presence of a market for selling the shares.

While some regard ESOPs as very useful mechanisms for motivating staff, one should also take into account the resulting increase in the employees’ individual risks. All staff members face a risk to their
incomes if the organisation should fail and go into bankruptcy. Their risk position will become even greater if they have invested some or all of their assets in the same organisation, because shareholders typically only get money out of a bankrupt company once all other claims have been paid out. As a result, the shareholders usually get nothing. This risk is seldom discussed when the benefits of an ESOP are described to the potential employee-shareholders.

Employees can be motivated by knowing that they are shareholders in the company and that they can participate in the success of the firm. In this sense ESOPs may be useful elements of a “high commitment” human resource strategy. But the same objective might be achieved by letting employees participate in the firm’s success through a simple profit-sharing plan. Or perhaps it may be sufficient to use ESOPs as a motivating device for top managers only.

The point here is not to disqualify ESOPs as useless mechanisms but to point out some of their weaknesses as incentive devices (not to mention their considerable costs). The industry will need to gather more experience with employee ownership before reaching any informed conclusions. As incentive scheme designers, we should simply note that both ESOPs and profit-sharing plans work as long-term motivational devices. Their impact on short-term goals such as productivity will be very limited.

**Delayed Benefits**

As financial institutions grow and mature there is a tendency for the average age of staff members to increase as well. Most organisations only make the obligatory contributions to the national pension and social security plans, but it may be worthwhile to consider funding a private pension plan. With increasing age, most people worry more about their situation after retirement. Since many public systems do not provide adequate coverage after retirement, a private plan can have a very positive effect on employees’ motivation. In fact, many people might then be quite willing to forego short-term monetary benefits (such as a higher monthly bonus) in favour of a higher regular income after retirement.

Another interesting feature of delayed benefits such as pension entitlements is that they tend to increase with tenure in the organisation. They therefore provide staff members with an incentive to remain in the MFI, and the strength of this incentive keeps increasing with tenure. This is especially beneficial in the case of middle and upper managers, but it also applies to experienced field staff, whose loss can be detrimental to the portfolio. When a good loan officer leaves the organisation, we not only lose a valuable staff member, but we might lose his or her clients as well! There is much anecdotal evidence from Latin America of banks and MFIs “poaching” loan officers from their competitors. Long-term incentives, such as delayed benefits, can help to reduce turnover since they increase the perceived cost of changing jobs.

**Perks**

As opposed to benefits, perquisites “perks” are typically awarded to only a small proportion of the management staff. One common perk is the use of a company car.

**6. Employee Relationship Marketing (ERM)**

**Employee Relationship Marketing**

ERM uses the concept of marketing to influence employee behaviour by re-enforcing the values and vision of the institution on a regular basis to staff. Under ERM models, outstanding performance is acknowledged and symbolically rewarded. While short-term bonus schemes attempt to increase performance directly through significant monetary rewards, ERM focuses on an indirect enhancement of performance through strengthening the loyalty and commitment of staff members.
7. What if Schemes Do Not Fit in the Institution?

**Incentives in Public Sector Organisations**

Some financial institutions, such as the postal banks, belong to the public sector. One of the basic attributes of such organisations is that they often have extremely rigid pay scales. Typically, staff members are paid according to seniority; there are few – if any – opportunities to relate pay directly to performance or to award monetary incentives to excellent employees. Obtaining the necessary approval for flexible pay schemes or performance-related pay may require lengthy negotiations with the government (ministry of finance) or perhaps even an act of parliament.

Given these serious constraints, what are the measures that managers of such organisations can take in order to motivate their staff to focus on productivity and service excellence? If there is no way to increase the salaries of the better performers or to pay performance-related bonuses, what mechanisms are there?

**Tournaments:** Non-monetary tournaments could be conducted in such institutions. If employees recognised that their performance is monitored and compared regularly they already may increase their performance: To avoid to belong to the “losers”, to climb up the ladder in the ranking or to defend their position. It may even be possible to find funds in the budget to award cash prizes to the best branches (look for spare money in the marketing budget!). These prizes might be used for improvements in the branch facilities or for a training seminar for branch staff.

Thus, despite an inability to reward staff members individually, it is possible to create a culture of open (but friendly) competition that will have a positive impact on productivity and quality of service.

**Employee Relationship Marketing:** We already discussed the advantages and limits of ERM. Since this approach works without affecting the remuneration system, it should be possible to use it in almost all environments if it is accepted by staff.

**Disincentives for poor performance:** While it may be impossible to reward good work performance, managers generally may design disincentives for poor performances. Employees with bad or substandard work performances should not be allowed to remain in the organisation. Firing a notoriously bad staff member can do wonders for general staff morale. If it is not possible to fire bad employees, managers may try to move them to a different government department, or to place them in the least attractive jobs or locations that the organisation has to offer.

8. Incentives for the Maintenance of Equipment

**Maintenance of Equipment**

In order to carry out their functions as loan officers or field agents, some staff members are provided with motorcycles or other means of transportation. Many MFIs spend considerable resources on the purchase, maintenance, and repair of such equipment.

For instance, the purchase price of a simple 125-cc. motorbike is typically around $2,000. There is a common complaint in the industry that loan officers do not take proper care of the equipment that they use. Careless handling and shoddy maintenance can produce sizeable repair bills. In other instances, these motorbikes are lost or stolen. Again, it should be possible to design a simple incentive scheme to mitigate these problems.

In some financial institutions, loan officers are not issued motorbikes that belong to the organisation. Instead, they purchase their own motorbikes with the help of an interest-free loan (the MFI can also organise a bulk purchase to reduce the price). The regular monthly loan repayment (for instance, over two or three years) is deducted from the payroll.
At the same time, the MFI pays these loan officers a monthly fee for making use of their private means of transportation. This fee is calculated to include fuel as well as regular wear and tear. Such schemes give loan officers a strong incentive to take good care of their own equipment. Once the original loan is paid back in full, these loan officers actually earn some additional money – month after month.
Session Six: Conduct the Technical Design Work (Step Four)

1. Staged Schemes vs. Linear Schemes

**Staged Schemes**

A significant percentage of incentive schemes encountered in practice are built around stages. Examples include the Alexandria Business Association (as you may remember, we have discussed ABA’s incentive scheme in Session Three), Compartamos (Mexico) and SafeSave (Bangladesh). Stages serve as triggers that are used to decide whether a bonus will be paid or what the bonus will be. The easiest way to think of a staged scheme is to imagine it as a “staircase”. The following two examples highlight the concept:

1. An MFI has designed a simple staged staff incentive scheme for loan officers. One component of this scheme includes a bonus which is based upon the number of loans which the loan officers disbursed during the month. As demonstrated in Exhibit 6.1.1 and Table 6.1.1, the loan officers of this MFI received $20 if they disbursed 21–40 loans and $40 if they disbursed more than 40 loans within this month.

Exhibit 6.1.1: One part of a staged bonus scheme

![Staircase Graph]

<table>
<thead>
<tr>
<th># Disbursed loans</th>
<th>Bonus</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 – 20</td>
<td>$0</td>
</tr>
<tr>
<td>21 – 40</td>
<td>$20</td>
</tr>
<tr>
<td>&gt; 40</td>
<td>$40</td>
</tr>
</tbody>
</table>

2. Another MFI wished to maintain its arrears rate below 4%. Thus, in order to become eligible for a bonus (which is determined by their achievements in other areas), the PAR rate of loan officers had to be below 4%.

*What are the strengths and weaknesses of such a scheme?*

While loan officers have a clear incentive to keep their arrears rate below 4%, they have no incentive to improve it further. In their perspective, it does not make a difference whether their PAR rate was at 0.5% or 4%.

13 To keep this section simple, we consider only one part of a bonus scheme for loan officers, namely a bonus for disbursing loans. Obviously, such a scheme would have severe drawbacks, mainly because the portfolio quality is not considered. The purpose of this section is to discuss different techniques of bonus accruals and not to present comprehensive incentive schemes.
Linear Schemes

Linear schemes are based on a simple formula, such as:

\[ \text{Bonus} = a \times b, \]

where

- \( a \) is the output measure (e.g., the number of disbursed loans), and
- \( b \) is a monetary value (e.g., $1).

Example: A loan officer who disbursed 20 loans would receive a bonus of \( 20 \times 1 = 20 \) dollars.

Exhibit 6.1.2 demonstrates this linear relationship between the performance and reward. Some MFIs, such as BancoSol (Bolivia), even use more complex schemes. For example, linear schemes could have a “break” at a certain stage as demonstrated in Exhibit 6.1.3.

With a linear system, even very small changes in the output of staff members have a perceptible economic impact for them. This means that the employees have an economic incentive to improve their performance at all times, and not just whenever they are close to reaching a new stage.

It is also possible to generate curvilinear relationships between output and reward by utilising power functions such as exponential functions (Exhibit 6.1.4 demonstrates an example). The idea here is to provide special incentives for staff members who have already reached high levels of productivity or portfolio quality.

Linear schemes avoid the major drawback of staged schemes, which encourage staff members to remain close to a certain stage or trigger point. However, depending on the formula chosen, linear schemes can sometimes be complex and correspondingly difficult for the employees to figure out. Thus, the signalling function of such schemes might be lost (remember, one of the advantages of staged schemes is that they send simple signals). Still, it appears that linear schemes will produce better results than staged schemes where the production of microfinance services is...
concerned. In practice linear schemes are widely used. Examples include Banco Los Andes Procredit in Bolivia, Centenary Bank in Uganda and BURO, Tangail in Bangladesh.

**Strengths of Staged Schemes**

The main argument in favour of staged schemes is their simplicity. A small table (such as in the first example) or a single “if-condition” with one trigger point (as in the second example) sends out a simple and easily understandable message to those who are affected by the scheme: “This is what we would like you to do.” There is no need to perform any complex calculations, and changes to the scheme can be introduced and communicated easily.

Some institutions, such as the Alexandria Business Association (Egypt) or Compartamos (Mexico) have developed structured “career plans” for their credit officers. Under that scheme, junior loan officers who have reached certain tenure as well as a certain performance level become automatically promoted to “Senior Loan Officers” (and from there to “Master Loan Officers”). Of course, the promotion to different functional levels, such as credit supervisors or branch managers, that require additional skills, such as leadership skills, cannot be done automatically.

**Weaknesses of Staged Schemes**

The virtue of simplicity can also become a disadvantage: staff members are tempted to maintain their performance close to whichever particular stage they find attainable. In the worst case, such a scheme might not have any motivational effect at all. Imagine that the loan officers of the first example disbursed 20 loans on an average. Now the credit officers would have to work extremely hard in order to match the goal of 41 (average performance would need to double!). The current scheme would be ill-suited to accomplish that goal. Most loan officers would probably try to disburse 21 loans to receive the $20 award. Even worse, some may attempt to shift some disbursements into the coming month – Just imagine a loan officer had already disbursed 21 loans at the end of a month and would be ready to disburse some more. He obviously would be better off if he disbursed these loans in the coming month to assure that he easily can reach the benchmark of the 21 loans in that period as well.

One obvious solution would be to introduce more stages. But each additional stage reduces the scheme’s simplicity. Financial institutions might prefer a linear scheme instead. Overall, linear schemes appear to produce better outputs than staged schemes.

2. **Maximum Performance Levels and Bonus Caps vs. Reference Performance Levels**

**Maximum Performance Levels**

Some incentive schemes utilise maximum performance levels in order to calibrate bonus entitlements. For example, we may know from experience that it is almost impossible to inaugurate more than 10 new village banks per month, or to grant more than 60 individual loans, or to have more than 700 individual loans in one’s portfolio. Such values might then be set as maximum performance levels in the corresponding incentive schemes, for instance by deciding that any credit officer inaugurating 10 new banks will receive a top bonus of $150.

Intuitively, this type of approach seems to make sense. Experience shows that there are certain maximum performance levels for almost all activities in finance. So why not use these “natural” borders in the calibration of bonuses?

The risk is that by defining a maximum performance level, in effect we would place a cap (upper limit) on the bonus payments that staff members can achieve. In our village bank example, even those staff
members who manage to inaugurate 11 groups will only receive the maximum bonus payable for 10 groups.

The use of a maximum performance level produces a disincentive for staff members to develop ideas on lifting the current “frontier” by changing the delivery process or coming up with product innovations. It is amazing to see the extent to which even very efficient production processes can be improved even further if employees are properly motivated to think about innovations.

**Bonus Caps**

Bonus caps are upper limits on the bonus that staff members can earn, regardless of the underlying formula. For instance, in a bonus scheme for loan officers that is based on the number of outstanding loans, portfolio volume, and portfolio quality, management might decide that under no circumstances will the total bonus payment exceed $150.

Managers sometimes try to justify bonus caps with distributive arguments such as, “It is not fair to pay more than a certain maximum amount.” But they should take note that it is also possible to achieve this goal by adequately calibrating the bonus formula, while at the same time avoiding the (ugly) pitfalls of caps.

Exhibit 6.2.1 demonstrates the differences between maximum performance levels and bonus caps.

The effect of a bonus cap is essentially the same as that of using maximum performance levels. It stifles innovation and provides a disincentive for putting in extra efforts – in our example to disburse more than 60 loans per month.

Nevertheless, bonus caps, or, less frequently, maximum performance levels, are often used. Prominent examples include Compartamos (Mexico), Centenary Bank (Uganda) or Share (India).

**Reference Performance Levels**

Reference performance levels are the main instruments for calibrating bonus formulae and for avoiding excessive bonus payments. Instead of looking for some (actual or hypothetical) “best” possible output level, we look at what we consider to be a ‘solid’ level of performance.

For instance, for experienced loan officers engaged in individual lending one might find that it is reasonable to expect a monthly output of 40 loans, an outstanding portfolio consisting of 400 loans, and a portfolio at risk of 2%. These values could be plugged into a bonus formula as base values against which we compare the real output of any given loan officer. Depending on whether individual performance levels are above or below the reference values, the corresponding bonuses would be higher or lower than the “reference bonus”.

We will design such a bonus scheme in later in this session. Here, we only will provide an example which includes one part of a bonus scheme for loan officers, namely a linear incentive for the number of disbursed loans:

Management has decided that well performing loan officers can reasonably disburse 40 loans per month (which is the reference value). The MFI is further willing to reward this performance with a bonus of $60 (the “reference bonus”). If loan officers disbursed more they receive proportionally higher rewards, if they disbursed less they receive proportionally lower bonuses. Hence, this portion of the loan officer’s bonus can be calculated by a simple formula:
In our example, a loan officer who disbursed 30 loans would receive a bonus of $45:

\[
\text{Bonus} = \frac{\text{Number of disbursed loans}}{\text{Reference value}} \times \text{Reference bonus}
\]

For 30 loans disbursed:

\[
\text{Bonus} = \frac{30}{40} \times 60 = 45
\]

Using reference performance levels can bring several important benefits:

- The values chosen for the reference output levels reflect the reality of MFI operations. In fact, the numbers denote what can reasonably be expected from committed, competent, and experienced staff members. Thus, reference levels have a more positive, more effective signalling function than theoretical (or practical) maximum numbers that might seem unattainable for the majority of staff members.

- By using reference values, it is possible to pay higher bonuses to staff members whose performance exceeds reasonable expectations. Thus, this type of scheme establishes positive incentives for everyone – including the best performers – to work harder and to produce even better results.

Once the organisation moves up the learning curve, there will be changes in what are considered “reasonable” performance levels for experienced staff members. If the incentive formula uses reference levels, it is very easy to adjust the values used in the formula. Such changes can be communicated without too much controversy. After all, the staff's own experience will show that the new reference levels are reasonable and attainable.

By adjusting the reference levels upwards, management makes it relatively more difficult for staff members to earn the same bonuses as before. This effect will tend to control the maximum bonuses earned in the organisation. At the same time, it will still allow truly exceptional performers to earn adequate (and theoretically unlimited) rewards, so that these staff members retain an incentive to “walk the extra mile”.

Frequently, management cannot expect that all staff of a given functional group achieve the same results. For instance, new loan officers usually manage smaller loan portfolios with a higher portfolio quality than their more experienced colleagues. Loan officers managing SME loans naturally manage larger loan volumes and fewer loans than microcredit loan officers. Or, management has different expectations at the performance of rural branches and urban branches. Hence, well designed staff incentive schemes require that reference performance levels, as a reflection of management’s expectations, are adjusted according to relevant operational circumstances. Otherwise, staff may become demotivated if they did not perceive the incentive scheme as fair. Nevertheless, designers need to make a trade-off between fairness and simplicity of the scheme. The point is, that reference performance levels do not need to be the same for all employees.

### 3. Minimum Requirements

**Minimum Requirements**

Minimum requirements are trigger points which employees must achieve in order to become eligible for a reward. In our sample bonus scheme of Table 6.1, the minimum requirement was set at 20 disbursed loans. Whoever disbursed less would not receive any bonus under that scheme.

Technically, minimum requirements can easily be used in staged schemes (see Table 6.1.1) – and they are frequently employed with staged schemes in practice. When linear schemes with reference values are used, the calculation is slightly more complex. In our example above, one part of an incentive scheme for credit officers included the number of disbursed loans and was calculated by:
**Strengths and Weaknesses of Minimum Requirements**

Although minimum requirements make the incentive scheme more complex, many MFIs utilise them (e.g. Centenary Bank in Uganda, Compartamos in Mexico or ABA in Egypt) – mainly for two reasons:

Firstly, one might argue that staff already receive basic salaries and are supposed to do their job. Consequently, they should only be rewarded for “the extra mile” they might go.

The second argument which is in favour of minimum requirements is related to the first one: minimum requirements either save bonus costs or allow the provision of higher incentives for outstanding performance. In our example without the minimum requirement, the sample loan officer received $45. He or she received only $30 in the example with the minimum requirement. Even more, the scheme without the minimum requirement rewards loan officers with $3 for each loan above the benchmark, whereas the first scheme provides them an incentive of $1.5 per disbursed loan. Hence, MFIs can save money when using minimum requirements as long as they are easily attainable! Otherwise, loan officers would not try to put in an extra effort. Hence, designers have to assure that staff need not work extraordinarily hard to achieve the minimum requirement. The money saved by the MFI also could be used to increase the reference bonuses and, thus, providing a stronger monetary incentive for outstanding performance. Note, however, that the scheme is subject to loose much of its effect if it is not understood by staff!
4. Further Calculation Techniques and Weights

Further Calculation Techniques

Some performance measurement parameters naturally need different formulas. Examples include the portfolio at risk rate or the “processing speed” of disbursement (e.g. the number of days needed from the loan application to the disbursement). For such parameters (where high values represent poor performance and vice versa), we could calculate a ratio according to the formula below:

$$\frac{Minimum \ \text{Requirement} - Achievement}{Minimum \ \text{Requirement} - Reference \ \text{Value}} \times Reference \ \text{bonus}$$

Example for the portfolio at risk rate:

$$\frac{Max. \ \text{acceptable PAR} - Actual \ PAR}{Max. \ \text{acceptable PAR} - tolerated \ PAR} \times Reference \ \text{bonus}$$

Note, that the “tolerated PAR” rate could be set at zero. While “negative bonuses” should never be “paid out”, a number of successful incentive schemes use poor performance in the portfolio quality (which will result in a “negative bonus”) to reduce the bonuses earned for the performance in other areas.

Weights

Weights reflect the importance of the different performance measurement criteria and should be in line with the objectives of the incentive scheme. Weights must add up to 100%. The use of weights is demonstrated in the next section.

