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Developing Staff Incentive Schemes

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TABLE OF CONTENTS

MicroSave **Reader on Staff Incentive Schemes - Introductory Comments**

Microfinance operations depend on a number of factors, among them management, geography, and access to funding. Without doubt, the quality and dedication of MFI staff stand out as perhaps the most decisive ingredients of successful service delivery. Boosting the productivity of staff members enables MFI managers to reach more clients and improve financial performance. It is widely believed that staff incentive schemes can make positive contributions to these goals. Consequently, many MFIs have established some kind of staff incentive mechanism, such as bonus schemes or ESOPs.

MicroSave's Action Research Partners (ARPs) are good examples of a trend towards the increase in the use of such schemes. Almost all of ***MicroSave***'s ARPs have some form of staff incentive scheme in place.

If one looks at the genesis of incentive schemes, it is notable that in most cases the systems currently in place evolved as the consequence of an "exploratory process", rather than being the final result of a well-defined design process. In other words, many schemes were developed in some form of "trial and error" process, and they have undergone (and, typically, are still undergoing) numerous changes and revisions.

Another fact that stands out with regard to staff incentive schemes is that many MFI managers are not entirely (and in some cases not at all) happy with the systems that are in use in their organisations. There is a lot of anecdotal evidence of schemes that have failed to achieve the intended results, and some incentive mechanisms have even produced completely unwanted side effects.

Given the importance of staff incentive schemes, as well as the many problems associated with their practical application, ***MicroSave*** thought that it was appropriate to bring together its Action Research Partners and other interested parties in order to conduct a workshop on the topic – with the eventual aim of developing a toolkit to assist MFIs develop staff incentive schemes in a systematic manner.

The workshop was organised in collaboration with Ebony Consulting International, financed by DFID through FINMARK and held in Pretoria on 28 February – 1 March 2002. The workshop was preceded by individual assessments of the staff incentive schemes in place at selected ***MicroSave*** Action Research Partner institutions.

This reader contains most of the presentations that were made at the conference. We are grateful to the authors for undertaking the effort of expanding their presentations to paper size. The reader is divided into three main parts:

Part 1 casts some light on the **role of staff incentive schemes in MFI operations**. In other words, we ask why it is important to study the design and use of staff incentive schemes.

Part 2 provides an impressive **overview of the experience accumulated by the *MicroSave* Action Research Partners**. The case studies present some of the incentive schemes that were developed by microfinance institutions operating in different countries and environments. Nevertheless, readers will discover many common elements among these schemes. Readers will also realise that none of the schemes described is "perfect", even when new schemes were developed as a response to the flaws of previous systems. We believe that the remaining deficiencies are an illustrative and useful reflection of reality: Incentive scheme design is a dynamic process, and improvements are usually made step by step. Thus, readers are invited to draw their own conclusions from the case studies and to speculate as to how the various schemes might be improved even further.

Part 3 of this reader approaches the topic from a more conceptual angle and develops some **general lessons regarding the architecture of "good" incentive schemes**. So far there has been very little serious research on staff incentive schemes, therefore this conference reader cannot contain the answers to all the potential questions that practitioners might ask. But at least it is a start, and we are pleased that this effort comes from a challenging and very promising region.

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Lessons to be Learnt (or Questions to be Asked) Regarding the Design of Staff Incentive Systems

Martin Holtmann[1]

Introduction

In microfinance, incentives are used at all levels of the "institutional pyramid" in order to influence the behaviour of clients, staff members, management, and the individuals who make up the "governance structure" of organisations. Much has been written and is known about incentives for microfinance clients: successful microlenders utilise a number of instruments for inducing on-time repayment by their borrowers. Examples of such mechanisms are the graduation principle (excellent borrowers are offered larger loan amounts and longer loan terms) and interest rebates. If we conceptualise client incentives as being located at the "bottom" or "foundation" of the microfinance incentive pyramid (without good client repayment microfinance activities can never be sustainable in the long run), appropriate incentives for operational staff as well as for management and the governance structure make up the other "levels". So far, there appears to be much less systematic knowledge about these areas.