5. Designing and Calibrating Bonus Formulae

Overview

The design and calibration of bonus formulae involves six steps:
1. Selection of the performance measurement parameters
3. Allocation of weights to each of the performance measurement parameters
4. Allocation of minimum requirements (optionally) to each of the performance measurement parameters
5. Construction of the bonus formula
   a. Linear formula
   b. Staged bonus scheme
6. Calibration of the scheme’s parameters

1. Selection of the Performance Measurement Parameters

When being asked how they measure the performance of loan officers, most institutions will probably mention at least three types of criteria, namely the outstanding loan portfolio, the disbursement of loans and the portfolio quality. However, these must be defined further. Examples include:

1. Outstanding loan portfolio
   a. Number of outstanding clients

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14 Those who intend to design a very simple individual or team-based incentive scheme may want to use one of the tools in the folder "Handouts → Tools" of this Toolkit.
b. Number of outstanding loans  
c. Outstanding loan portfolio volume  
d. Net-increase in the loan portfolio volume  
e. The number of village banks  
f. The number of group members in a group (group lending scheme)  
g. The timeliness of the recapitalisation of groups  

2. Disbursement  
a. Number of disbursed loans  
b. Volume of disbursed loans  
c. Number of loans disbursed to new customers  
d. Number of loans disbursed to repeat customers  
e. Volume of loans disbursed to new customers  
f. Volume of loans disbursed to repeat customers  
g. The number of groups inaugurated  

3. Portfolio quality  
a. Portfolio at risk (optional: differentiated by the number of days the loans are in arrears)  
b. Repayment rates  
c. Collection rates  
d. Provision rate  
e. Number of loans in arrears  
f. Number of clients in arrears  

Although all of these portfolio quality measurement parameters are widely used in practice, we strongly recommend to use the portfolio at risk rate (PAR, defined by the outstanding volume of loans in arrears divided by the outstanding loan portfolio volume) to assess the loan portfolio quality. Other measures, such as repayment or collection rates are less meaningful parameters for the appraisal of the loan portfolio quality and can even pretend a healthy portfolio quality where in fact the financial institution is loosing a third of its loan portfolio every year.  

Idea: Do not consider loans which are less than 7 days in arrears to assure that loan officers are not overly reluctant to disburse loans at the end of the month. Alternatively, but more complex to calculate, you could calculate the average PAR rate during the evaluation period. Or, you could capture it randomly within the month (then, the scheme is more likely to be accepted by loan officers if the PAR was captured three or four times a month and the average PAR is considered).  

4. Further performance measurement parameters could include the “processing speed” (e.g. the number of days needed from the loan application to the disbursement) or growth rates. Note, however, that the use of growth rates is not recommended because more experienced loan officers (who already maintain large portfolios) would be disadvantaged.

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15 It is beyond the scope of this toolkit to discuss the advantages and pitfalls of delinquency ratios. Instead, we refer to Richard Rosenberg’s article “Measuring Microcredit Delinquency: Ratios Can Be Harmful to Your Health”. CGAP Occasional Paper #3, June 1999.
2. Allocation of Reference Levels Including a Reference Bonus and Reference Performance Levels

In the second step, we should define the reference levels and the reference bonus. As you may recall from Session Five, reference levels are values which refer to a reasonably high performance of loan officers. The reference bonus is the reward which we would pay for exactly this performance.

### Example:
Choosing reference levels and a reference bonus (green flipcharts)

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of outstanding loans</td>
<td>200</td>
</tr>
<tr>
<td>Volume of outstanding loans</td>
<td>$20,000</td>
</tr>
<tr>
<td>Portfolio at risk (7-360 days)</td>
<td>2%</td>
</tr>
<tr>
<td>Number of loans disbursed to new customers</td>
<td>20</td>
</tr>
<tr>
<td>Number of loans disbursed to repeat customers</td>
<td>30</td>
</tr>
</tbody>
</table>

Reference bonus = $150

3. Allocation of weights to each of the performance measurement parameters

The third step involves the allocation of weights to each of the performance measurement parameters. These weights should reflect managements’ preferences. Weights are set in percent and must add up to 100%.
4. Allocation of minimum requirements to each of the performance measurement parameters

As discussed in Session 5, minimum requirements are benchmarks which staff have to achieve in order to become eligible for a bonus. Except for the PAR indicator, they could be set at zero to reduce the scheme’s complexity.

5. Construction of a “bonus formula”

Finally, we have to combine these parameters to a “bonus formula” which calculates the bonuses. Except for the performance measurement parameter which refers to the PAR rate, we can calculate “performance ratios” for each performance indicator using a simple formula:

\[
\frac{(\text{Achievement} - \text{Minimum Requirement})}{(\text{Reference Value} - \text{Minimum Requirement})} \times \text{Weight}
\]

To include the portfolio quality, we use a different formula:
Then, we simply sum up these ratios and multiply the result by the reference bonus to calculate the loan officers’ bonuses. You may want to arrange the flipcharts on a paper accordingly, and include the mathematic operators as demonstrated in the example below:

\[
\frac{\text{Minimum Requirement} - \text{Achievement}}{\text{Minimum Requirement} - \text{Reference Value}} \times \text{Weight}
\]

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Example: Bonus calculation

- Number of outstanding loans
  - (200 - 120) * 15% = 15%

+ Volume of outstanding loans
  - ($20,000 - $15,000) * 15% = 7.5%

+ Number of loans disbursed to new customers
  - (20 - 0) * 20% = 4

+ Number of loans disbursed to repeat customers
  - (30 - 0) * 10% = 3

Total Bonus = $150

MicroSave – Market-led solutions for financial services
Features of this incentive scheme:
- The scheme uses formulae and linear relationships. Every (small) change in performance leads to a corresponding change in bonus entitlement.
- This scheme makes use of reference values. These reference values can be changed if and when overall performance improves.
- Theoretically there is no limit on the bonus that can be earned by excellent loan officers.
- The scheme uses minimum requirements. Thus, the bonus could become negative. Remember from Session Four that we never should deduct anything from the base salaries or future bonuses.
- In this case, management has placed emphasis on portfolio quality. 40% of the total bonus entitlement is based on arrears as measured by PAR.
- The example shows how additional indicators can be integrated easily into the bonus formula. Remember that to include another indicator, we must be able to measure performance objectively.
- This model is rather simple. Most loan officers should be able to grasp its main components and how they are related to each other and to the final bonus.
- The scheme also avoids the negative incentive effects of staged and capped bonus systems.

In summary, the scheme may well present a useful compromise that could be applied to medium sized lending operations.

Alternative: Staged Bonus Schemes

Some financial institutions may prefer to use a simpler staff incentive scheme. This would include a staged design.

Therefore, we could simply set a small number of trigger points for each of these performance measurement parameters and link these to bonuses as demonstrated in the example below (the bonus of each loan officer is calculated as the sum of the bonuses earned in each of the five performance measurement parameters):

Example:
A simple staged bonus scheme for loan officers.

<table>
<thead>
<tr>
<th>Number of outstanding loans</th>
<th>Bonus</th>
</tr>
</thead>
<tbody>
<tr>
<td>200 and above</td>
<td>$22.50</td>
</tr>
<tr>
<td>121 – 199</td>
<td>$11.25</td>
</tr>
<tr>
<td>120 and below</td>
<td>$0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Outstanding portfolio volume</th>
<th>Bonus</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20,000 and above</td>
<td>$22.50</td>
</tr>
<tr>
<td>$15,001 – $19,999</td>
<td>$11.25</td>
</tr>
<tr>
<td>$15,000 and below</td>
<td>$0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Portfolio at risk (PAR 7-360 days)</th>
<th>Bonus</th>
</tr>
</thead>
<tbody>
<tr>
<td>2% and below</td>
<td>$60</td>
</tr>
<tr>
<td>1.9% - 4.9%</td>
<td>$30</td>
</tr>
<tr>
<td>5% and above</td>
<td>$0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number of loans disbursed to new customers</th>
<th>Bonus</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 and above</td>
<td>$30</td>
</tr>
<tr>
<td>10 – 19</td>
<td>$20</td>
</tr>
<tr>
<td>&lt; 10</td>
<td>$10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Number of loans disbursed to repeat customers</th>
<th>Bonus</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 and above</td>
<td>$15</td>
</tr>
<tr>
<td>11 – 29</td>
<td>$7.5</td>
</tr>
<tr>
<td>10 and below</td>
<td>$0</td>
</tr>
</tbody>
</table>
A slightly more complex scheme could link the rewards earned for the achievements in the portfolio quality with those for the outstanding portfolio volume. The example below demonstrates this technique.

**Example:**
Combining two performance measurement parameters (staged scheme). Other parameters could be included using separate tables (see above).

<table>
<thead>
<tr>
<th>Portfolio Vol.</th>
<th>PAR</th>
<th>&lt;1.5%</th>
<th>1.5% - 2.9%</th>
<th>3.0 – 4.5%</th>
<th>&gt;4.5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;25,000</td>
<td>100</td>
<td>70</td>
<td>50</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>20,000-25,000</td>
<td>80</td>
<td>60</td>
<td>40</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>15,000 – 19,999</td>
<td>70</td>
<td>50</td>
<td>30</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>10,000 – 14,999</td>
<td>60</td>
<td>40</td>
<td>20</td>
<td>0</td>
<td></td>
</tr>
<tr>
<td>&gt;10,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td></td>
</tr>
</tbody>
</table>

You also could include “negative bonuses” for weak performers. Although you should never deduct anything from the base salaries or future bonuses, a “negative bonus earned” for a poor performance in one area (e.g. portfolio quality) could decrease the bonuses earned for outstanding achievements in other areas (e.g. portfolio volume). However, this method would make the scheme more complex again.

**Main features of staged incentive schemes:**
- The scheme is simple and will easily be understood by the targeted staff members, and it will be easy to use in practice.
- The scheme could be improved further if more stages were included.
- In this example, management places a relatively strong emphasis on portfolio quality. The potential bonus for maintaining excellent portfolio quality amounts to 40% of the maximum bonus.
- Of course the scheme suffers from the structural disadvantages of staged schemes. In this example, once a loan officer has improved portfolio quality to 2% PAR, there is absolutely no incentive to make any additional efforts.
- All these techniques could be used to design group-based (e.g. branch-based) staff incentive schemes. You only needed to readjust the reference values accordingly. The formula would then calculate a group-bonus which could be distributed among lending staff (e.g. equally or according to their base salaries).
- In summary, this type of scheme may work quite well when the environment is not very complex or when lending operations are still at a relatively early stage.

**Calibration of Bonus Formulae**

Once the structure of the scheme is set, we must calibrate the bonus formula’s parameters such that:

1. **All employees have a fair chance to earn rewards which reflect their additional efforts**
   Using the past performance of employees, designers should calculate the rewards for which staff would have become eligible if the scheme would have been in place. Rewards should also be calculated by the use of performance projections which consider seasonal factors.

Using this technique, designers should identify the “winners” and the “losers” of the scheme. If they had common characteristics for which they are not accountable, it may be necessary to adjust the reference performance levels and minimum requirements of the incentive scheme. For instance, we may find that there are a number of branches whose staff members would have earned significant lower bonuses than the average. If these branches had a common characteristic such as the location in very remote areas, it may be necessary to adjust relevant parameters respectively. In practice, staff incentive schemes are differentiated by one or two of the following characteristics: location of the branches or the employees (e.g. urban vs. rural), maturity of the branch (e.g. new vs. old), seniority of the employee (e.g. junior teller vs. senior teller), or type of product managed (e.g. SME loans, agricultural loans, microloans, consumer loans) – so keep these (and
other issues) in mind when searching for structural outliers: it may be necessary to calibrate the staff incentive schemes differently.

Designers should make sure that minimum requirements are achievable. Remember, that staff members who cannot easily achieve the minimum requirements may not react on the incentive scheme. Thus, designers should assure that virtually all staff members (e.g. 95% or 100%) would have achieved the minimum requirements of the scheme during the past periods and in the projected scenarios.

Likewise, it should be cross-checked whether the size of the rewards reflects the additional staff effort on which projections are based. Hence, the portion of the bonuses in the total remuneration should be analysed. Would employees increase their productivity by e.g. 20% in the medium term if they could increase their total income by 25% due to the incentive scheme?

In addition, designers should control the maximum bonuses which high performers would earn. If bonuses were capped, the number of employees who earn the maximum incentive should be identified – remember, those who earn the maximum reward do not have an incentive to increase their performance further!

To cross-check the fairness of the incentive scheme, designers should discuss the results with the direct superiors of the affected staff members and ask them, whether the differences in the reward correlate with their personal assessment of the employees’ performances. If not, we need to find out the reasons and, eventually, redesign the scheme.

2. **The weights allocated to the parameters are in line with the incentive scheme’s objectives**

Spreadsheet analysis should also be conducted for — ‘hypothetical employees’ to test the sensitivity of the incentive scheme to marginal changes in the employees’ performance. For instance, how would the disbursement of one additional loan affect the bonus of a loan officer? Or a reduction in the PAR rate by 0.5%? Are such proportions in line with institutional preferences?

3. **The scheme is beneficial to both, the financial institution and the employees**

Finally, the drafted staff incentive scheme should pass a cost-benefit analysis. While we discuss respective techniques in the next Step, it should be mentioned here that results of a cost-benefit analysis may require the re-calibration of the incentive scheme.

Finally, it is helpful to test the incentive scheme for unexpected or extreme results which seasonal factors may cause. For instance, arrears usually increase after Christmas. Or, seasonal loan products may lead to a loan portfolio in which disbursements, risks and repayment schedules are all but equally distributed across time. Does the incentive scheme cope with seasonal factors?
6. Further Guidelines for Designing Staff Incentive Schemes for Lending Staff

Profile of Loan Officers

Typically, the position of loan officer is attractive for young professionals, who often hold a good secondary or even tertiary degree from a university or college (economics, accounting, social work), who like to be out with the clients, and who have something of an “entrepreneurial” spirit.

As the primary contact with clients, loan officers have a decisive impact on an institution’s outreach. In most MFIs, loan officers enjoy a high degree of autonomy. Most of the work is carried out in the field, right where the clients live and work. In spite of the obvious importance of demanding conditions and of regional factors (for instance urban versus rural lending), a loan officer’s success primarily depends on his or her own effort. Teamwork is generally less important since loan officers are normally assigned to clearly defined regions of client clusters.

Four Main Tasks of Loan Officers

Loan officers bear responsibility for generating and safeguarding the major asset of an MFI, namely the loan portfolio. Thus they also help to generate most of the (interest) income, which has a strong impact on sustainability. Some important tasks of loan officers are:

1. **Generation of new business.** This includes acquiring new clients or helping to constitute new groups of borrowers.
2. **Loan analysis.** Depending on whether the loan officer is working in individual lending or employing solidarity group or village banking methodologies, loan analysis can include: responsible application of the MFI’s lending policies to determine repayment capacity and willingness; scaling of loans to meet client’s demand; and cooperation with borrower groups or village banks to ensure proper training and distribution of loan funds.
3. **Monitoring, control, and follow-up work.** The main purpose of these tasks is to ensure the quality of the MFI’s loan portfolio.
4. **Generating reports and statistics.** Loan officers are responsible for collecting and compiling a multitude of information. Timeliness and accuracy of reporting are essential requirements.

Annex A includes more examples of bonus formulae for loan officers.

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Case Study: Loans for Tea Farmers at Equity Bank

Equity Bank Ltd. (EBL) has experienced a strong growth in its network and operations over the last years. Since the year 2000, EBL could increase its number of savers by around 750% to 450,000; And whereas EBL managed 20,000 outstanding loans five years ago, its loan portfolio includes now almost 80,000 loans. During the same period, the staff have grown by more than five times to nearly 600, with further growth highly likely given the rapid pace of network expansion.

The widening scope of the bank necessitates a number of adjustments in human resource management including the design of a staff incentive scheme. It was decided to provide branches with a number of quarterly targets in key areas. The achievement of these targets determines a quarterly branch bonus pool which is shared equally among branch staff.

When EBL started to calibrate a drafted scheme, the bank stumbled over a potential side-effect which one of its products may cause to the incentive scheme: Loans for tea farmers are repaid after the harvest, which is just between two quarters. Obviously, the quarterly targets can only be set accurately if designers knew whether these loans are repaid in the first or in the second quarter. The bank felt that it was necessary to calibrate the scheme using a trigger point, namely the repayment of the tea loans.
Guidelines for Incentive Scheme Design

Let us return to the principal design issues outlined in Session 5. What would be an appropriate scheme for staff members who have a high degree of autonomy, whose performance is relatively easy to ascertain (both outreach and quality can be measured quite accurately), and who do not depend on teamwork to any significant degree? You guessed correctly: It is good to think about using an individual bonus scheme. Recalling the importance of the bonus’s weight within the total pay package and the importance of the timing of bonus payments, we might decide that:

- The bonus should equal up to 100% of the loan officers’ base salaries (thereby doubling their total pay), and
- Bonuses will be paid on a monthly basis.

Remember that there are no definite rules for setting these types of parameters. For instance, we might alternatively opt for quarterly bonus payments and fix the bonus at up to 75% of base salary. The Uganda Microfinance Union (UMU), for example, has opted for a branch-based staff incentive scheme which fits better into their organisation culture and credit technology.

Group Lending Schemes

The examples listed above deal with individual lending schemes. But many MFIs engage in group lending and do not lend to individuals. There is a wide variety of group lending methodologies, such as the solidarity group and the village banking models. Group sizes also can vary widely, from as few as five group members to as many as fifty. Given such heterogeneous situations, are there any common guidelines for the design of staff incentive schemes?

Despite all the differences in lending methodologies and delivery mechanisms, most MFIs share this common set of basic goals:

- Outreach (i.e. the greatest possible number of loans in the portfolio)
- Portfolio volume (which has a direct impact on costs and financial performance)
- Quality (i.e. controlling the portfolio at risk)

We could call this list the “smallest common denominator”, since MFIs may also try to optimise many other variables, such as the percentage of female borrowers or of rural customers.

In a group lending environment, the MFI’s loan officers usually do not deal directly with the group members (apart from perhaps helping the group to form) and do not analyse the borrower’s business activities. The screening and monitoring functions are typically performed by the groups themselves.

Nevertheless, the field officers bear the primary responsibility for achieving all of the basic goals listed above. They help form the groups, they attend the group meetings when new loans are disbursed, and they deal with groups that experience problems with delinquency or high drop-out rates. Therefore, it should be possible to include the three variables in a simple incentive formula for field staff engaged in group lending.

You could actually use any of the schemes discussed so far, only changing some of the reference values to fit the circumstances of your specific situation.

Of course, a major requirement for utilising such simple techniques is the ability to measure the relevant variables. Timely measurement of portfolio quality might be a problem if group members pay back their loans through commercial banks, as the reconciliation of accounts may take extra time. In such cases we could use a lagged variable – for instance using the PAR of the last month rather than the current one. Secondly, we could calculate bonuses on a quarterly basis in order to access more data.

Further Aspects (Not Only for Lending Staff)

1. **Local operational circumstances:** As you may recall from Session Four, fair staff incentive schemes measure the performance of staff, and not external effects which also influence the loan
officers’ outcomes. Whereas this cannot be fully assured in practice, it helps to utilize different benchmarks for loan officers who work in different environments. Respective criteria could include the maturity (e.g. new branch, old branch) and the location (e.g. urban branch, rural branch) of the branch. However, do not use too many different benchmarks to assure that the scheme remains both, simple to administer and objective.

Most financial institutions allocate different geographic zones to its loan officers to avoid excessive travel costs and to assure that their loan officers know one area with its (potential) customers well. Typically, these zones have different advantages and challenges and the likelihood to achieve good results also depends on the zone allocated to the loan officer. For instance, managing a large number of microentrepreneurs may be easier for a loan officer who works close to the branch in a market zone than for a loan officer who works in residential zones. Such differences are natural, and as the case of Calpiá (see Case Study 2.1.1) has shown resulting differences in the size of the bonuses are accepted if they were not too large and as long as staff perceive that the process by which the bonuses are determined is transparent and as fair as feasible. Where differences between zones within branches are very large, financial institutions may think about utilizing different reference performance levels for different types of zones. Calpiá has chosen a similar approach: the institution employs different bonus formulae for loan officers managing agricultural loans (and, thus, work in rural zones) and loan officers who manage microloans (and, thus, are more likely to work in urban or semi-urban zones).

2. Transfers of portfolios: Sometimes it is necessary to transfer loan portfolios between loan officers or to transfer loan officers to another branch. Of course, this will have an immediate impact on their bonuses which may not be fair – especially if transfers are directly related to the performance of the loan officers, such as the transfer of a high performing loan officer to a poor loan portfolio.

A good way to assure that these loan officers have a fair chance to build up their new portfolio (or to fix a portfolio to which they got assigned) is to allow them a grace period of e.g. three months, during which they earn the average incentive which they received during the past six months.

If experienced loan officers were systematically transferred in order to improve poorly performing loan portfolios or branches, it may be necessary to design a different incentive scheme for them. For instance, they could be called “firefighters” and participate in an incentive scheme which uses less challenging reference performance levels or which is based on the improvement of a loan portfolio.

If employees were transferred regularly, e.g. to prevent fraud, work results cannot be measured and we need to design the incentive scheme around processes as the case of SHARE (see Case Study 5.2.1) has shown.

3. Timing: In general, it is useful to introduce a financial incentive scheme only after employees have received sufficient training. Practical experience suggests that staff should begin participating in bonus schemes approximately six months after joining the organisation. Before that, they should receive just a fixed (trainee) salary.

4. Seniority of staff: Many MFIs distinguish between junior and senior loan officers. Typically, junior loan officers manage smaller loan portfolios and maintain a higher portfolio quality than their more senior colleagues. Senior loan officers usually receive higher base salaries. Many of the larger MFIs consider these differences in their staff incentive schemes.

For example, a linear staff incentive scheme for senior loan officers may include higher reference bonuses and more challenging reference values for outreach and the portfolio volume than a scheme for junior loan officers. In contrast, the scheme of junior loan officers could focus on maintaining a high portfolio quality and acquiring new customers. The reference bonuses could be set lower.

5. Crisis: In a crisis or work-out situation (for instance when there is a rotten loan portfolio that needs to be cleaned up), you may need to adjust the incentive scheme: Remember that the goals fixed in a bonus scheme must be attainable in order for the scheme to be effective. If you want your staff to
clean up a particularly bad branch, you cannot expect them to work according to the standards that normally prevail in the organisation. In such cases it may make sense to suspend the bonus scheme and to agree on a set of goals that you expect the staff in question to meet. Based on their ability to meet these objectives, you should then pay out a special bonus.

**Profile and Tasks of Credit Supervisors**

**Profile:** Credit supervisors are almost always recruited from among the best loan officers. In addition to having excellent lending and analysis skills, they must also possess a talent for managing people.

**Tasks:** Credit supervisors typically assist branch managers in managing and organising the lending business. In particular, they supervise and help loan officers, participate in credit committees, prepare reports and conduct market researches.

**Staff Incentive Schemes for Credit Supervisors**

To assure goal congruency between loan officers and credit supervisors, credit supervisors simply could receive a fraction of the total bonus pool earned by the loan officers they supervise. This technique would also guarantee that credit supervisors, who are in charge of more loan officers, and, hence, bear a higher responsibility, are more likely to earn higher bonuses.

**Idea:** Consider “negative” bonuses of weak loan officers (which, of course are not “paid out”) to assure that credit officers also have an incentive to assist those.

Where staged schemes are used for loan officers, credit supervisors could participate in the same scheme. Requirements and rewards must be adjusted accordingly. If credit supervisors received a fixed percentage of the loan officers’ bonuses, they may be encouraged to reshuffle the loan portfolios of loan officers to maximise their rewards.

**Checklist for Designers: SIS for Loan Officers and Supervisors**

1. Design a formula-based scheme if possible. It will be more accurate and will help to avoid the disadvantages of staged systems.
2. Make use of reference levels since this will make the scheme more flexible in the future.
3. Be as frugal as possible in selecting performance criteria to include in the bonus formula. Too many criteria will make your scheme overly complex, and staff members may have difficulty understanding the scheme’s essential message.
4. For each variable that goes into the scheme, you must be able to accurately assess (measure) individual performance.

**Tasks and Profile of Other Credit Staff (Support Staff)**

Loan officers and field agents are usually supported by other staff members in the front and the back office.

- **Office assistants** may handle prospective borrowers and organise information sessions in the branch.
- **Data typists** transfer the information contained in the loan officers’ analysis forms into the MFI’s computer system.
- For larger loans, a **branch lawyer** may need to review the supporting documents and the legal status of the collateral.

These and other support staff are part of the lending operation, but they do not play the same role as the loan officers. They have little individual influence over the quantity of new lending, which is mainly determined in the field.

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Support Staff: Guidelines for SIS

In most cases, the workload of support staff in lending is directly related to that of the loan officers or field agents. This relationship between loan officers and support staff is symbiotic; the loan officers can only work effectively with the support provided by their colleagues in the front and back office.

Therefore, when designing an incentive scheme for support staff, we must try to align the incentives of these staff members with the incentives of those whom they support—namely the loan officers. One simple way of aligning the two is simply to calculate the bonuses for the various categories of support staff as a certain percentage of the bonus pool that was earned by the loan officers in a given month.

For example, if one data typist provides administrative support to three loan officers in the branch, he or she could be awarded a small percentage (for instance between 5% and 8%) of the total bonus pool earned by these three staff members. This ensures that the typist is interested in providing the best possible support to the loan officers (as if the typist makes many mistakes during data entry, the productivity of the loan officers would suffer).

The same type of system could be applied to other support functions, such as the legal department. One could pay a small percentage of all the bonuses earned by the loan officers (or by those loan officers who regularly require legal support) to the lawyer of the whole legal department. But keep in mind that lawyers and other professionals usually receive more generous base salaries than other staff members; they should not necessarily need to be motivated by large bonuses.

Checklist for Designers: SIS for Support Staff

1. Whenever possible, try to completely align the incentives of the support staff with those of the operational staff (loan officers, field agents, etc.) whom they assist.
2. The easiest way of aligning incentives is to calculate the support staff’s bonuses as a percentage of the total bonus pool earned by the operational staff.
3. When it is not possible to identify the individual contributions of the support staff, you may want to distribute the bonus evenly between the employees.

7. Guidelines for Designing Staff Incentive Schemes to Mobilise Savings

Why Incentives for Savings Mobilisation?

Deposit mobilisation is important for several reasons. The small entrepreneurs and salaried employees who form an MFI’s typical clientele have a high demand for accessible and affordable deposit facilities. This is even true for very poor people, whose capacity and willingness to save are often underestimated. These locally mobilised funds help to reduce the dependence on (foreign) donors, and they mitigate exchange rate risks. Successful deposit mobilisation can help to increase an MFI’s outreach dramatically, and the savings business that clients conduct with their bank can serve as a useful market research tool for later offering credit services to the same customers. This method has been used with considerable success by the credit union movement.

Upon Which Factors Does Successful Savings Mobilisation Depend?

The key for successful deposit mobilisation is trust – and trust in an institution can only be built if its staff members are also trustworthy. Hence, in order to mobilise savings, staff should be open and friendly to all clients, and they should be willing to work in a team. Good interpersonal skills are much more important for staff members in this area than are highly developed analytical skills or a background in economics or accounting.
**Suggested Features of Staff Incentive Schemes for Savings Mobilisation**

The fairness principle (mentioned earlier) implies that there must be a clear relationship between the effort exerted on the job and the output variable that is used to calculate the bonus. In savings mobilisation, some clients may be actively “sought out” by extension workers, while others will simply walk into one of the branches. At the branch level, it is often a matter of chance who deals with the new customer; usually it is the next available desk officer or teller.

In savings mobilisation, it is often difficult to discern exactly what (and who) caused the customer to entrust the institution with his or her funds. And branch operations are usually organised in such a way that it is difficult to match the results achieved with each staff member’s individual efforts.

Thus, rather than rewarding individual performance – which is difficult to measure and to match with the results that were achieved during a given period – it is much more useful to pay incentives based on team results. This can be done easily at the unit or branch level. The advantage of a team bonus is that it rewards good cooperation among all those who attend to savings clients, even if their individual actions are not directly related to generating a new deposit. This technique also avoids the problem of measuring individual performance.

In general, it is best to pay staff engaged in savings collection a generous base salary. Very often even the best efforts will not produce immediately tangible results in the form of new deposits. Thus the ratio of base salary to bonus as a percentage of total salary might be closer to 70% and 30%, or even 80% and 20%, respectively. The mobilisation of savings is a long-term effort, and it requires the building of trust. Excessive bonuses based on short-term performance would send the wrong signal to the staff members involved.

There are some exceptions to these guidelines. For instance, some organisations want their loan officers (or field agents) not only to “sell” the lending products such as group or individual credits, but also to actively recruit depositors outside of the branches. In these cases it may make sense to pay individual bonuses based on the field agents’ ability to generate deposits. However, we would need to make sure that there is a way of identifying the individual loan officer or field agent who solicited the deposit.

**Designing a Simple Bonus Formula**

In order to incentivise staff to mobilise savings, we could provide them commissions both, on the number of new accounts opened and the volume deposited. A team bonus could be calculated by:

\[
\text{Team bonus} = \text{Number of new accounts opened} \times \$1 + \text{Volume of funds deposited} \times 1\%
\]

**What are the advantages and pitfalls of such a scheme?**

If the commissions (in our example $1 for each new account opened and 1% of the deposited volume) were large enough, we could expect our staff to aggressively seek new clients.

However, the system would also have its disadvantages. It is important not only to acquire new deposits and clients, but also to retain them. If bonuses are awarded only for bringing in new customers, staff members might find that providing good service to existing clients is not worthwhile. This means that we need to include more variables in our bonus formula.

**Designing a Simple Bonus Formula (2)**

Adapting our bonus system to these considerations entails some modifications:
The bonus formula should not include the number of new accounts and the volume deposited. Instead, we could use the net increase in the number of accounts during the period and the total outstanding balance in the savings accounts at the end of the period. This will help to make sure that employees have an incentive not merely to attract new clients but also to induce existing clients to maintain their accounts (by providing efficient and friendly service) and to deposit funds on an ongoing basis.

As a useful exercise, let us now construct a simple bonus system for those staff members who are engaged in the mobilisation and handling of savings deposits in a particular branch.

The first output variable is the net increase in the number of accounts held at the branch during the given period (one month, for instance).

\[ V_1 = (\text{number of accounts at the end of period}) - (\text{number of accounts at the beginning of the period}) \]

The second variable reflects the volume of funds that savings clients have deposited in their accounts:

\[ V_2 = \text{total volume of savings deposits held at the branch at the end of the period} \]

Now we need two factors, P1 and P2, in order to convert the output variables into a financial bonus. The total bonus “T” is then calculated as:

\[ T = V_1 \times P_1 + V_2 \times P_2 \]

In our example, P1 should be an absolute monetary value (e.g. $1), while P2 should be a fraction of a percentage point, e.g. 0.1%.

Assume
- that the branch attracted 350 new accounts during the period,
- that 50 accounts were closed during the period
- that the deposit volume at the end of the period amounts to $180,000.

In this case, the total branch bonus would be calculated as:

\[ T = (350-50) \times 1 + 180,000 \times 0.1\% = 480 \]

**Features of This Staff Incentive Scheme**

1. With a simple scheme like this one, staff members engaged in deposit mobilisation and savings transactions actually feel rewarded for working harder. There would almost certainly be a positive effect on motivation, especially if there is already an incentive scheme in place for staff engaged in lending operations.
2. By factoring in the outstanding volume of deposits, there is a clear incentive not just to attract new clients but also to keep existing clients happy. (This should then be reflected in stable or growing deposit volumes.)
3. The exact value of the two factors P1 and P2 depends on two points: the message that management wants to send to staff, and the total amount which the institution is prepared to pay to its staff in bonuses. Clearly, both issues depend on the local situation.
4. The scheme is very simple, making it easy to understand and implement. The system could also be refined further. If there are different types of savings accounts, variable weights could be attached to them to reflect management’s evaluation of their relative importance. Likewise, it would be possible to attach different weights to deposits raised in rural and urban areas, or even to provide special incentives for mobilising funds from very poor clients.

**Variations and Extensions**

The scheme presented here can be refined further. Examples include:

1. If there were different savings products, variable weights could be allocated to them to reflect the preferences of the MFI.
2. Other relevant products and services could be included (e.g. money transfer services, insurance policies).
3. Different commissions could be set for different (clusters of) branches to reflect local operational circumstances.
4. To prevent staff members from encouraging new accounts that will not be active, we could consider the net-increase in the number of active accounts instead of the net-increase in the number of accounts.
5. If management predicts that rewarding the “number of active accounts” might result in staff members encouraging customers to open new accounts with funds that they withdraw from their existing accounts, management might change this variable to “number of active savers.”
6. Although customers’ satisfaction is indirectly taken into account through the proxy variables of net increase in accounts and/or volumes outstanding, a more precise and direct measurement could be factored in. We will discuss respective techniques later in this Session.

Distributing Group Bonus Pools

There are various ways how the branch bonus pool can be distributed among branch staff. While the equal distribution is not only very simple but may also strengthen the team-spirit, the variable portion of the total salary is smaller for senior staff (e.g. branch managers) – which they may perceive as unfair. Hence, where base salaries largely differ across individual staff members (and if this was desired), designers might alternatively think about distributing the branch bonus pool according to the base salaries. A mixture of these techniques is possible but would make the scheme more complex. If basic salaries differ within functional levels of staff (e.g. due to merit pay schemes), an equal distribution or a distribution according to the staff members’ formal position could decrease this gap. A more sophisticated way would include the distribution according to tournaments which are conducted between individual staff members. However, it will not always be possible to measure individual performance adequately and fair and the method could reduce team-spirit since it enhances competition among staff (and if high monetary rewards are involved in tournaments, they may not be perceived as “friendly” by staff).

8. Guidelines for Designing Staff Incentive Schemes to Enhance Customer Service

Enhancing Customer Service

The staff incentive schemes discussed so far in this Session measure customer service indirectly: If staff are to increase the number of savings accounts or the deposit volume of their branch, they have to deliver a good – or reasonable – customer service. However, we also mentioned that the ability of an MFI to generate deposits depends largely on trust, and trust cannot be produced on command. Building trust takes time and, hence, staff might find it difficult to perceive a link between the efforts they spend to increase the quality of customer service and their bonus (which naturally comes “delayed”). Thus, it may be useful to think about employing further performance measurement parameters which measure staff performance more directly.

How Can We Measure the Quality of Customer Service Directly?

Essentially, there are two supplementary tools to measure customer service quality: quantitative and qualitative measures. Quantitative techniques include:

• The transaction speed (e.g. the number of transactions per teller and day);
• The number of mistakes (which delay processes, require additional resources, and may have negative impacts on the customers’ trust in the bank);
• Punctuality of staff members;
• Regular quizzes with prizes could measure the product knowledge of staff.

Obviously, these indicators measure only a few aspects of customer service, and probably not even the most important ones. If we used only such quantitative parameters, we could send the wrong signals to staff. For instance, staff could increase their transaction speed at the cost of friendliness or good advice to customers. At the end, the customer has to decide what good (or reasonable) customer service is. Hence, we should also
employ supplementary, qualitative performance measurement techniques to mitigate the weaknesses of the quantitative measures. These could include:

- Results of customer satisfaction surveys;
- Results of mystery shopping exercises;
- Supervisors’ assessments.

In comparison to quantitative techniques, all of these qualitative techniques are usually time consuming and expensive. However, it may be sufficient to accrue performance semi-annually. We already have discussed the difficulties of human assessments. Hence, such techniques should be applied carefully.

Transforming Qualitative Performance Measurement Techniques into a Staff Incentive Scheme

We have already discussed the design of bonus formulae in depth. Such formulae could be constructed to calculate a “customer service” performance score for the quantitative performance measurement parameters.

Example:
Performance score = Number of transactions * score1 - number of mistakes * score2

If management sets the score1 at 1 and score 2 at 200, a teller who conducted 5,000 transactions and made 6 mistakes during the month, would receive a performance score of 3,800:

\[ 5,000 \times 1 - 6 \times 200 = 5,000 - 1,200 = 3,800. \]

This score could be directly transformed into a bonus (e.g. by multiplying it with a monetary value). Of course, such a performance score could also be calculated for branches instead of for individual staff.

To include the qualitative measures into this performance score, we need to use a slightly different approach. If we, for example, decided to calculate a semi-annual qualitative performance score for customer service, we could use customer satisfaction surveys, results of mystery shopping exercises and supervisors’ assessments as performance measurement tools. Each of these tools includes performance indicators for which customers, mystery shoppers or supervisors, respectively, provide performance scores (e.g. a customers’ score for service speed or for the accuracy of the information they have received). Management could weight these scores according to its preferences. By multiplying the scores with these weights and adding up the results, we receive a final score for the performance of staff for each of the three performance measurement techniques (customer surveys, mystery shopping, supervisors’ appraisals). Likewise, management can weight these scores and, hence, calculate a final performance score. This final score could then serve as basis for rewards.

Individual or Branch-Based Incentives?

Only think about employing individual incentives if you are sure that you can measure individual performance adequately. In most cases, this will not be possible. Furthermore, we have to bear in mind that customer service is a team effort. Hence, team-based staff incentive schemes may be more appropriate in most environments.

However, non-monetary individual tournaments among tellers (e.g. considering the number of transactions and the number of mistakes) are likely to improve their performance without negative impacts on other aspects of service quality (e.g. friendliness). Prizes or commendation letters could be awarded to the best performers.

Types of Incentives

If there were other monetary incentives in effect for relevant staff members (e.g. bonus schemes for savings mobilisation), we could combine these with a staff incentive scheme focusing on enhancing customer service. Otherwise, you could conduct tournaments both, between branches and between individuals within
branches. The results of these tournaments could be published internally and the best performers could receive prizes. Other types of incentives, such as semi-annual branch-based bonuses are possible as well.

**Checklist for Designers: Staff Incentive Schemes to Enhance Savings Mobilisation and Customer Service**

1. In most cases, it may be sufficient to construct a simple formula-based scheme taking into account outreach (i.e. the development of the number of accounts) and deposit volume.
2. When deposits are mobilised through branches, the incentive awards (such as monthly bonuses) should be based on group performance and should be shared equally among the staff members.
3. Setting regular targets and conducting tournaments for the branch network can help to enhance deposit mobilisation performance.
4. Successful deposit mobilisation depends on trust. Good cooperation among all MFI employees is a necessary condition for generating trust among potential savings customers, but it is not sufficient. Other factors such as the composition of shareholders and the general image of the organisation in the market also play a major role. It would not be fair to allocate the full burden and risk of deposit mobilisation on the staff members by paying large bonuses, and correspondingly small base salaries, for attracting new deposits.
5. To emphasize customer service quality, qualitative performance appraisals could be factored in.
6. Both, quantitative and qualitative performance measures could be utilized to measure the individual performance of staff members.
7. Regular quizzes can be employed to enhance staff knowledge.
8. Employee Relationship Marketing can be a powerful supplementary tool to enhance staff loyalty and commitment.