MFI Personnel and the Role of Incentives – Relevance of the Topic

The principal motivation for studying the role and design of incentive schemes for MFI staff is related to the enormous labour-intensity of microfinance activities. Typically, the salary burden (i.e. the percentage of total administrative expenses that is accounted for by salaries and other labour costs) amounts to between 60 and 70%. In addition, the provision of microfinance is usually very decentralised (for example, BRI in Indonesia has a network of more than 4,000 branches, Credit Indemnity has 120 branches, Centenary Bank 17, Equity Building Society 13, whilst Teba Bank has 80 outlets and Finca Uganda 6). This not only means that staff expenses are by far the most important cost category in microfinance but also that staff often act in very remote areas on behalf of the owners and other stakeholders. The quality of their decisions invariably affects the owners as well as the whole institution. Clearly, the way in which staff are paid and their performance measured must have an important impact on MFIs.

If there are good reasons to agree that incentives for staff performance are important in general, it seems even more logical to point to the very special role of lending staff within the delivery of microfinance services: loan officers and other staff engaged in lending operations generate and safeguard most of the assets, and they typically also generate most of the income of microfinance organisations. Again, it is necessary to think about adequate incentives for good performance.

The search for new staff members is costly and may take a lot of time, as does the training of loan officers and other microfinance staff. Typically, loan officers reach their productivity "peak" after at least two years of work experience. Consequently, the loss of experienced staff members is costly in several senses: apart from the direct loss in output and knowledge, the organisation incurs additional costs for searching for and training of new staff members. Thus, it seems a reasonable (and economically rational) strategy to reduce staff fluctuation by paying competitive salaries. Performance-related pay schemes may be useful here since they will pay higher rewards to the best (most productive) staff members.

The quality and commitment of management is as important for institutional success in microfinance as in any other industry. Again, it seems justified to think about intelligent incentive schemes for microfinance managers.[2]

Among most microfinance practitioners there is a widely held consensus that adequate incentives for staff members will have positive effects on overall institutional performance, including outreach and sustainability (through influencing productivity and costs). However, despite this general consensus there seems to be very little agreement as to which types of incentives are optimal.

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[1] Also a compilation of group discussions

[2] Although not a direct part of the operational structure of microfinance, the Board of Directors should also be regarded as an important mechanism for whom incentives could be designed in order to induce appropriate behavior (for instance adequate oversight and control of management).

Finally, one commonly heard complaint in the microfinance industry is that the particular incentive schemes that are in use in microfinance organisations are deficient and not fulfilling their purpose. For all these reasons it seems like an excellent idea to study the use and design of staff incentive schemes.

Questions Regarding the Design and Use of Staff Incentive Schemes

Types of Incentives

Staff members of microfinance institutions may be affected by many different types of incentives, for instance:

- Sense of mission and direction ("do I feel that what we are trying to accomplish is important and useful?")
- Job satisfaction ("do I like what I am doing?")
- Possibilities for promotion
- Non-monetary benefits
- (Monetary) bonus systems
- Profit sharing
- (Stock) Ownership

The question then arises whether staff incentives necessarily need to be of a monetary nature in order to be effective. One might argue that the potential for promotion can be an extraordinarily powerful stimulus, and that even very competitive salaries will not keep people who simply do not like what they are doing. If staff members share and support the goals of the organisation, this will positively affect their intrinsic motivation. Without doubt, most human beings are (to a certain extent) motivated by money – but can a monetary incentive scheme function without regard for other determinants of employee satisfaction?

Short Term Versus Long Term Monetary Incentives

The question here is whether monetary incentives such as performance-related bonuses should be paid out in short intervals (for instance monthly) or whether it makes more sense to space out the intervals for performance measurement and bonus remuneration at longer intervals (for instance semi-annually or even annually). Those criticising shorter terms argue that staff members would develop an "entitlement" attitude (taking the bonus pay for granted) and that short-term productivity maximisation will negatively affect the quality of work.

Individual vs. Group-based Incentives

Should the incentive scheme foster competition between individuals (by paying bonuses based on individual performance) or should it enhance cooperation and teamwork by focusing on unit output and performance?