**9. Setting Specific Targets**

**Setting Specific Targets**

There may be specific situations in which the bonus systems described above may not be suitable for the organisations in question and where it would be better to design a different scheme.

Setting goals or targets regularly can be an effective way of communicating management’s expectations and performance standards to the employees. Deposit mobilisation is one area where it may be useful for management to set such targets for the organisation and its various units and then to pay out bonuses for achieving these targets on time. Here is a crude example to highlight how this process works:

- Management defines a target of “$15,000 in new deposits within the next three months” for a certain branch.
- If the target is met, all staff members then receive a fixed bonus of $200.

Of course, the scheme of this simple example could be refined further, e.g. by including more stages and/or more performance measurement parameters. Such simple schemes also could be employed occasionally (whenever deemed necessary, e.g. to fix problems or to promote a new product). Experience has shown that such “spot bonuses” can have a very high impact on staff performance.

**Tournaments**

Special bonuses could also be paid according to the results of regular branch rankings. The idea here is to instil a sense of competition in the branch network by conducting regular “tournaments”. The areas in which branches compete against each other could be the same as mentioned above, namely the net-increase in the number of accounts (per staff member) and the outstanding portfolio volume (per staff member). Of course, management can also identify other areas.

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Although quarterly performance accruals and bonus payments would strengthen the link between performance and reward and, thus, would possible increase the scheme’s impact on staff performance, it will not be feasible to appraise branch performance qualitatively in such short intervals.
Management might sponsor a number of prizes (cash or otherwise) for the top three branches in terms of savings mobilisation (based on the volumes raised, or on the number of accounts opened, or on a combination of the two). Likewise, a prize could be given to the branch with the most improved deposit mobilisation performance.

Where the implementation of monetary incentives is not possible, such tournaments could also be conducted non-monetarily. In some environments (e.g. in Acleda Bank, Cambodia), a simple ranking of branches including the publication of the results in a newsletter or on notice boards can already translate into improved staff performance.

10. Further Techniques: Examples for Middle Managers

Why Staff Incentives for Middle Management (e.g. Branch Managers)?

Middle management includes branch managers, department heads and area managers (e.g. regional managers) and is probably the most overlooked critical resource of microfinance. By nature, microfinance activities (and especially micro credit) are highly decentralised. Delegation of decision making authority to branch managers is a key requirement for scaling up operations and for increasing institutional outreach.

Essential Skills for Middle Management

Good middle managers need to possess several skills:

- **Technical competence** in the core areas of operations, such as micro credit and savings mobilisation. Without highly developed technical skills and solid experience, they could not ensure service quality and compliance with operational standards; nor would they be taken seriously by their subordinates.

- **Planning and control skills.** Middle managers are the most important link in an MFI’s chain of control. They must analyse complex tasks and situations and plan ahead (for their department, their branch, their staff, etc.).

- **Personnel management skills.** While loan officers only need to manage their own affairs, branch managers are responsible for larger groups of staff, ranging perhaps from 4 to 40 persons. They must guide and motivate their employees and also take disciplinary actions when necessary.

- **Entrepreneurial skills.** Last but not least, branch managers should act like entrepreneurs who develop “their” own business (i.e. the branch) as if it were an enterprise. In addition to planning and goal setting, this involves the ability to take measured risks and the management of conflicting goals (for instance increasing the market share while also controlling costs).

Most microfinance practitioners would probably agree that good branch managers are a scarce resource. The necessary combination of qualities is not readily available, even when the branch managers and some department heads are recruited among the best loan officers or field agents.

Requirements at Staff Incentive Schemes for Middle Managers

Unfortunately, most of the existing incentive schemes for branch managers are somewhat unimaginative; they do not provide an adequate set of stimuli. So let us think about how an appropriate incentive scheme can both motivate middle managers and help to produce the necessary skills among them. Essentially, staff incentives for middle managers should firstly assure that the goals of managers and the staff they supervise are widely congruent. Secondly, they should account for the long-term and multi-tasks managers have.

Aligning Goals

Middle managers and especially branch managers play an important role in operations: they oversee and carry major responsibility for the production of services. The key to tying branch managers into the production process is to align their incentives with those of the staff members whom they supervise.
This can be achieved by awarding branch managers a certain percentage of the total bonus pool earned by the branch loan officers and — in cases where incentives are provided for savings mobilisation — staff members engaged in deposit services. This way there will be no conflicting interests between employees in operations and their superiors (note that the same argument applies to department heads such as the manager of the accounting or audit department). One additional benefit to paying managers a certain percentage of the total bonus pool is that managers in charge of larger units generally will earn larger bonuses than those who supervise smaller branches. Since the burden of responsibility and the control span tend to grow with the size of the staff, this type of mechanism seems fair.

The Balanced Scorecard Approach

We also need to consider the requirement for branch managers and department heads to plan ahead and to optimise several business goals at the same time (or to find a workable compromise between different objectives). One way of dealing with this is through the use of a “balanced scorecard”. Essentially, a balanced scorecard is a method of breaking down the overall development of a company, unit, or branch into several areas, each with a number of objectives. Different weights are then allocated to each of these goals and sub-goals, and ratings, or scores, are awarded to managers depending on their performance in these areas.

What might some of these main areas of manager responsibility and performance be? Depending on the organisation and the specific situation, we could draw up a number of different lists. Looking at one for branch managers in a standard MFI, where the main products are micro loans and small deposits, we might define four major areas:

1. Financial performance.
2. Operational performance.
4. Personnel management.

The next step is for management to attach weights to each of these main areas. These weights should reflect management’s preferences. For instance, we might attach the following weights to the main indicators:

1. Financial performance  30%
2. Operational performance  40%
3. Market development  10%
4. Personnel management  20%

Other indicators or weights are possible as well. The allocation and selection depends on management’s preferences and overall objectives. It may also vary according to the specific situation in each branch. In some cases, more emphasis may be placed on financial performance; in other cases, developing the market may be considered the more important goal.

For each main area we should define additional sub-goals. For instance, “financial performance” could be further refined with the help of such indicators as profitability and cost control, or the development of interest income from lending. “Operational performance” could be broken down into some measure of asset quality (mainly the loan portfolio) and a number of productivity indicators both in lending and in the savings area. “Market development” can be clarified by such indicators as portfolio growth, growth of deposits, and some kind of market penetration ratio (or market share). Finally, for “personnel management” we could use the staff turnover ratio in the branch and the quality of training.

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19 It is possible to develop similar schemes for department heads at the head office level. As an exercise, you might think of a scheme for the head of the finance department or the head of branch operations.
20 If branches do not operate as profit centers but rather as cost centers, cost control would be a substitute for profitability. In both cases organizations need rather advanced accounting systems.
As in the case of the mayor areas, sub-weights are allocated to each of these sub-goals. Management then rates the middle managers’ performance in each of these sub-goals (e.g. using a scale from 1 to 5). The rules of these ratings should be clear to all staff affected by the scheme.

The achieved scores in each of the sub-goals are then multiplied by the respective sub-weights. The product is added up and determines the score of the respective mayor area. Likewise, scores of the mayor areas are multiplied with the respective weights and the product is added up. Hence, we will receive the “final performance score”. The maximum possible performance score should refer to a maximum bonus. The percentage to which the maximum performance score is achieved, determines the portion of the maximum bonus which the middle manager earns. We already used a similar approach in Exercise 6.7.

Since this road map will be used by both senior management and middle managers, it is important to use an interactive process when defining these areas. The best way to do this is to use the annual or semi-annual business planning exercise, during which the main goals and specific objectives and targets are fixed for each branch. A quarterly or semi-annual review can be conducted to establish the degree of target compliance. The specific bonus awarded for the balanced scorecard can then be calculated based on the weights allocated to each area.

The whole point of this exercise is to develop a tool to assess the performance of managers on multiple dimensions. Having to optimise different objectives at the same time is one of the distinguishing features of managerial jobs. The balanced scorecard approach can both guide middle managers in their work and provide a “road map” for upper management to use in monitoring performance.

**Subjective Facets of Management**

So far, we have developed two incentive components for branch managers: one bonus based on the total bonus pool earned by staff in operations, and another bonus based on the balanced scorecard approach. But it is not always possible to measure every aspect of managerial performance accurately, or with the help of numbers and percentages. There are many subjective facets of management, such as

1. Leadership skills.
2. Problem solving ability.
3. Motivation of staff (and perhaps clients).
4. Ability to grow the market and the institution.

These are just a few examples of the aspects of a middle manager’s performance that can only be gauged subjectively. In order to include such performance attributes in our incentive scheme, it may be useful to devise a third incentive component, namely a regular evaluation by senior management. This evaluation would include most or all of the aspects mentioned, but it would allow senior management to take into account the specific circumstances of the branch or department in question. For instance, there may be situations where a capable manager has been appointed to a problem branch with serious delinquency issues or with a declining market. Based on the first and second components of our incentive scheme alone, the manager’s performance would appear to be quite poor. The third component would allow senior management to make the necessary adjustments and to provide some compensation for the relative difficulties of specific managerial jobs.

**Emphasizing Profitability**

Increasingly, profitability is a major goal at MFIs, especially when they operate as formal financial intermediaries. In decentralised organisations the profitability of the branch network is the major determinant of overall financial success and sustainability. So far, we have included (branch) profitability as one of the variables in the “financial performance” section of the balanced scorecard.

We could increase the profit goal’s prominence by establishing a separate (fourth) component to the branch managers’ incentives (i.e. one that would be based on branch profits). Under such a scheme we would award the manager a very small fraction of branch profits in order to focus him/her on this goal. But this only makes sense if the accounting system supports the establishment of profit centres and if the profit goal is deemed to be of outstanding importance. For other middle managers such as department heads, similar...
schemes could be devised. Departments that by definition do not make any contributions to profits could be organised as cost centres.

**Frequency of Bonus Accruals (and Payouts)**

What timing makes sense for middle managers’ incentives? Since we do not want to focus branch managers on the same short term as the operational staff, quarterly or semi-annual bonuses will be adequate. Moreover, it would not be practical to compute the balanced scorecard every month nor to have senior management conduct frequent evaluations.

**Weight of Bonus in Total Remuneration**

What weight should incentive pay have in middle level managers’ total compensation? It is difficult to come up with an exact answer. It should be significant enough to really motivate the managers. As in the case of the loan officers, there should not be any artificial limit or cap since such instruments will usually act as a disincentive for really exceptional staff members. However, middle managers usually receive (and deserve) higher base salaries than staff in operations, so the relative weight of the bonus may not need to be quite as high as it is at the loan officers’ level. The exact calibration of these incentives would depend on the specific situation of each MFI and on the signals that senior management would like to send to this critical management level.

Lastly, we should not forget that most middle level managers are not only motivated by money but also react very positively to a host of other rewards. One could argue that the level of vanity rises with seniority (just look at some of the egos at the top of many famous MFIs21)! Regular tournaments and contests such as the “manager of the year” can help to create a competitive spirit and to boost morale. Training opportunities can also serve as a device for motivation; such training is needed in any case to produce good middle managers.

**Checklist for Designers: Staff Incentive Schemes for Middle Management**

1. Try to align the incentives of managers with the incentives of those whom they supervise. For operations (branch managers) this means paying a certain percentage of the total bonus pool earned by a manager’s subordinates.
2. The balanced scorecard approach can be very helpful in motivating managers to optimise multiple, and sometimes conflicting goals. Be mindful of the fact that middle managers should focus on medium- and long-term goals, and not only on the short-term.
3. Incentives for middle managers should focus on medium to long term goals.
4. Where appropriate, unit profitability can and should serve as an additional foundation for bonus entitlements.
5. Finally, senior management should take the responsibility for conducting regular evaluations to take into account the more subjective aspects of management.

11. **Further Techniques: Employee Relationship Marketing**22

**Employee Relationship Marketing**

Employee Relationship Marketing (ERM) is the process of creating, maintaining and enhancing strong, value-laden relationships with staff. In other words, ERM uses marketing to influence employee behaviour and create a workforce that values the MFI and its mission so that customer service becomes an operational priority. In the same way that microfinance institutions market their products and services to their clients,

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21 This statement is not intended to be taken utterly seriously. In any case, in this respect as in many others, the microfinance industry does not differ very much from other businesses.

22 Much of this section is borrowed from Parrot, Lisa and Hudson, Marion “Employee Relationship Marketing”. MicroSave Briefing Note #33.
they must market their brand, their products and the principle that customer service excellence drives their business to their staff.

A well developed ERM strategy may include a reward programme in which employees earn points for customer service excellence and staff development initiatives (i.e. points are awarded for excellent service delivery, taking professional development courses, or consistently scoring 100% on product knowledge quizzes). Employees can then “cash-in” their points for branded merchandise, corporate sponsored events, or to support community initiatives supported by the MFI. Building an ERM programme, however, takes time and may require a significant change in corporate culture. Consider starting with simple initiatives to acknowledge the value and contribution of staff to the success of your MFI. “Surprise and delight” employees, introduce mystery shopping with rewards for excellence, or organise a day of “voting” for employees to provide feedback on the corporate culture by setting up polling stations with climate survey questions that allow you to gauge and respond to internal satisfaction.

**Example around Customer Service**

Successful ERM begins with commitment by upper management to making customer service a core business strategy. Once service excellence becomes as important as growth and profitability (essentially profitability rests on attracting and retaining clients, and customer service is central to retention), an MFI can focus on making service a prime directive for its staff. Some institutions translate the notion of service excellence into the desire to be “employer of choice”, a goal as important as profitability and sales volumes.

To motivate excellence in customer service, an institution may implement a “Staff Loyalty Programme”. It attempts to strengthen the existing relationship between staff and management by offering rewards that encourage good performance and staff loyalty. All staff automatically participate in that scheme. They can earn points through various activities and outstanding performance in selected areas, e.g. as indicated in Table 6.11.1.

**Table 6.11.1: Example of a Staff Loyalty Programme**

<table>
<thead>
<tr>
<th>Activity</th>
<th>Point Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receiving a Moment of Beauty voucher in the Reward programme</td>
<td>25</td>
</tr>
<tr>
<td>Achieving a 100% rating in the Mystery Shopper programme</td>
<td>50</td>
</tr>
<tr>
<td>Facilitating a departmental training course and providing follow-up</td>
<td>10</td>
</tr>
<tr>
<td>Successfully completing approved job related external course</td>
<td>10</td>
</tr>
<tr>
<td>Entering internal newsletter competitions on product knowledge</td>
<td>5</td>
</tr>
<tr>
<td>Participating in Corporate Social Investment initiatives</td>
<td>10</td>
</tr>
<tr>
<td>Achieving a 100% attendance record over a three month period</td>
<td>50</td>
</tr>
<tr>
<td>Achieving an A rating on a Performance Appraisal</td>
<td>100</td>
</tr>
<tr>
<td>Achieving an B rating on a Performance Appraisal</td>
<td>50</td>
</tr>
</tbody>
</table>

Points are approved by a supervisor and maintained in a database. Staff can redeem their points for branded merchandise and 3rd party benefits, such as free movie tickets, invitations to VIP functions, movie premieres, airtime, discounted rates at select retail and restaurant outlets. Additional benefits can be negotiated on an ongoing basis.

Staff could also qualify for a club membership including Blue, Gold or Platinum level statuses. Different benefits are allocated to these levels of membership.

**Strengths of ERM**

If conducted well, ERMs may contribute to enhance staff commitment and staff loyalty. ERM-type incentives can contribute to a better working environment. They can supplement other types of incentive schemes, could be integrated into existing tournament schemes and can be employed to identify free-riders in group-based incentive schemes.
Weaknesses of ERM

The rewards provided under ERMs are rather symbolic than of real monetary value. Hence, the scheme’s impact on productivity is limited. ERMs also require significant supervisors’ appraisals which may not always be accepted by staff (see Session Four).

However, there is only very little experience with ERM-type incentives in the financial sector, and it is too early to provide a detailed evaluation of these schemes.

12. Designing Staff Incentive Schemes for Back Office & Administration Staff and Senior Managers

Introduction: Staff Incentive Schemes for Back Office & Administration Staff

If one of the major goals of introducing staff incentive schemes is to boost an MFI’s productivity and organisational performance, new bonus schemes for back office and administrative staff probably won’t generate the same impact as bonus schemes for staff engaged in operations. There are several reasons for this assessment:

- In most cases, the functions and staff positions in the administrative departments are “indivisible”. For instance, every MFI needs an accounting department and an MIS. The employees handling at least some of these functions would have the same workload regardless of whether the organisation has a total of 100 clients or 10,000.
- In many cases, quality of work is much more important than quantity. Just imagine what would happen if the accounting department made many faulty postings to the ledger.
- Unlike staff engaged in operations (especially loan officers and other field agents), administrative employees do not have much influence over the workload that they will handle on a certain day. These workloads are generated by their colleagues in the field and in the front office, whom they support. Again, incentives based on the quantity of work that has been processed would not make much sense and indeed would be unfair.
- Our inability to accurately measure output or performance in many administrative areas presents an additional problem for the design of an effective incentive scheme.

Why Staff Incentive Schemes for Back Office and Administration Staff?

Despite these caveats we should not ignore our administrative and back-office staff altogether. As incentive schemes are introduced for staff engaged in operations, other employees might demand their own incentive scheme. In order to maintain a culture of equity and fairness, managers may then be compelled to introduce bonuses for everyone in the organisation. Moreover, many of these employees provide direct support services to staff engaged in operations. Since their effort has a direct impact on the ability of the MFI to reach its clients, management may be well-advised to design and implement some kind of incentive scheme.

Guidelines for Incentive Scheme Design

When devising incentive schemes for this particular group of MFI employees we should strive for the following basic features:

1. The scheme(s) should be kept as simple as possible since the contributions of some administrative and back office staff to output and operations are indirect and cannot be accurately measured.
2. For those employees who directly support the staff engaged in operations, the best way of aligning incentives is to base their reward on the bonus entitlement earned by those whom they assist.
3. For some staff positions the participation in simple profit-sharing plans may be sufficient.
4. The real workload should be measured and rewarded where feasible. This is usually only the case for certain functions, such as in the accounting department where large numbers of debit and credit notes are posted. It would be very useful if the MIS were able to identify the number and accuracy of...
postings by each accounts assistant, so that the bonus calculation could utilise this important performance variable. Output can be measured quite accurately for the internal audit department. Here it would be useful to include both adherence to the audit plan as a variable and the quality of the audits that were performed. For instance, if problems were encountered in a group within a certain period of time after the audit was conducted, a deduction should be made from the total number of points earned by the responsible auditor.

5. In most cases, qualitative performance evaluations will be necessary to measure individual performance. These evaluations would serve as the basis for awarding a bonus that could be paid out monthly, quarterly, or semi-annually. Evaluations would be conducted twice a year and basically would consist of a supervisor assessment. In order to reduce the impact of subjective assessments, it may be a good idea to ask two supervisors to agree on a joint assessment. The evaluations would be discussed with each employee before being forwarded to the personnel department. As much as possible, the evaluations should be carried out according to objective indicators. For instance, they might incorporate some of the numerical indicators mentioned above (such as the numbers of transactions posted by an accountant or the number of on-site audits performed by an internal auditor). We will not go further into detail here because we will review a sample staff incentive scheme below.

6. For most functions, medium-term incentives will be most appropriate because conducting the qualitative appraisals is time-consuming and general administrative work is much steadier than field operations.

**Checklist for Designers: Staff Incentive Schemes for Back Office and Administration Staff**

1. Keep the scheme simple and easy to manage.
2. Do not try to develop objective performance criteria for areas where this is very difficult – it will be a waste of time. If possible, utilise data generated by the organisation’s MIS.
3. If appropriate, “piggyback” on an existing staff evaluation system – there may be positive synergy.
4. A simple profit-sharing plan may be sufficient for some staff positions.

**Example: Staff Incentive Scheme for Internal Auditors**

The sample staff incentive scheme for internal auditors provided below includes two performance measurement techniques:

1. A qualitative semi-annual performance appraisal which is conducted by two supervisors and in which the appraised staff member has the chance to comment on his or her appraisal (Table A). Many financial institutions already utilize such types of appraisal forms on a semi-annual or annual basis.
2. The performance evaluation according to quantitative indicators. In this example these are adapted to the work of internal auditors. However, you would probably be able to identify quantitative performance indicators for other functional levels of staff as well. However, they are naturally not comprehensive, and it is therefore important to supplement them by the first, qualitative, set of performance measurement parameters.

In this example, internal auditors are eligible to receive up to 30% of their basic salary as an additional bonus. This bonus is paid semi-annually. Whereas the first part of the scheme (the supervisors’ qualitative appraisals) is accrued semi-annually, the second, quantitative part is accrued quarterly to provide auditors a more frequent feedback on their performance. Thus, the bonus of the internal auditors consists of three elements:

1. **PART A**: The result of the qualitative performance appraisal.
2. **PART B**: The result of the quantitative performance assessment during the first quarter.
3. **PART C**: The result of the quantitative performance assessment during the second quarter.

Each of these parts consists of an integer score ranging from 1 (“far below expectations”) to 5 (“significantly exceeds expectations’’). Tables A and B below demonstrate how these scores are determined.
The semi-annual bonus is then calculated in two steps. First, a total performance score is calculated by a simple formula:

Total performance score (TPS) = (PART A * 40%) + (PART B * 50% + PART C * 50%) * (100% – 40%)

In our example, this total performance score will obviously be between 1 (“far below expectations”) and 5 (“significantly exceeds expectations”).

This score needs then to be transformed into a bonus in a second step:

\[ \text{Bonus} = \frac{(TPS - 2.5)}{(5.0 - 2.5)} \times 30\% \times \text{basic salary for the six months} \]

Thus, if an auditor received
- 3.84 scores in PART A,
- 2.70 scores in PART B, and
- 4.20 scores in PART C,

his total performance score (TPS) would be:

\[ 3.84 \times 40\% + (2.70 \times 50\% + 4.20 \times 50\%) \times (100\% - 40\%) = 3.61. \]

If the auditor earned a monthly base salary of $200 (which is $1,200 for the six-month period), he would be eligible for a bonus of:

\[ \frac{(3.61 - 2.5)}{(5.0 - 2.5)} \times 30\% \times $1,200 = $159.84. \]
Table A: Sample of the structure of a qualitative semi-annual employee performance appraisal form.

<table>
<thead>
<tr>
<th>1) Criteria (should be broken down into sub-areas and evaluated sub-area wise)</th>
<th>2) Score of first appraiser</th>
<th>3) Score of second appraiser</th>
<th>4) Average Score (or score as agreed in a committee)</th>
<th>5) Weight</th>
<th>6) Weighted score (col. 4 * col. 5)</th>
<th>7) Total weighted score for criteria (Col. 6 * col. 5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Communication skills</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Verbal</td>
<td>3</td>
<td>4</td>
<td>3.5</td>
<td></td>
<td>10%</td>
<td>0.35</td>
</tr>
<tr>
<td>Written</td>
<td>5</td>
<td>4</td>
<td>4.5</td>
<td></td>
<td>30%</td>
<td>1.35</td>
</tr>
<tr>
<td>Interpersonal skills</td>
<td>4</td>
<td>4</td>
<td>4.0</td>
<td></td>
<td>10%</td>
<td>0.40</td>
</tr>
<tr>
<td>Assertiveness</td>
<td>4</td>
<td>4</td>
<td>4.0</td>
<td></td>
<td>10%</td>
<td>0.40</td>
</tr>
<tr>
<td>Ability to listen</td>
<td>4</td>
<td>3</td>
<td>3.5</td>
<td></td>
<td>10%</td>
<td>0.35</td>
</tr>
<tr>
<td>Ability to disseminate information</td>
<td>5</td>
<td>3</td>
<td>4.0</td>
<td></td>
<td>15%</td>
<td>0.6</td>
</tr>
<tr>
<td>Teamwork</td>
<td>3</td>
<td>2</td>
<td>2.5</td>
<td></td>
<td>5%</td>
<td>0.125</td>
</tr>
<tr>
<td>Dressing</td>
<td>3</td>
<td>3</td>
<td>3.0</td>
<td></td>
<td>5%</td>
<td>0.15</td>
</tr>
<tr>
<td>Manners</td>
<td>4</td>
<td>4</td>
<td>4.0</td>
<td></td>
<td>5%</td>
<td>0.15</td>
</tr>
<tr>
<td>Communication skills total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>15%</td>
<td>3.875</td>
</tr>
<tr>
<td>Leadership skills</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Leadership skills total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0%</td>
<td>0.00</td>
</tr>
<tr>
<td>Quality of work</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Quality of work total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>25%</td>
<td>3</td>
</tr>
<tr>
<td>Quantity of delivered results</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>20%</td>
<td></td>
</tr>
<tr>
<td>Personal attributes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reliability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Creativity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adaptability/flexibility</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initiative</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Attitude towards work</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal attributes total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>10%</td>
<td>3.5</td>
</tr>
<tr>
<td>Time / organisation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to meet deadlines</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Punctuality</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to manage multi-tasks</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost-consciousness</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ability to solve problems</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time/organisation total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>15%</td>
<td>4.5</td>
</tr>
<tr>
<td>Technical knowledge</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Specific job knowledge</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General knowledge of the company</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technical knowledge total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>15%</td>
<td>4.5</td>
</tr>
<tr>
<td>Grand Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3.84</td>
</tr>
</tbody>
</table>

23 In this example, the supervisors provide scores between 1 (“far below expectations”) to 5 (“significantly exceeds expectations”)
Table B: Sample structure of the quantitative assessment of the auditor’s performance.

<table>
<thead>
<tr>
<th>Performance measurement parameter</th>
<th>Calculation of score(^{24})</th>
<th>1st quarter (PART B)</th>
<th>2nd quarter (PART C)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Actual</td>
<td>Score</td>
</tr>
<tr>
<td>Percentage to which targets were completed in time (different weights could be allocated to different tasks)</td>
<td>(Actual – 50%) * 10</td>
<td>95%</td>
<td>4.5</td>
</tr>
<tr>
<td>Number of minor problems encountered after the audit</td>
<td>Actual * (– 0.2)</td>
<td>7</td>
<td>-1.4</td>
</tr>
<tr>
<td>Number of mayor problems encountered after the audit</td>
<td>Actual * (– 0.4)</td>
<td>1</td>
<td>-0.4</td>
</tr>
<tr>
<td>Total Score</td>
<td></td>
<td>2.7</td>
<td>4.2</td>
</tr>
</tbody>
</table>

The example illustrates how qualitative and quantitative performance measurement techniques can be combined into one bonus scheme. The scheme can be adjusted to the annual performance appraisal form the institution utilises. Furthermore, it will be necessary to adjust the quantitative performance measurement parameters to fit the operational circumstances of the internal auditors (or other employees!) of the institution.

**Introduction: Staff Incentive Schemes for Senior Management**

Senior managers must make strategic decisions and think over the long term. Providing them with significant incentives based on short-term performance measures would be counterproductive. In any case, many of their actions and decisions are unobservable and are not directly related to particular outputs (as opposed to a loan officer, for instance), making it difficult to measure their performance. For these reasons, upper management usually receives a generous base salary, and few incentives focused on short-term performance.

**Guidelines for Incentive Scheme Design**

The design of staff incentive schemes requires the participation of the board of directors. Incentives should focus on the long-term to account for the long-term perspective management needs to consider in most of their decisions. Incentive schemes could include bonuses according to the achievement of targets, profit-sharing plans or a mixture of these techniques. ESOPs are also possible but in most cases more complex to administer.

**Example: Five Steps to the Design of A Staff Incentive Scheme for Senior Management**

In this example, senior management is eligible for annual bonuses which are based upon three criteria:

1. The MFI’s annual net-profits;
2. The importance of the manager’s particular function;
3. The manager’s individual performance in selected areas which is assessed by the board of directors.

The scheme can be designed in five steps:

**Step 1: Define the Group That Will Be Targeted by the Scheme**

Example:

1. General Manager
2. Operations Manager
3. Finance Manager

**Step 2: Definition of the Bonus Fund That Will Be Available for Distribution**

Example:

2% of the organisation’s annual net profits

\(^{24}\) Values of this column are adjusted by management and should assure that auditors receive fair scores for their performance.
Profits should be calculated based on the budget that was approved by the board of directors at the beginning of the financial year. The reason for this is simple: imagine that the board changes the provisioning policy during the course of the year based on a more cautious (or more positive) assessment of the overall economic situation. Clearly, this would have an effect on the annual profits. However, such changes would be beyond the control of the management.

**Step 3: Division of the Bonus Fund Between the Functions**

This bonus fund is divided among the managers according to certain criteria, e.g.:

- Importance of each function for the general leadership of the institution.
- Contribution of each function to profitability.
- Scope and complexity of task (typically, operations score high on this).
- Others (depending on organisational strategy and external challenges).

**Example:**

- General Manager: 37%
- Operations Manager: 34%
- Finance Manager: 29%

As a cross-check, the distribution could be compared to the distribution of base salaries within the same pool.

By multiplying the percentage distribution with the total bonus fund we arrive at the maximum payout that could be achieved by each person affected by the scheme.

**Step 4: Definition of Performance Criteria for Each Function**

In this step, the board of directors sets out to define performance criteria for each managerial function. For this, the board must make an effort to clearly define and spell out its expectations from management. Each item should be broken down into sub-goals. Management must have detailed knowledge of the criteria and ideally participates in the definition of these. It may not be necessary to fix exact targets.

**Example:**

General Manager
- Leadership (internally, externally)
- Ability to achieve strategic goals
- Ability to identify and control risks
- Development of human resource base

The exercise must be repeated for all management positions.

**Step 5: Performance Assessment and Distribution of Rewards**

The exact allocation of the bonus fund will be done according to an assessment of the performance of each manager, to be carried out by a board committee, including an evaluation meeting and a thorough discussion with each individual. In this meeting, the performance criteria for the coming year could also be settled.

**Example:**

Based on the evaluation meeting (which includes a self-appraisal by the manager), the board committee decides to award 80% of the maximum possible bonus to the general manager. Due to excellent performance of operations, the operations manager is awarded 95% of the maximum possible bonus.
Session Seven: Analyse the Costs and Benefits (Step Five)

A Step By Step Approach to the Cost-Benefit Analysis of Staff Incentive Schemes

Once management has determined that an incentive scheme is necessary, it must analyse the scheme’s potential costs and benefits to ensure that it achieves the desired results. In addition, management will need to develop a credible case for key stakeholders such as the board of directors and investors.

Whether staff incentive schemes are profitable or not is a frequently asked and discussed question. Experience shows that well designed staff incentives do have a positive impact on staff productivity and performance. However, it is hardly feasible to measure the financial impact of staff incentive schemes, because we can only roughly appraise the effects, which staff incentives will have on the performance of the staff. Furthermore, staff incentives typically include many effects (and side-effects) which hardly can be predicted and usually cannot be quantified (e.g. on staff turnover or staff recruitment).

In order to conduct a cost-benefit analysis for a given staff incentive scheme, we suggest to follow the six steps as summarized in Exhibit 7.1: In the first step, we need to define the different types of costs and benefits of the incentive scheme. Then, we should identify the predicted costs and benefits of the scheme which can easily be measured financially (second step). Steps 3-5 refer to a financial cost-benefit analysis that will provide us with a monetary estimation of the incentive scheme’s profitability. However, we should not overestimate this result because we were probably not able to include most of the factors, which influence the incentive scheme’s profitability. Hence, the sixth and last step includes a critical interpretation of the financial analysis’ result. Based upon this interpretation, we can make a decision: the scheme is either likely to be profitable or it is not.

Exhibit 7.1: Six steps to conduct a cost-benefit analysis

1. Define the types of benefits & costs of the scheme
2. Identify the factors that can be measured financially
3. Determine the normal scenario
4. Determine the incentive scenario
5. Measure the financial benefit
6. Appraise the overall benefit

Step 1: Define the Types of Benefits & Costs of the Scheme

Table 7.1 includes some examples of incentive schemes’ benefits and costs.

Table 7.1: Benefits and costs of staff incentive schemes.

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increased staff productivity (and, thus, reduced staff costs such as training, workspace, equipment, etc.)</td>
<td>Bonuses / rewards: You may deduct planned salary increments (e.g. under a merit pay scheme or adjustments for inflation) if these were</td>
</tr>
</tbody>
</table>
Increased outreach
(temporarily) replaced by the incentive scheme.

Self-selection of staff (those who are not willing to work hard might not find the job attractive or may resign)

Higher potential to attract highly skilled staff (and to retain them) due to higher total salaries.
Increased risks (the higher the productivity of employees is, the higher is the concentration of responsibility and the higher the damage if an employee leaves the institution).

Increased income from interest and fees
Non-staff costs related to the increase in business

Increased portfolio quality (and, thus, decreased provisions and write-offs)
Maybe: increased loyalty and commitment of staff
Maybe: decreased intrinsic motivation

Others
Others

### Step 2: Identify These Factors Which Can Be Measured Financially

In order to run a financial cost-benefit analysis, we have to select these factors which we can measure financially. This will largely depend upon the capability of the MIS and the finance, operations and human resource departments.

In all cases, financial institutions will be able to calculate the interest income for a given portfolio as well as the fees for a given number of loans disbursed\(^\text{25}\). On the cost side, it should be possible to appraise the non-staff expenses per disbursed unit (e.g. USD), the salaries of the relevant staff members and the size of the bonuses or rewards for a given staff performance and incentive scheme.

The assessment of the benefit associated with a possible reduction of the write-off rate is more difficult to assess (see below).

Of course, if the incentive mechanism is not set at that stage, bonuses cannot be calculated. In this case, the financial benefit of the scheme (as calculated in Step 5 below) could serve as estimation on what the organisation could spend on bonuses to break even.

#### Estimating loan losses

As recommended earlier, the portfolio at risk rate (PAR) should be used to measure and reward for the loan portfolio quality. To relate write-offs to PAR, a clear write-off policy has to be defined as a function of PAR—at least to conduct the cost benefit analysis. For instance, a financial institution may decide that all loans which are overdue for more than 365 days are written off immediately. Then, we need to predict the likelihood that loans at risks are written off and, hence, lost. For example, we could appraise that 20% of the PAR (1-365 days) is written off. Thus, if we are to calculate the net-income of the institution on a monthly basis, we should deduct an amount which is calculated by:

\[
20\% \times \text{volume of the portfolio at risk} / 12 \text{ months}
\]

If the institution decided to write off loans after 6 months and calculated the income quarterly, the amount deducted from the net-income would be calculated by:

\[
20\% \times \text{volume of the portfolio at risk} / 2 \text{ quarters}
\]

Generally, we can predict the loan loss for a given period of time using a simple formula:

\[
L \times VPAR / P, \text{ where:}
\]

\[
L = \text{Likelihood that the loan portfolio volume at risk is written off}
\]

\[
VPAR = \text{Loan portfolio volume at risk}
\]

\(^{25}\) To keep this Session simple, we will discuss a cost-benefit analysis for a monthly, monetary staff incentive scheme for lending staff. It is further assumed, that there is only one loan product with a loan term of one year and equal monthly instalments. The technique will be similar for incentives enhancing savings mobilisation, for team-based incentive schemes or for medium- to long-term incentive schemes.
P = Number of days after which loans are written off / number of days within the period in question

Loan loss estimations are more accurate if aged PAR reports were used. Then we could predict annual (if delinquent loans were written off after 365 days in arrears) loan losses by using loan loss likelihoods which are based on the number of days which loans are in arrears. Example:

Predicted annual loan loss =
- Volume of portfolio at risk (1–30 days) X 5%
- Volume of portfolio at risk (31-90 days) X 30%
- Volume of portfolio at risk (91-180 days) X 70%
- Volume of portfolio at risk (181-365 days) X 90%

The most difficult part in this assessment is the estimation of the likelihood that loans in arrears are written off. This percentage depends on the loan product designs (including loan term, number of instalments and collateral), seasonal factors and resources mobilised to recover loans in arrears. To estimate such a ratio accurately, we need to analyse historical data. If management feels that its loan loss provisions are accurate, the provisioning policy may be used to estimate the likelihood, that the loan portfolio volume at risk is lost. Note however, if the loan loss provisions are made conservatively we would overestimate the predicted loan loss and. Hence, assuming that staff incentives contribute to a higher loan portfolio quality, we would overestimate the incentive scheme’s benefit.

**Step 3: Determine the Normal Scenario**

The basic approach to assessing the measurable benefit of the scheme is to compare predicted results of implementing the scheme against the predicted results of continuing without it. These two scenarios are referred to as “incentive” and “normal” respectively.

Determining the financial institution’s normal performance requires a realistic and unbiased assessment on both the cost and revenue sides. Past performance coupled with management’s own projections and budget provide a good indicator of a financial institution’s future performance without the scheme. As already discussed earlier, it may take some time until staff react to the scheme, thus it is best to predict the performance for the third month of the scheme.

We can then design a spreadsheet which calculates the financial institution’s monthly net-income according to the factors which we have selected in step 2, e.g.:

Net income =
- Number of loans disbursed x disbursement fees
- loan portfolio volume x interest rate
- Likelihood to write off loans at risk x loan portfolio volume x PAR (7-365 days)/12
- loan portfolio volume x average monthly cost per unit borrowed (without salaries and loan losses)
- salaries

**Step 4: Determine the Incentive Scenario**

Identifying the scheme’s future impact on the institution requires a careful estimation of the potential cost and income. This is probably the most critical step in the cost-benefit analysis because we need to predict the extent to which staff change their performance. Of course, this will depend upon the design of the incentive scheme which we have in mind for our staff. Based on the estimated performance under the normal scenario, we need to quantify the performance of staff under various incentive scenarios including: optimistic scenarios, expected scenarios and conservative scenarios in the areas which we have defined in step 2. For each scenario, we then calculate the net-income as in step 3, e.g.:

Net income =
- Number of loans disbursed x disbursement fees
- loan portfolio volume x interest rate
- Likelihood that loans at risk are written off x loan portfolio volume x PAR (7-365 days)/12
- loan portfolio volume x average monthly cost per unit borrowed (without salaries and loan losses)
- salaries
- staff rewards (e.g. bonuses)

In this example, we would have to quantify the expected increases in
- the number of loans disbursed,
- the loan portfolio volume and
- the costs of the rewards (bonuses)
- as well as the reduction in the PAR rate and the likelihood that loans at risk are written off
to calculate the net income for various incentive scenarios.