Importance of Bonus Component in Total Pay Package

If an MFI uses a monetary bonus scheme, what would be the proper weight of the bonus as a percentage of the total pay package? Also, how much flexibility (and consequently risk) are staff members willing to bear? Is there a danger of attracting risk-seekers to the job?[3]

Functional Level of Incentive Schemes

We can observe empirically, that monetary incentive schemes are widely used at the operational levels of MFIs. Typically, there is an incentive scheme for loan officers in place. A growing number of organisations have also developed and implemented incentive schemes for other banking staff and back office operations. It is somewhat surprising that there are far fewer incentive schemes for branch managers and other middle managers (such as department heads). In the experience of the author this level is usually the scarcest resource in microfinance. Also, there are still rather few explicit incentive schemes for top management and members of boards of directors of microfinance organisations.[4] At the operational level we are thus faced with having to decide on the strengths and weaknesses of a variety of

[3] In the language of economics, this would be called *adverse selection*.

[4] We can hypothesize that some of the more spectacular failures in the microfinance industry might have been averted if there had been effective incentive schemes in place for the boards of directors.

existing systems. At the higher levels of MFIs there seems to be a lack of experience with incentive schemes so that our task might be more one of deciding on the most important design principles for a future system that would be adequate for these levels.

Mistakes in Designing and Implementing Incentive Schemes

Some common mistakes associated with the introduction of incentive schemes are:

- Incompatibility with organisational culture;
- Inadequate internal promotion;
- Unforeseen (and undesirable) side effects;
- Incentives that are too big or too small;
- Technical deficiencies (inadequate formulae etc.)

The question arises how such mistakes can be avoided by careful design and adequate implementation.

In summary, many interesting issues are related to the design of staff incentive schemes. Some of these are:

- What is the effectiveness of short-term monetary incentives at the loan officer level?
- What would provide effective incentives for other banking staff (i.e. staff not directly engaged in lending operations)?
- How can an incentive scheme foster joint efforts and teamwork?
- What should comprise the main elements of effective incentive schemes for middle and upper management, including branch managers?
- What (if any) should good incentive mechanisms for members of boards of directors look like?
- What is the potential role of long-term incentive mechanisms such as ESOPs?[5] How should these be designed?
- How can staff incentive schemes be designed so that the risk of severely negative effects ("perverse incentives") is minimised?

[5] ESOP = Employee Stock Ownership Plan

Case Studies

Staff Incentive Schemes: Case Study of Equity Building Society

Gerald G. Warui

Background

Equity Building Society (EBS) was started in 1984 and is registered under the Building Society Act Cap 489 Laws of Kenya. The amendments of the Building Society Act through the finance bills of 1998 - 2001 have enabled EBS to offer banking services just like any commercial bank in Kenya.

Between 1984 and 1993 Equity Building Society experienced a stagnant deposit base, stagnant loan base, a deteriorating loan portfolio and continuing losses. From 1994 the company began to transform. Equity, a Building Society that focused on savings and mortgage loans started to focus on the mobilisation of savings and term deposits and other funds to promptly and efficiently provide loan facilities to the micro finance sector to generate sufficient and sustainable profits for the welfare of all stakeholders. In essence, the transition entailed a complete change in focus.

Since then Equity has experienced consistent growth of 40 – 50% per year in terms of profitability, deposit base, loan portfolio, portfolio of investments, and asset base. It has received excellent ratings by the Central Bank of Kenya and Planet Finance.

The mission of EBS is to mobilise savings, term deposits and other funds for the timely and efficient provision of loan facilities to the micro-finance and "missing middle" sector with the objective of making sufficient and sustainable profits for the welfare of all stakeholders.

The target market of EBS is the micro-finance and "missing-middle" sectors. These sectors include all members of the population who are economically active in predominantly market-based transactions. The target market of EBS therefore includes:

- Micro-, small and medium scale entrepreneurs
- Commercial smallholder farmers
- Salaried employees in the private and public sector.

As at 31/12/2001 Equity had 164 staff members who were spread out among the organisation's 12 branches and the 18 mobile units.

Current Status

The following table provides a short overview of Equity Building Society's balance sheet.