**Step 5: Measure the Financial Benefit of the Scheme**

The estimated net income under the scheme is compared to the projected net income under the normal scenario. If the net income from using the incentive scheme is greater than the net income without the scheme, implementing the scheme should be considered further.

To assure that not only the incentive scheme is profitable as a whole, but also that performance increments in each of the performance indicators are profitable, we could increase our projections (under the incentive scenario) by one unit (e.g. one additional disbursed loan) for each of the performance measurement parameters separately. If these marginal changes in one area are profitable, the respective benchmarks of the scheme are set rightly.

**Step 6: Appraise the Overall Benefit of the Scheme**

Finally, we have to appraise the overall benefit of the incentive scheme by including the results of the financial cost benefit analysis (step 5) and all these factors which we were not able to consider in this analysis. Would the latter factors, as a whole, increase or decrease the profitability of the incentive scheme? Are they likely to change the main result of the cost-benefit analysis (would the scheme loose or win its financial profitability when these factors are considered?). Of course, this is a difficult task and involves some subjectivity. Usually, the factors which cannot be measured financially will rather increase than decrease the profitability of the scheme; however, this will depend largely on the organisation culture. The point is that we should not overestimate the meaning of the financial cost-benefit analysis. Instead, we should be aware of all these factors which positively or negatively influence the profitability of the scheme and appraise the incentive scheme’s benefit in the medium term.

Click on “Go to Step 1” to access the slide of the brainstorming exercise (which should include the factors which positively or negatively influence the profitability of the scheme). From there, you can use the link “Back” to go back to the current slide.

**Long- & Short-Term Perspectives**

As already mentioned earlier, staff incentives are naturally not profitable in the short term. There are mainly two reasons for this assessment:

Firstly, staff usually need time to adjust their behaviour to the (changed) incentive schemes’ signals. They have to experience, that it is worth to work better and harder. This process may need around three months (under monthly schemes).

Secondly, we have to set the minimum requirements below the existing performance level (or not to use any minimum requirements) to assure that all staff have a fair chance to earn significant rewards when they increase their efforts. Hence, some parts of the bonus cannot be attributed to an increased performance of staff. Exhibit 7.2 demonstrates these relations: before the introduction of the scheme, we neither have costs nor benefits. At the introduction, we have to provide staff the “incentive” to increase their work effort. While

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26 However, remember that we are not able to include all the benefits and costs into our analysis. Practitioners will agree that a loan disbursed to a new customer is “worth” more than the disbursement fee and interest income (since the customer is likely to continue banking with the organisation).
this involves costs (bonuses), we cannot expect that staff immediately increase their work effort. Nor can we expect that staff who perform below average will react to the incentive scheme if the minimum requirements equalled to the average performance. This is indicated by the steep increase of the red bonus costs at the implementation of the scheme. However, well designed staff incentives assure that increments in staff performance are profitable for the MFI. This relation is indicated by the higher growth rate of the scheme’s benefit. Hence, after a while (e.g. three months), the incentive scheme breaks even and then becomes profitable. The net-benefits of the scheme are represented by the green area, the net-losses by the red area (for a given period of time). The “natural maximum performance level” demonstrates that staff can only increase their performance to a certain degree.

Exhibit 7.2: Short-term and long-term benefits of staff incentives

The Need for Adjustments

In our cost-benefit analysis we have not considered that MFIs climb up the learning curve: staff would also have become more productive without an incentive scheme (but not as much as with an incentive scheme). Hence, our reference performance levels and, if applicable, minimum requirements need to be adjusted accordingly. Exhibit 7.3 demonstrates how the costs of our incentive scheme increase as the MFI becomes more productive without staff increasing their efforts (e.g. through standardisation of processes). In other words, the normal scenario of our cost-benefit analysis would not be adequate any more.

Exhibit 7.3: The need for adjustments
Another Technique to Approach the Profitability of SIS: Avoiding Costs

Another approach to appraise the profitability of a staff incentive scheme would include the consideration of opportunity costs. We could assume that the MFI would be able to expand its (profitable!) business at the same pace without a staff incentive scheme – which is a rather conservative assumption. However, if staff were more productive, we needed fewer employees to cope with that growth. Hence, we would save on base salaries, training costs, equipment and work space, allowances (e.g. health allowance) and administration costs.

Example:
If we could expect our staff to increase their output by 25% on an average, we could employ 25% less employees. We also could spend e.g. 25% of the average base salaries on bonuses, and our gain would include savings on training, equipment, work space, personnel administration and allowances.
Session Eight: Run a Pilot Test (Step Six)

**Why Pilot Testing Staff Incentive Schemes?**

Field testing the scheme in a controlled environment is very important. With all the models and all the spreadsheets, the only real test for our scheme is how it will be received in the field.

Imagine that we overlooked a small but significant detail that rendered our scheme useless. And imagine that we had introduced the scheme in 27 branches at the same time! It is far more sensible to implement the scheme in one or two representative branches on a trial basis and to monitor its performance over a certain period, for instance three months. Based on the results of the field test, we can then make any necessary adjustments. Only then should we implement the scheme in the entire network.

**How Can a Pilot Test Be Designed? – A Step By Step Approach**

You could follow the seven steps of Exhibit 8.1 to pilot test your incentive scheme.

**Exhibit 8.1: A Step by Step Approach to Pilot Testing Staff Incentive Schemes.**

1. Selecting the sample
2. Selecting the time frame
3. Defining the success criteria of the pilot test
4. Commencing the pilot test
5. Monitoring the effects of the scheme
6. Making the decision
7. Roll out (Step 7)

Adjust the scheme as necessary

**1. Selecting the Sample**

For most MFIs, it is sufficient to pilot test the staff incentive scheme in two branches. Large MFIs could consider to conduct the pilot test in three or four branches as well. Make sure that these branches represent your institution (e.g. select one rural and one urban branch). You should also select two “control” branches in which no staff incentive scheme is pilot tested, but which operate in the same environment as the pilot branches. When evaluating the pilot test, you can compare the performance of the pilot branches with the performance of the control branches. This technique allows you to control better for external circumstances, such as seasonal factors.

If you selected your best branches, the observed effect on performance may be lower because staff is likely to work already hard and, thus, cannot increase their performance as much as other branches possibly could. So make sure that you select a representative sample of your MFI.

Some staff incentive schemes can naturally hardly or not at all be pilot tested (e.g. institution-wide incentive schemes such as profit-sharing plans). We will come back to this later.
2. Selecting the Timeframe

The timeframe for the pilot test depends on the frequency both, of the performance measurement and the distribution of rewards. Although employees are subject to react very sensitive to incentives, it usually requires time until staff understand the mechanics of the scheme and really feel that they can earn significant rewards by working better and harder. As a general guideline, plan at least three months for monthly incentive schemes.

3. Defining the Success Criteria of the Pilot Test

Before commencing the pilot test, you should clarify your expectations: How do you want to evaluate the pilot test? When is the scheme successful enough to be rolled out to the branch network? As already mentioned above, it is difficult to evaluate quantitative parameters only – unless you liked to spend a significant period of time to run the pilot test. Hence, you also should conduct interviews with the branch managers both, before and after the pilot test to appraise the effect of the scheme qualitatively. In addition, designers could attempt to quantify the degree to which the performance of staff in the pilot branches should overshoot the expectations which management reasonably had at the branch without the scheme to make the scheme a success. Furthermore, you could try to quantify the level to which the pilot branches’ performances should exceed the performances of the control branches.

4. Commencing the pilot test

Implement the scheme at the pilot branches and make sure that:

1. Staff have understood the scheme well (see Step Seven);
2. Staff have all necessary information to anticipate their rewards;
3. Staff have a chance to earn rewards;
4. Staff have understood that the SIS is being pilot-tested and, thus, is subject to be changed or even dropped!

5. Monitoring the Effects of the Scheme

Monitor not only the parameters which are part of the scheme but also those which are not part of the scheme – they may change as well! Remember, that it may take some time until financial or operational ratios reflect the effects of the scheme. To control for the external factors which also influence staff productivity, you should compare the pilot branches’ performances with the outcomes of the control branches. The participation of branch managers and affected branch staff will be invaluable for the interpretation of the quantitative effects of the incentive scheme. Remember that it may take some time until financial or operational ratios reflect the effects of the scheme – this especially applies to incentive schemes where the link between individual effort and reward is fairly indirect (e.g. team-based incentives or incentives for savings mobilisation).

6. Making the Decision

If the incentive scheme met your expectations at the end of the pilot test, you can roll it out to the entire network. In some cases, it will be necessary to prolong the pilot test. In others, if the incentive scheme has not achieved the desired targets (or was even counterproductive), it will be necessary to revise it or even to drop it entirely – remember: it is better not to have a staff incentive scheme than to have a poorly designed one.

7. Roll Out

If the pilot test was successful, you can proceed to Step Seven.

What About Long-Term or Institution-Wide Group-Incentives?

Long-term staff incentives can not be pilot tested in the short term. Naturally, the impact of these schemes on performance is very indirect. “Pilot testing” institution-wide schemes with a few employees may even cause
the demotivation of staff members who do not participate in the scheme – just think of pilot testing a profit sharing plan with 10% of your head office staff.

In such cases, you simply could implement the scheme institution-wide. Assure that you have taken great care in designing the incentive scheme which includes the use of participatory approach in the design and a careful anticipation of possible side-effects which may have detrimental impacts. Furthermore, make sure that all employees understood that the scheme is being tested and, hence, is subject to be changed or dropped in the coming period.
Session Nine: Sell the Scheme to Staff (Step Seven)

Why Is a Good Communication of the Scheme Important?

Like everything that affects the daily lives of our staff members, new incentive schemes (or changes in existing ones) will be critically reviewed by everyone. If staff feel “tricked out” by a revised scheme, they may become demotivated. So we need to think carefully about the task of selling the scheme. If staff members participated in the scheme’s design, this task will be made easier.

The importance of the incentive scheme’s communication is frequently underestimated. While designers spend days to calibrate the scheme carefully, they frequently overlook to explain the incentive scheme’s mechanics to staff in detail. Not very surprisingly, these incentive schemes cannot fully translate into improved performance. In practice, many problems could have been avoided if staff incentive schemes were better communicated to staff.

When Should the Scheme Be Presented?

After the pilot test was successful and before you are about to roll it out. As a general rule, the incentive scheme should be presented as early as possible to allow staff some time to cope with it. This especially applies to redesigned schemes which include hardships for staff. If a new scheme was presented in detail too early, you may raise staff expectations which you cannot meet later. Never apply staff incentives before they are communicated!

How Can We Sell the Scheme To Staff?

The scheme should be presented carefully by the staff incentives team and the direct superior. The team should also be prepared to address critical human resource issues which arose in the past (if there were any).

It is crucial that the direct superior (or branch manager) understands all schemes which are applied to the staff members he supervises. Hence, he can monitor the incentive scheme’s performance and answer questions of those who are affected by the scheme. If the scheme is very complex, participating staff members should receive a printed version of the scheme’s description; otherwise, it may be sufficient if a description of the scheme was pinned at the notice board. It will be much easier to sell the scheme if staff participated in its design.

On-Going Communication

Make sure that staff not only understand the scheme well but are also able to anticipate their reward. Obviously, this includes that staff have regular access to their actual performance (they e.g. could receive respective print outs or have access to a data base of results) upon which their rewards depend.

In addition, it is helpful to compare performances across levels (ask the branch manager, e.g., to show how the branch has performed in comparison to other branches in monthly meetings).

The establishment of a system for feedback from staff on how they feel about the scheme and how it could be improved are parts of a fair and transparent incentive scheme.

What Else Should We Consider?

To avoid that the intrinsic motivation of staff is reduced, you should also assure that staff perceive that the scheme rewards for high performance (as opposed to penalising poor performance).

Do not underestimate the intelligence of your employees – if the scheme results in any disadvantages or hardships (lower pay, harder work, etc.) they will quickly figure it out. If staff feel “tricked out” by a new or
revised scheme, they may become unmotivated, so make sure that staff understand the reasons for the scheme. It usually helps to explain the reasons for changes, such as:

1. “Delinquency has become a real problem for this organization – so we toughened the standards for PAR.”
2. “Our average productivity has increased by 50% over the past year – so we raised the benchmark performance levels in the bonus formula for loan officers.”
3. “Our owners and directors want us to increase outreach – so we now pay a higher bonus for new clients than for repeat customers.”

Of course, some types of scheme do not require much selling (who would oppose a profit-sharing plan?). But other schemes clearly make work more difficult for the affected staff members.

In such cases, one useful approach is to calibrate the scheme in such a way that initially even the lowest performers will be as well off with the new scheme as they were under the previous one. However, when first introducing the new scheme, management should announce that the scheme’s current performance standards will apply for a certain, temporary, period (for instance 3-6 months) and that these performance standards will be raised after the initial timeframe. This provides everyone with a fair opportunity to bring performance levels up to the new standards and greatly facilitates the introduction of the scheme. A participatory approach in the design also helps to sell the scheme.
Session Ten: Monitor and Adjust the Scheme as Necessary (Step Eight)

Why Should Incentive Schemes Be Monitored and Adjusted?

The performance of incentive schemes should be monitored regularly and adjusted as necessary because:

1. **Organisational goals may change.**  
   *Example:* One Latin American institution has changed one of its major goals from profitability to outreach. Thus, management has reshuffled the weights of the incentive scheme for loan officers accordingly.

2. **Operational challenges may change.**  
   *Example:* Organisations may need to emphasise customer service with increasing competition.

3. **Processes may change.**  
   *Example:* e.g. the deployment of “loan recovery officers” if the institution has accumulated high overdue amounts which it desires to recover. It may be necessary to design a separate staff incentive scheme for these employees.

4. **Products may change.**  
   *Example:* One Latin American institution introduced a Small and Medium Enterprise loan product. There was a need to design a special incentive scheme for the loan officers managing it.

5. **Resources and equipment of staff may change.**  
   *Example:* The computerisation of branches usually increases staff productivity. Hence, the reference parameters or benchmarks of the staff incentive scheme could be set more challenging.

6. **Overall economic conditions may change.**  
   *Example:* Factors which are out of the employees’ control, such as earthquakes, floods or macroeconomic crises usually have a negative impact on the staff members’ remuneration if monetary incentive schemes were employed. To avoid that staff become unmotivated, it may be necessary to lower the reference parameters or benchmarks of the staff incentive scheme. Otherwise, if staff had no real chance to earn bonuses, they will not react on the incentive scheme.

Who Should Monitor the Staff Incentive Scheme and What Should Be Monitored?

The **board of directors** should monitor the objectives and effects of staff incentive schemes for senior management.

**Senior management** should monitor the objectives, overall effects and side-effects as well as the comprehensiveness and adequacy of the incentive schemes.

**Middle managers** should monitor the performance of the incentive scheme for the staff they supervise. In particular, they should explore the scheme’s effects and side effects on motivation and observe the employees’ perceptions on the scheme.

The **Human Resource Department** should monitor the payroll to assure that the vast majority of staff members have a realistic chance to earn bonuses. The department also should observe whether the scheme has any impacts on staff transfers, promotions, recruitment or turnover.

The **incentives team** should regularly monitor the overall performance of the scheme and assist senior management in coordinating its development.
**When Should the Scheme Be Adjusted?**

The scheme needs to be changed when it does not meet the (changing) objectives of the organisation any more. Benchmarks (e.g. reference parameters) need to be changed when they become too low or high, e.g. because the organisation has climbed up the learning curve, has automated processes or if there is an economic crisis in certain areas.

In practice, the parameters of incentive schemes slightly change once within one to two years. The structure of incentive schemes change less frequently, but there is a tendency to schemes becoming more complex as the MFI grows.

**Some Words of Caution**

Changes to the scheme are critical because they can directly affect the employee’s payroll, thus:

1. The scheme should not be changed arbitrarily;
2. The scheme should not be changed too frequently;
3. It is crucial that employees understand the reasons for the changes;
4. Pilot-test the re-designed scheme before replacing an existing scheme entirely.
Remember …

1. The two minimum requirements of staff incentive schemes:

   - Transparency
   - Fairness

2. That staff incentive schemes must be tailor-made according to the organisation’s:

   - Culture
   - Clientele
   - Products
   - Processes

Avoid Common Mistakes including …

- **Failure to analyse the internal culture and how the incentive scheme would fit in**
  
  *Example:* Prodem had to adjust its incentive scheme several times until it fitted into the institutions’ organisation culture

- **Bad internal promotion.**
  
  *Example:* Staff became unmotivated when one East-African institution changed its scheme because the reasons for the change were not explained.

- **Failure to think thoroughly through the scheme and its likely effects.**
  
  *Example:* One South Asian institution has provided bonuses for loan officers which were based on the number of customers in their portfolio. Hence, the portfolio quality suffered until a respective performance measurement parameter was included in the scheme.

- **Failure to properly calibrate the incentives.**
  
  *Example:* One East-African institution calibrated its scheme such, that eligibility requirements were not achievable: Not very surprisingly, staff did not increase their performance

- **Faulty bonus formulae.**
  
  *Example:* An institution in East Africa has set the minimum requirements of their incentive scheme for loan officers so high, that the vast majority of loan officers have seen no scope to earn any incentives. Thus, the scheme rather decreased than increased their motivation.

- **Failure to align incentives properly between different organisational levels**
  
  *Example:* An institution in Caucasus made heavy use of bonus payments for their loan officers. Considering incentive payments, the best performing loan officers earned more than the branch managers. Not very surprisingly, many of them refused to become promoted to branch managers.
Selected Bibliography

  For those who are willing to invest real time and effort, this text will offer many rewards. The authors provide a very thorough overview of the strategic importance of human resources and give an excellent introduction to a host of modern economic theories that are relevant for the topic.

  Bazoberry’s MBB article argues against short-term monetary incentive schemes and makes the case for motivating staff with the help of long-term incentives. PRODEM is one of the leading Bolivian MFIs and was the founding organisation of BancoSol.

  This is a very useful text that gives microfinance practitioners a general overview of management issues in microfinance organisations. It also contains material on human resources and on bonus schemes for loan officers.

  This book focuses on best practice in individual lending. It covers such topics as product design, lending procedures, and automation, and contains some information on loan officer incentive schemes.

  This is a good general text on the management of human resources. Where the book by Baron and Kreps focuses on economic theories, Gary’s book focuses more on practical applications.


  This older textbook gives an interesting overview of incentive schemes for managers (outside of the microfinance industry).

  This is a monograph on human resources management with many examples and practical applications.

  Similar to the last reference – read one or the other, but not both!

  This article from the Bulletin provides interesting background and data on efficiency in microfinance.

  A Bulletin article on the design of monetary incentive schemes for loan officers.
*The classical reference on the balanced scorecard approach that is used when managers or organisations face multiple objectives.*


Mutesasira, Leonard (2002): The Introduction of A Staff Incentive Scheme – Views from the Clients, in: MSA Reader on Staff Incentive Schemes, Nairobi


Stearns, Catherine (1993): Monetary Incentive Schemes for Staff. Bethesda, MD: GEMINI and USAID.
Annex

Annex A: Examples of Bonus Schemes for Loan Officers

Example I – A complex Formula

The performance-based compensation system for loan officers that is presented here involves a variable “P” for the loan portfolio (as a combination of the number of loans and the volume of the portfolio), a variable “A” for the arrears (measured on a portfolio at risk basis), and a variable “L” for lending (measured in terms of numbers of loans disbursed). The example makes use of a reference compensation level which is multiplied with the individual performance ratios of each loan officer. The standardized compensation level for a junior loan officer was defined as $150, and the reference compensation level for both a senior loan officer and a supervisor was defined as $225.

For all junior loan officers the bonus “B” is calculated according to the following formula:

\[ B = P \times A \times \$100 + L \times \$50 \]

For all senior loan officers and supervisors the bonus is calculated according to the following formula:

\[ B = P \times A \times \$150 + L \times \$75 \]

P, A, and L are calculated as follows:

**credit portfolio:**

\[ P = \frac{c}{a} \times \frac{1}{2} + \frac{d}{b} \times \frac{1}{2} \]

(a) reference value defined by the institution for the volume of the outstanding portfolio per loan officer

(b) reference value for the number of outstanding loans per loan officer

(c) volume of the loan officer’s outstanding portfolio

(d) number of the loan officer’s outstanding loans

**arrears:**

*for junior loan officers*

\[ A = \frac{2 - m}{2} \]

(m) = volume of loans overdue/c*100

*for senior loan officers*

\[ A = \frac{3 - m}{3} \]

(m) = volume of loans overdue/c*100

*for supervisors*

\[ A = \frac{3 - m}{3} \]

(m) = volume of loans overdue/c*100
lending: \[ L = \frac{n}{g} \times \frac{1}{2} + \frac{o}{h} \times \frac{1}{2} \]

- \( g \) reference value for the number of loans disbursed to new customers during the month, per loan officer
- \( h \) reference value for the number of loans disbursed to repeat customers during the month, per loan officer
- \( n \) number of loans disbursed by the loan officer to new customers during the month
- \( o \) number of loans disbursed by the loan officer to repeat customers during the month

We apply the same reference values for both junior and senior loan officers. For supervisors, we define the reference value as a multiple of the amount applied to individual loan officers. For supervisors managing three loan officers, the reference value for individual loan officers is multiplied by 3. For supervisors managing four loan officers, the value for individual loan officers is multiplied by 3.5.

**Working it Out: Sample Values for a Senior Loan Officer in Example Scheme I**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) reference value defined by the institution for the volume of the outstanding portfolio per loan officer</td>
<td>$150,000</td>
</tr>
<tr>
<td>(b) reference value for the number of outstanding loans per loan officer</td>
<td>700</td>
</tr>
<tr>
<td>(c) Volume of the loan officer's outstanding portfolio</td>
<td>$88,799</td>
</tr>
<tr>
<td>(d) Number of the loan officer's outstanding loans</td>
<td>590</td>
</tr>
<tr>
<td>(g) reference value for the number of loans disbursed to new customers during the month, per loan officer</td>
<td>50</td>
</tr>
<tr>
<td>(h) reference value for the number of loans disbursed to repeat borrowers during the month, per loan officer</td>
<td>100</td>
</tr>
<tr>
<td>(m) portfolio quality</td>
<td>1.85%</td>
</tr>
<tr>
<td>(n) Number of loans disbursed by the loan officer to new customers during the month</td>
<td>38</td>
</tr>
<tr>
<td>(o) Number of loans disbursed by the loan officer to repeat borrowers during the month</td>
<td>108</td>
</tr>
</tbody>
</table>

**credit portfolio:** \[ P = \frac{c}{a} \times \frac{1}{2} + \frac{d}{b} \times \frac{1}{2} = \frac{88,799}{150,000} \times \frac{1}{2} + \frac{590}{700} \times \frac{1}{2} = 0.72 \]

**arrears:** \[ A = \frac{3 - m}{3} = \frac{3 - 1.85}{3} = 0.38 \]

**lending:** \[ L = \frac{n}{g} \times \frac{1}{2} + \frac{o}{h} \times \frac{1}{2} = \frac{38}{50} \times \frac{1}{2} + \frac{108}{100} \times \frac{1}{2} = 0.92 \]

And finally, the performance-based bonus for a senior loan officer:

\[ B = P \times A \times (150 + L \times 75 = 0.72 \times 0.38 \times (150 + 0.92 \times 75 = 41.39 + 69 = $110.39) \]

The formula for this incentive scheme is probably more complex than you had anticipated. If you have not done so already, please do take the time to work through the numerical example so that you understand the relationships between the different variables and the various elements of the formula. This may require some time and the use of a calculator, but it is well worthwhile.
Main Features: Example Scheme I—A Complex Formula for Loan Officers

1. The system is completely linear. This means that even a small change in one of the performance variables will also change the resulting bonus. Thus, the scheme is elastic and provides positive incentives to loan officers at all levels of output and performance.

2. The scheme emphasises loan portfolio quality. Since the arrears variable is multiplied with the portfolio variable, a decline in portfolio quality has a disproportionately high effect on the bonus. In other words, loan officers are heavily penalised if portfolio quality slips.

3. The formula allows differentiation between loans to new customers and to repeat clients. This feature is meant to allow management to set different priorities when necessary.

4. The scheme is very complex. It would probably take loan officers considerable time and a good degree of analytical thinking in order to grasp all the relationships entailed in the formulae. In consequence, the incentive scheme risks losing some of its power and effectiveness.

One potential remedy for this (possibly unnecessary) degree of complexity would be to simplify some of the formula's components. For instance, one could eliminate the differentiation loans to new customers and to repeat borrowers.

In conclusion, what we have here is probably something akin to the “Rolls Royce” of loan officer incentive formulae. The scheme is surprisingly complex and designed to incorporate many different performance criteria within the main categories of “lending”, “portfolio”, and “arrears”. However, in most situations less complex schemes will probably do just (or almost) as well.

Example Scheme II—A Simple Staged Scheme for Loan Officers

The following bonus scheme for loan officers calculates the loan officers’ bonuses using a combination of three variables: a $-amount “A” for the number of outstanding loans, or caseload; “B” for the outstanding portfolio volume; and “C” for the portfolio quality indicator—in this case portfolio at risk (PAR).

\[
\text{Bonus} = A + B + C
\]

For each indicator several stages have been defined.

Table 1 (Example Scheme II) Variable A — Number of Outstanding Loans

<table>
<thead>
<tr>
<th># of Outstanding Loans</th>
<th>Bonus (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>200-220</td>
<td>10</td>
</tr>
<tr>
<td>221-240</td>
<td>15</td>
</tr>
<tr>
<td>240+</td>
<td>30</td>
</tr>
</tbody>
</table>

Table 2 (Example Scheme II) Variable B — Outstanding Portfolio Volume

<table>
<thead>
<tr>
<th>Volume (US$)</th>
<th>Bonus (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 80,000</td>
<td>10</td>
</tr>
<tr>
<td>&gt; 90,000</td>
<td>20</td>
</tr>
<tr>
<td>&gt; 100,000</td>
<td>30</td>
</tr>
<tr>
<td>&gt; 110,000</td>
<td>40</td>
</tr>
</tbody>
</table>
Table 3 *(Example Scheme II)*  Variable C — Portfolio Quality

<table>
<thead>
<tr>
<th>PAR</th>
<th>Bonus (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; 4%</td>
<td>0</td>
</tr>
<tr>
<td>&lt; 4%</td>
<td>15</td>
</tr>
<tr>
<td>&lt; 3%</td>
<td>30</td>
</tr>
<tr>
<td>&lt; 2%</td>
<td>50</td>
</tr>
<tr>
<td>&lt; 1%</td>
<td>70</td>
</tr>
</tbody>
</table>

**Working it Out: Sample Values For Example II**

At the end of the month, loan officer Mary had a caseload of 206 loans (C = $10 bonus), with a combined volume of $104,000 (O = $30 bonus), and a PAR of 2.1% (D = $30 bonus) giving her a total bonus of $70 under this incentive scheme.

**Main Features: Example Scheme II—A Simple Staged Scheme for Loan Officers**

1. The scheme is simple. It uses only three variables with a few stages each. Thus it will easily be understood by the targeted staff members, and it will be easy to use in practice.
2. In this example, management places a relatively strong emphasis on portfolio quality. The potential bonus for maintaining excellent portfolio quality is as large on its own as that for the two other variables taken together.
3. Management also chose to reward improvements at higher levels with higher bonuses. For instance, once the loan officer’s number of outstanding loans surpasses 240, the bonus is doubled.
4. Of course the scheme suffers from the structural disadvantages of staged schemes. In this example, once a loan officer has improved portfolio quality to 0.9% PAR, there is absolutely no incentive to make any additional efforts.

In summary, this type of scheme may work quite well when the environment is not very complex or when lending operations are still at a relatively early stage.

**Example Scheme III—A Less Complex Formula for Loan Officers**

Our third sample bonus scheme is based on four performance indicators. In addition to three basic indicators—arrears (for portfolio quality), number of outstanding loans, and number of approved loans—management decided that processing speed 27 was an important element of overall institutional performance. Hence this indicator was also added to the list of criteria. The bonus “B” is calculated monthly according to the following formula:

\[
B = 150 \times [(A \times 0.6) + (S \times 0.1) + (O \times 0.1) + (P \times 0.2)]
\]

The constituent variables of the bonus formula are calculated according to the following table:

Table 1 *(Example Scheme III)*  Performance Variables

---

27 Processing speed is calculated as the time between loan analysis and disbursement, measured in days. The MFI’s loan accounting software automatically calculates this number for all loans and then generates an average number for each loan officer.
<table>
<thead>
<tr>
<th>Parameter</th>
<th>Weighting</th>
<th>Compliance Calculation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A arrears</td>
<td>60%</td>
<td>5% - actual PAR</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5% - 2%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>objective = 2% PAR</td>
</tr>
<tr>
<td>S processing speed</td>
<td>10%</td>
<td>6 – actual processing time</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(6 – 3)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>objective = 3 days</td>
</tr>
<tr>
<td>O number of outstanding loans</td>
<td>10%</td>
<td>Actual # of outstanding loans – 150</td>
</tr>
<tr>
<td></td>
<td></td>
<td>200 – 150</td>
</tr>
<tr>
<td></td>
<td></td>
<td>objective = 200 loans</td>
</tr>
<tr>
<td>P number of approved loans</td>
<td>20%</td>
<td>actual # of approved loans</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50</td>
</tr>
<tr>
<td></td>
<td></td>
<td>objective = 50 loans</td>
</tr>
</tbody>
</table>

**Working it Out: Sample Values For Example III**

Last month, loan officer Richard had 55 loans approved and his outstanding portfolio consisted of 170 loans. His PAR stood at 1.9%, and his processing speed amounted to 2.5 days. According to the formula, his bonus would amount to:

\[
B = 150 \times [(A \times 0.6) + (S \times 0.1) + (O \times 0.1) + (P \times 0.2)] = 150 \times [(1.03 \times 0.6) + (1.17 \times 0.1) + (0.4 \times 0.1) + (1.1 \times 0.2)] = 150 \times [0.62 + 0.12 + 0.04 + 0.22] = 150 \times 1 = 150
\]

**Main Features: Example Scheme III—A Less Complex Formula for Loan Officers**

1. The scheme also uses formulae and linear relationships. Every (small) change in performance leads to a corresponding change in bonus entitlement.
2. This scheme makes use of reference values (which are denoted as “objectives” in the table), as does Example Scheme I. These reference values can be changed if and when overall performance improves. However, theoretically there is no limit on the bonus that can be earned by excellent loan officers.
3. In this case, management has placed greatest emphasis on portfolio quality. Fully 60% of the total bonus entitlement is based on arrears as measured by PAR.
4. The example shows how additional indicators can be integrated easily into the bonus formula. In this case, management decided to include processing speed. Remember that to include another indicator, we must be able to measure performance objectively (in this case the MIS contains information on average processing speed per loan officer).
5. This model is much less complex than Example Scheme I. Most loan officers should be able to grasp its main components and how they are related to each other and to the final bonus.
6. The scheme also avoids the negative incentive effects of staged and capped bonus systems.
7. In summary, the scheme may well present a useful compromise that could be applied to medium sized lending operations.

**Example Scheme IV – Another Scheme for Loan Officers**

Loan officers (LOs) receive a monthly base salary of US$ 400. The bonus B is derived as

\[
B = L + P + A; \text{ where}
\]

L => Lending (number of loans issued to new and repeat clients)

\[
= (n / g \times x1 + o / h \times x2) \times x8
\]

P => Portfolio (number of loans and balance outstanding)

\[
= (d / b \times x3 + c / a \times x4) \times x9
\]

28 This scheme is borrowed from M. Holtmann (2001): Designing Monetary Incentive Schemes for Loan Officers: Handle With Care!
A => Arrears (number of loans and portfolio at risk) 29

\[ A = (x7 - (#la / d * x5 + $la / c * x6 * 100)) / x7 * x10 \]

Bonus = \[ [n/g * x1 + o / h * x2] * x8 \]
\[ + [(d/b * x3 + c / a * x4)*x9] \]
\[ + [(x7 - (#la/d * x5 + $la/c * x6*100)) / x7 * x10] \]

The variables define targets and reflect the real results achieved. Additionally, weights are applied to the variables, and for each part of the formula a salary or bonus factor is given. The sum of the bonus factors defines the total amount the institution is prepared to pay as a bonus; at the same time, it is possible to convert the bonus into any currency. In this example the bonus factor is denominated in US$:

<table>
<thead>
<tr>
<th>Variable</th>
<th>Comments</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>G</td>
<td>(L) Target: # of disbursed loans to new customers.</td>
<td>10</td>
</tr>
<tr>
<td>N</td>
<td>(L) Actual # of disbursed loans to new customers.</td>
<td>6</td>
</tr>
<tr>
<td>H</td>
<td>(L) Target: # of disbursed loans to repeat customers.</td>
<td>10</td>
</tr>
<tr>
<td>O</td>
<td>(L) Actual # of disbursed loans to repeat customers.</td>
<td>4</td>
</tr>
<tr>
<td>B</td>
<td>(P) Target: # of outstanding loans.</td>
<td>120</td>
</tr>
<tr>
<td>D</td>
<td>(P) LO’s actual portfolio (# loans) outstanding.</td>
<td>80</td>
</tr>
<tr>
<td>A</td>
<td>(P) Target: US$ outstanding.</td>
<td>600,000</td>
</tr>
<tr>
<td>C</td>
<td>(P) LO’s actual outstanding portfolio (US$).</td>
<td>450,000</td>
</tr>
<tr>
<td>#la</td>
<td>(A) Actual # of loans in arrears for LO.</td>
<td>3</td>
</tr>
<tr>
<td>$la</td>
<td>(A) Actual volume of LO’s loans in arrears (US$).</td>
<td>25,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Factor</th>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>x1</td>
<td>weight factor for L number (new)</td>
<td>0.7 &lt; 1</td>
</tr>
<tr>
<td>x2</td>
<td>weight factor for L number (rep.)</td>
<td>0.3 &lt; 1</td>
</tr>
<tr>
<td>x3</td>
<td>weight factor for P volume</td>
<td>0.3 &lt; 1</td>
</tr>
<tr>
<td>x4</td>
<td>weight factor for P number</td>
<td>0.7 &lt; 1</td>
</tr>
<tr>
<td>x5</td>
<td>weight factor for A #la</td>
<td>0.5 &lt; 1</td>
</tr>
<tr>
<td>x6</td>
<td>weight factor for A $la</td>
<td>0.5 &lt; 1</td>
</tr>
<tr>
<td>x7</td>
<td>weight factor arrears reference</td>
<td>5 &gt; 1</td>
</tr>
<tr>
<td>x8</td>
<td>bonus level factor L ($)</td>
<td>100 &gt; 1</td>
</tr>
<tr>
<td>x9</td>
<td>bonus level factor P ($)</td>
<td>100 &gt; 1</td>
</tr>
<tr>
<td>x10</td>
<td>bonus level factor A ($)</td>
<td>200 &gt; 1</td>
</tr>
</tbody>
</table>

The overall factors (x1 through x10) are weighted according to the importance of the respective performance indicator to the MFI and can be defined for each LO individually, depending on what the institution expects the LO to achieve during a certain period (usually one month).

The variables and factors are predetermined in accordance with the example of LO(1) from the “variables bonus system” to make it easier to identify differences between the bonus systems.

Each component of the formula “Bonus = L + P + A” is explained below.

(1) L - Lending (number of loans issued to new and repeat customers)

\[ L = (n / g * x1 + o / h * x2) * x8 \]
- \( n \) = the number of loans issued to new clients during the period
- \( g \) = the loan officer’s target for loans issued to new clients during the period
- \( o \) = the number of loans issued to repeat customers
- \( n \) = the loan officer’s target for loans issued to repeat clients during the period
- \( x1, x2 \) = the weight in terms of the importance given to the number of loans issued to new and repeat customers, respectively. \( x1 \) plus \( x2 \) must equal 1. If more importance is attributed to the number of loans issued to new customers, \( x1 \) should be given a weight greater than 0.5.
- \( x8 \) = the bonus level factor for L. The part of the monthly bonus which is to be attributable to L is defined under x8. The remaining components of the bonus payment are defined by x9 and x10. In our sample

29 In the following paragraphs, the term “arrears” denotes “portfolio-at-risk” starting from the first day of irregular payment.
calculation the total monthly bonus is US$ 400, which we have divided up as follows: x8 = 100, x9 = 100 and x10 = 200. However, if for a certain period greater importance is attached to, say, new loan output rather than to low arrears, then x8 should represent a larger portion of the bonus than x9 or x10 (i.e. L - x8 = US$ 200, P - x9 = US$ 100, A - x9 = US$ 100).

In the sample calculation, the loan officer issued 6 loans to new clients, while the target was 7, and issued 4 loans to repeat clients, while the target was 6. As a result, the bonus amount under this part of the equation is $52.50.

\[ L = \left( \frac{n}{g} \times x1 + \frac{o}{h} \times x2 \right) \times x8 \]
\[ L = \left( \frac{6}{10} \times 0.7 + \frac{4}{10} \times 0.3 \right) \times \$100 = \$54 \]

(2) P stands for portfolio and measures the extent to which a loan officer has met a given period’s targets for the volume and number of loans outstanding.

\[ P = \left( \frac{c}{a} \times x3 + \frac{d}{b} \times x4 \right) \times x9 \]

The individual factors are:
- c = Loan officer’s total outstanding portfolio
- a = Loan officer’s target for the total outstanding portfolio
- d = Loan officer’s total number of outstanding loans
- b = Loan officer’s target for the total number of outstanding loans
- x3, x4 = the weights representing the importance given to the volume and number of loans outstanding, respectively. x3 plus x4 must equal 1. If more importance is attributed to the number of loans, x4 should be given a weight greater than 0.5.

The result of this part of the formula is a percentage representing the extent to which the loan officer has fulfilled the established targets for the total outstanding portfolio. In the sample calculation, the loan officer had an outstanding portfolio of US$ 450,000, whereas the target was US$ 600,000; consequently he/she achieved 75% of the target. In the example, more significance was given to the number of loans issued, which is reflected in the fact that x4 was set at 0.7. It was probably felt that the loan officer needed to increase his/her number of loans outstanding (for instance to increase outreach or diversification), and hence greater weight was attached to this target. The target was 120 loans outstanding, whereas the LO achieved 80, or 67% of the target.

In our example the bonus for component P is calculated as follows:

\[ P = \left( \frac{\$450,000}{\$600,000} \times 0.3 + \frac{80}{120} \times 0.7 \right) \times \$100 = \$69.17 \]

(3) The next part of the formula is represented by “A”, which stands for arrears.

\[ A = \left( x7 - \#la / d \times x5 + Sla / c \times x6 \times 100 \right) / x7 \times x10 \]

This formula calculates the extent (by volume and number) of a loan officer’s portfolio that is delinquent, and the extent to which any bonus should be reduced as a consequence. The individual components of this part of the formula are:
- x7 = the weight factor for the arrears. This can be any number greater than or equal to 1. The lower the weight factor x7, the greater the negative effect on the LO’s potential bonus. The use of this weight factor and the fact that the arrears component is not deducted from the total bonus allows the institution to fine-tune the impact of arrears targets by changing the factors every month. Thus, an LO may get a substantial bonus for bringing down the arrears rate.
- #la = the total number of loans in arrears in the loan officer’s portfolio
- d = total number of outstanding loans in the loan officer’s portfolio (same as above under component “P”)
- Sla = the total volume of outstanding loans in arrears (portfolio at risk)
- c = loan officer’s total outstanding portfolio (same as above)
- x5, x6 = the weight in terms of the importance given to the number and volume of loans in arrears, respectively. x5 plus x6 must equal 1. If more importance is attributed to the number of loans in arrears, x5 should be given a weight greater than 0.5.
- x10 = the bonus level factor for the arrears portion of the formula. In our example the arrears bonus level accounts for half of the total bonus, i.e. $200 out of $400. The LO had 3 arrears cases representing a total of US$ 25,000 at the end of the month.
In our example the bonus for part A is calculated as follows:

\[ A = \frac{(x7 - (\#la / d \times x5 + $la / c \times x6 \times 100)) \times x7 \times x10}{x7} \]

\[ A = \frac{(5 - (3/80 \times 0.5 + $25,000/$450,000 \times 0.5 \times 100))}{5 \times 200} = $88.14 \]

Looking at this result and remembering the large portion of the maximum total bonus (50%) that the LO could have earned on arrears, he/she obviously failed to make significant progress in this field during the past month.

Now that all three components of the formula have been calculated, we combine them according to the formula: \( \text{Bonus} = L + P + A \). Thus, the resulting bonus is:

\[ $54 + $69.17 + $88.14 = $211.31 \]

The loan officer’s bonus for the period is $211.31 out of a possible $400 or (54% of L, 69% of P and 44% of A, which is 53% of the maximum possible total). As can be seen from the above, the extent to which the LO has met the target for the total outstanding portfolio has a direct effect on the bonus amount attributed to arrears in the portfolio. The importance of reducing arrears was expressed in the bonus level factor for arrears. The loan officer was punished for not reaching arrears targets, his performance in this area having been factored in prior to his performance against the target for the total portfolio. This mechanism can be applied to any part of the formula.

**Example Scheme V: A Simple Bonus Scheme for Credit Officers in a Village Banking Context (East Africa)**

The operation of any incentive system absorbs management time and produces costs (for instance for data collection). The following example originates from a village banking operation where the most important indicator is the timely “recapitalisation” of the groups. In the village banking methodology, the basic loan cycle is sixteen weeks long. After that, the group (“bank”) can receive a new loan. Obviously, if groups can be recapitalised on a timely basis, the lending organisation optimises the income that is generated by the loan portfolio. Also, the use of the recapitalisation parameter provides at least a partial proxy for the indicator of loan portfolio quality, which is difficult to generate on a timely basis in a village banking environment since loan repayments are typically made through the commercial banking system. A second major concern in village banking is group size. If any group members drop out and are not replaced by new members, there will be a negative effect on the MFI’s portfolio size and administrative expenses. Since both of these variables are easy to measure one can devise a very simple incentive scheme.

Credit officers receive a basic bonus \( BB \) for each group that is recapitalised in week 16, regardless of group size. In this example, we will assume a basic bonus of Shs. 10,000 (Shs. 2,000 = $1). In addition, they are eligible for an extra bonus, which is a function of the group size. The threshold would be set at 21, i.e. up until this level a loan officer would not be eligible for any additional bonus (but would still receive the basic bonus). Starting at 22 members, we could then introduce the following variables:

- \( x1 \): number of group members from 22-25
- \( x2 \): number of group members from 26-29
- \( x3 \): number of group members above 30

Each of these variables would then be multiplied with a certain bonus amount, for instance:

- \( B1 \) (corresponding to \( x1 \)) Shs. 600
- \( B2 \) (corresponding to \( x2 \)) Shs. 1,500
- \( B3 \) (corresponding to \( x3 \)) Shs. 4,000

The bonus entitlements for each variable would simply be added, and the resulting bonus formula would then be:

\[ \text{Total bonus} = BB + x1*B1 + x2*B2 + x3*B3 \]

For example, a credit officer who has recapitalised a group with 27 members in week 16 would receive:

\[ \text{Total bonus} = 10,000 + 4*600 + 2*1,500 = \text{Shs.15,400} \]
In our (fictitious) example, the formula would result in the following combination of group size and bonus:

![Graph showing basic bonus (Y-axis: Uganda-Shillings)](image)

Figure 1 Basic Bonus (Y-axis: Uganda-Shillings)
One can observe from the graph that the “curve” is really a combination of linear functions, each of which covers one of the intervals defined above. The advantages of this type of calculation are:

1. The steady function avoids the pitfalls of staged systems—every increment in group membership earns a bonus. Even credit officers with smaller groups can earn a bonus when they recapitalise a group.
2. Nevertheless, there are different “payoffs” for different levels of membership. There is an additional incentive for credit officers to seek group memberships in the region that is considered optimal by management, i.e. around 30.
3. The scheme is flexible in the sense that it is parametrized, i.e. the values for the different variables can be changed. Thus the curve can be made steeper or flatter, as desired by management.
4. The calculation itself is very simple and only utilises data that are constantly produced in the field operations.

The next step in the design of this “incremental” system is the question as to how to factor in the objective of portfolio growth. If we intend to keep things as simple as possible, one convenient way to provide an extra incentive for credit officers to increase their portfolios would be to multiply the bonus with a certain factor, if the growth requirement is met. In other words, if the recapitalised group receives a loan greater than in the previous cycle, the bonus that the loan officer would earn based on the other criteria could be multiplied by a factor, of for instance 1.3 (thus, it would increase by 30%). Such a multiplication would then move the “curve” upward. If the loan size did not increase, A would be equal to 1.

If “P” denotes the adjustment factor of 1.3, the bonus formula would now be:

\[ \text{Total bonus} = (BB + x1*B1 + x2*B2 + x3*B3)*P \]

---

Of course, this applies for the design phase of the system. Once the scheme is implemented, it would not be advisable to change it too often.
It should be noted that the multiplication with a constant factor assigns the same “value” to a portfolio increase, regardless of the group size. Also, the value of 1.3 for factor P was arbitrarily chosen for our example—management could assign a different value depending on its priorities.

A simple suggestion for recapitalisations in week 17 would be to multiply the whole bonus formula with a certain deflator, for instance 50%. Thus, for any recapitalisation in week 17 the bonus formula would be:

\[
\text{Total bonus} = ((BB + x1*B1 + x2*B2 + x3*B3)*P)\times0.5
\]

With these first two steps, we have accommodated two of our goals: number of clients and portfolio size. The easiest way of factoring in the third goal, namely portfolio quality, would be to maintain a deduction of, say Shs. 15,000, per group that was recapitalised after week 17 (this could be denoted the letter “A” for delinquency). Management could further emphasise the importance of the portfolio quality variable by making it known that credit officers who recapitalise more than a certain number of groups late within a certain period of time (e.g. six months) will be issued a warning letter and, if performance does not improve, will be dismissed.

Finally, for the inauguration of new groups a certain lump sum could be paid as before (e.g. Shs. 20,000), this variable would be denoted as N.

In conclusion, the total bonus formula would be

\[
\text{Total bonus} = \\
((BB + x1*B1 + x2*B2 + x3*B3)*P) + ((BB + x1*B1 + x2*B2 + x3*B3)*P)\times0.5 + N - A
\]

While this formula may seem complicated at first sight, it is really quite simple and straightforward. Thus, it would be easy to implement and would not require the collection of any complex data. Another attractive
feature of the scheme is that its input variables are important parameters within the village banking methodology.
Annex B: Case Studies on the Design of Staff Incentive Schemes

These case studies were developed for training purposes. The organisations mentioned in this training note are fictitious, and any similarities with real organisations are unintentional. Readers are invited to analyse the examples with the help of the instruments provided in this toolkit and to see if they can come up with any improvements to the schemes. Questions are included at the end of the Annex to aid discussions.

**Case Study #1: Stock Ownership for Employees at Fundación Confianza**

*Introduction*

Mr. Garcia, the president of the NGO “Confianza” (“Trust”) is widely regarded as a pioneer in microfinance in Central America. Starting with a loan fund of US$ 100,000 that was donated by a Christian organisation, he steered the NGO on a path of rapid growth, disbursing micro loans of up to US$ 1,000 to small traders and other urban microenterprises in the country. Confianza currently has 15 branch offices in the five major cities of this small nation. The average loan size amounts to approximately US$ 500, and the NGO’s portfolio consists of 25,000 loans, with a combined volume of roughly US$ 13 million. Since there is very little competition in the microcredit market, Confianza is able to charge high cost-covering interest rates (72% effective interest rate per annum).

Over the course of time, the NGO has been able to attract millions of donated funds in order to fuel the high rate of growth of the loan portfolio. It certainly did not “hurt” that the country was hit by several hurricanes as well as a couple of earthquakes – each time millions of dollars of relief aid poured in, and Confianza was often used as a conduit for the disaster relief funds. Consequently, Confianza built a sizeable capital base, and with the exception of US$ 3 million in long-term loans at concessionary interest rates (2% p.a.) the NGO does not have any other liabilities. Most of the loan funds and some of the donated capital comes from the regional development bank.

*The Proposed Scheme*

Given the dynamic development of the NGO’s credit operations, Mr. Garcia and some of the other directors of the Foundation have made plans to attempt to convert the NGO into a fully licensed commercial bank. This would also allow the organisation to capture savings from its clients as well as from the general public. The minimum capital requirement is US$ 15 million, so that Confianza would need only an additional US$ 5 million from prospective investors to overcome this hurdle.

The board has also approved a scheme for employee participation in the share capital of the organisation. So far, Confianza does not have any particular staff incentive scheme. Mr. Garcia, who was a social activist before embarking on his career in microfinance, never believed in using short-term monetary incentives in order to foster the performance of individuals. Rather, he has paid very attractive fixed salaries to all the 402 employees, and especially to the 312 credit officers. Staff turnover has been very low, and the NGO has been an attractive place of employment.

Mr. Garcia and his co-directors have devised a long-term incentive scheme that would grant all employees the possibility to receive shares in the organisation before it is converted into a bank. For this, it has been decided that the NGO (which is entirely controlled by the board of directors) will give away half of its shares to the current employees, who will thus be rewarded for their hard work in the past with an ownership stake.

In order to distribute the shares, Mr. Garcia has developed an allocation mechanism: all current staff members who have been with the institution for longer than six months will be eligible to receive shares. The allocation key consists of two criteria: (1) Length of tenure with Confianza, and (2) Highest level reached within the organisation. Thus, a branch manager with seven years of work experience in the NGO would receive much more than a messenger who joined two years ago. After the shares have been distributed, Confianza will engage on the process of transformation into a bank and will seek out a third party as additional investor. At this time, a valuation will be carried out so that the new investor can pay the true economic value of the share purchase (this will be accomplished through a capital increase).
potential investors have been identified, it appears most likely that the regional development bank (which
gave some loans and equity contributions) would be the first (and most attractive) candidate.

Thus, Mr. Garcia thinks that in future the shareholdings will be distributed among equally among the staff,
the NGO, and the new investor. Also, after a day of thinking, he is convinced that he has found a great
instrument for providing long-term incentives to his staff members at all levels of the organisation. He is
ready to sip a glass of wine and ponder his future as president of a larger and successful bank.

**Case Study #2: Compensation of Loan Officers at Ghengis-Khan Social Development Fund, Central Asia**

Ghengis-Khan Social Development Fund (GKSF) was established with substantial bilateral assistance from
the United States Congress. Initially, the fund was an integrated rural development program, but after a few
years the GKSF began to concentrate exclusively on micro and small business loans. The program is active
in three of the Central Asian republics, but by far the most successful site has been in the country of
Kazakhstan. Here, GKSF was able to build up a portfolio of approximately 6,000 micro loans with a
combined volume of US$ 8.6 million. Almost all of the loans are group loans, but recently GKSF began to
extend some individual loans. Due to almost unlimited funding and a good demand situation, it is expected
that GKSF’s growth will remain strong. However, there are no immediate plans to convert the fund into a
bank. While GKSF was one of the pioneers of microfinance in the region, now there are at least 20 other
organisations that offer micro and small business loans in Kazakhstan.

Kazakhstan is a very large country with a small population, so that potential customers are dispersed, and
loan officers need to travel long distances in order to visit their clients. Yet initially, Mary Hopeful, the
fund’s director, did not find it difficult to recruit and train excellent and committed young staff members.
There are thousands of university graduates in Kazakhstan, and never a lack of applicants. As a US-program,
GKSF offers a prestigious employment address, as well as specialised training in small and microbusiness
finance. GKSF has undergone strong growth, so there were many opportunities for promotion. GKSF’s loan
officers have in fact been quite productive.

During the past year, Mary has become increasingly aware of the fact that many of GKSF’s more
experienced loan officers have voluntarily quit their job. Mary cannot find any explanation for this since the
loan officers (who make up more than 80% of all staff) are very well paid by local standards.

In order to avoid having to deal with Kazakhstan’s extremely burdensome labour regulations, all loan
officers are hired as private consultants. This has not been a problem since GKSF pays enough to the
“consultant” loan officers so that they can comfortably pay their taxes and social security payments, and still
be better off than most of their colleagues and friends.

Also, when the program was started, an American compensation consultant proposed to remunerate the loan
officers on a pure commission basis. The advantage would be that staff would be extremely strongly
motivated to perform well, since they would not receive any base salary. For the same reason, there was no
paid vacation time, so that the loan officers would only take the time that was absolutely necessary for them.
Commissions were paid on group formation, the value of the outstanding portfolio as well as the number of
clients reached, and there was a strong disincentive for arrears. Another advantage of the scheme was that it
was extremely easy to dismiss loan officers if the quality of their work or their job attitude did not fulfil the
standards of the GKSF. In Mary’s view, the consultant had been absolutely correct. Having followed the
consultant’s advice, the GKSF has achieved much better productivity ratios than those of the closest
competitors.

Still, Mary is somewhat worried that something had changed and that she needs to look at the fund’s
compensation system in order to prevent further damage.
Case Study #3: Compensation of Loan Officers at Batumi Foundation, Caucasus

Batumi Foundation is an NGO with a successful track record of group lending in one of the Caucasus countries. Currently, the organisation has approximately 13,000 clients with outstanding loans. After some arrears problems in 1998, Batumi Foundation introduced an incentive scheme for the loan officers that placed a very high emphasis on loan portfolio quality. Consequently, PAR has been reduced to an average of 1.2% from the first day of arrears – a spectacularly good performance not only in this region, but also against the toughest standards in the industry.

The scheme is actually quite simple: fully accredited loan officers (i.e. loan officers with more than one year of experience) receive a base salary of US$ 400. If they disburse more than 70 loans per month, they can earn a bonus of 25% of base salary. Almost all of the loan officers manage to achieve this target. The second criterion for the bonus formula is the portfolio at risk of the individual loan officers. 

<table>
<thead>
<tr>
<th>PAR</th>
<th>Bonus as % of base salary</th>
</tr>
</thead>
<tbody>
<tr>
<td>4% and above</td>
<td>0</td>
</tr>
<tr>
<td>3-4%</td>
<td>25</td>
</tr>
<tr>
<td>2-3%</td>
<td>50</td>
</tr>
<tr>
<td>&lt; 2%</td>
<td>100</td>
</tr>
</tbody>
</table>

Nino Shevardnadze, the president of Batumi Foundation, has generally been very pleased with the performance of the incentive scheme. As pointed out above, arrears have been maintained at extremely small levels. Also, the NGO is one of the most productive lenders in the region, and in terms of outreach it actually belongs to the top five performers in all of Eastern Europe and the NIS.

Still, in recent staff meetings, some of her senior managers have pointed out to her that not all is well: recently, there were some job openings for branch managers at some soon to be opened rural branches. Surprisingly, when the new positions were advertised, not a single experienced loan officer applied for the job. Traditionally, it has been an important career step for junior staff members to spend some time as a branch manager. The position has a high level of prestige, and at US$ 750, it is also well-paid. Nino wonders what went wrong, and what would need to be fixed in order to improve the situation.

Case Study #4: Staff Compensation at Financiera “Plata”, South America

For the last 15 years, Financiera Plata (“Silver”) has been a very successful microfinance institution in Latin America. The organisation grew from humble beginnings as a credit-granting NGO to become one of the leading lenders in the region. In 1997, the NGO was converted into a (licensed) non-bank financial institution. It currently has 50,000 borrowers as well as 2,000 depositors. The balance sheet volume is approximately US$ 45 million.

Financiera Plata is a highly productive lender and has always given strong incentives to its loan officers through a monthly bonus scheme that puts a heavy emphasis on disbursement numbers and volumes as well as portfolio quality. In the past, the whole organisation was geared towards producing as many micro loans as possible. Consequently, the portfolio currently consists almost exclusively of short-term loans to small traders. Now, there are plans to convert into a full-scale commercial bank, which will mean the introduction of additional lending products (housing loans, small business loans), more types of deposits, as well as money transfers (both within the country and internationally). There are plans to expand the branch network from the current 10 branches to almost 40 outlets. Management expects staffing levels to increase from the current level of 100 to more than 300.
Pedro Minero, the General Manager of Financiera Plata, is wondering what all these changes will mean for the bonus system that has worked so well in the past. Surely, it will be important to find some kind of bonus system for the middle management, and especially the branch managers (currently, these managers receive a fixed salary). Also, there is a question as to whether the new products should be included in the same formula as the micro loans. Finally, Pedro would like to know how he can motivate his staff to mobilise more deposits, since the bank’s ability to generate a strong deposit base will have a significant impact on its future success.

Pedro has been told that you are a first rate compensation expert with ample experience in the design of staff incentive schemes. He needs a good expert since he would like to transform the organisation into a full bank by early next year. Can you give him the advice he needs?

**Questions for Discussion**

The following questions attempt to provide some guidance for the discussion of the cases. Please feel free to raise any other issues that may be interesting and relevant. Also, you can make any assumptions that you think are necessary for dealing with the problems.

**Case Study #1:**
1. Describe the motivation for the ESOP.
2. What are the benefits and some problems associated with the proposed approach?
3. What will be the likely distribution of the shares between existing as well as future staff members?
4. How will the potential equity investor react to the proposed scheme?
5. Does Confianza really need an ESOP? Please approach this question from an operational perspective.

**Case Study #2:**
1. Why do you think the experienced loan officers are leaving the Fund?
2. What would be an alternative compensation system?
3. Why did the scheme work well at the beginning, and why is it encountering problems at this point in time?

**Case Study #3:**
1. Can you think of a simple way in which to redesign the existing scheme so that there would again be incentives to be promoted to branch manager?
2. How could the existing scheme be made more complex so that it would respond more elastically to changes in performance?
3. Generally speaking, what should be good incentives for middle managers and branch managers?

**Case Study #4:**
1. Which kinds of issues will Pedro have to think through before he can actually sit down and design the formulae for his new incentive scheme?
2. What would be a good way of designing an incentive scheme for the branch managers?
3. Can you think of an appropriate incentive scheme for the staff who will be engaged in savings mobilisation?
4. Do you think that the current plans for transformation and growth are realistic?