Table 1: Balance Sheet of Equity Building Society as at December 31, 2001 (in US$)

ASSETS	
Cash and balances with Central Bank	3,235,822
Balances with other financial institutions	7,241,618
Investments	---
Customer advances	9,701,707
Fixed assets & other current assets	3,809,732
Total Assets	23,988,879
LIABILITIES	
Customer deposits	20,496,191
Managed funds	---
Other liability accounts and accruals	594,994
	21,091,185

SHAREHOLDER'S INTERESTS	
Share capital paid-up	647,585
Share premium	308,586
Capital reserves	1,195,722
Capital grants	---
Retained profits	745,801
Total Liabilities and Equity	23,988,879

Data on Equity Building Society's operational performance and financial ratios are contained in the following table:

Table 2: Operational Indicators and Financial Ratios as at December 31, 2001

Number of branches	12 fully fledged branches & 18 mobile units
Number of staff	164
Number of loans outstanding	22,000
Volume of loan portfolio ($)	9,701,707
Arrears rate (PAR from 1st day)	8.7%
Avg. loan size ($)	441
Number of depositors	110,000
Volume of deposits ($)	20,496,191
Avg. deposit ($)	186
RoE 2001	26%
RoA 2001	3%
Capital/Risk Weighted Assets	20.5%

Products and Services

Savings Products and Services

As of December 2001, Equity had 110,000 depositors. The products offered to these clients included:

- *Super Junior Investment Account*: The purpose of this account is to facilitate savings to cover education plans and future start-up funds for dependents.
- *Premium Savings and Credit Scheme*: This is a unique account that provides both savings and credit components while allowing the customer to save monies for old age, such as pension funds.
- *Ordinary Savings Account*: This account provides a secure channel for saving today's income for personal growth, future investment and security for future needs.
- *Business Savings Account*: The purpose of this account is to support entrepreneurship activities and it is designed in such a way that it is affordable, flexible and easily accessible.
- *Call and Fixed Deposit*: This account provides a secure savings mechanism for matching maturing assets with maturing obligations while maximising income through premium interest earnings.

Credit Products and Services

As of December 2001, Equity had 22,000 borrowers. The credit products are targeted at individuals, enterprises or members of organised social economic groups and include the following:

- *Medical Loans*: The purpose behind providing medical loans is to enable Equity to build a mutual, long lasting relationship with its clients.
- *Education Loans*: Equity believes that the best way of empowering the family and building the society is to provide financial solutions to investments in education. The education loans cover primary, secondary and tertiary education.
- *Salary Advances*: This facility enables salaried clients to meet unexpected financial needs.

- *Farm Input Loans*: The mainstay of the Kenyan economy is the agricultural industry. Equity supports this sector by providing credit to farmers to enable them to boost farm output and productivity. The loans cover various needs, ranging from financing farm operations, and investments in farm inputs to farm improvement.
- *Business Loans*: The purpose of these loans is to support private enterprise. They take the form of working capital loans and overdrafts.
- *Development Loans*: These loans are used for a multitude of purposes ranging from purchasing of land or farm to house construction or renovation, from expansion or purchase of business to the purchase of a motor vehicle.

The Staff Incentive Systems

Equity's mission statement recognises the contribution of staff as its most important asset, and Equity's staff incentive scheme is designed to reflect this. Like other firms in the service industry, Equity appreciates that an organisation's effectiveness can only be realised through the commitment and dedication of its staff. Equity has in place, an incentive scheme aimed at creating a suitable and enabling environment, and promoting a sense of belonging amongst its staff.

Objectives of the Incentive Scheme

The staff incentive scheme of Equity has the following seven objectives:

1. To recognise the importance of staff;
2. To motivate staff by recognising individual and team contributions;
3. To help staff internalise the mission and vision;
4. To align the focus of staff with the core business of Equity;
5. To create corporate culture through the enhancement of Equity's core values;
6. To create a sense of belonging and ownership; and
7. To create a conducive and enabling working environment that inspires staff to unlock their individual potential.

Structure of the Existing Incentive Scheme

The staff incentive scheme has a two-pronged approach. First, there is a bonus/profit-sharing scheme, which looks at the performance and contribution of an individual staff member with a view to rewarding him/her at the end of the calendar year. Second, there is a team incentive scheme which is based on the quarterly performance of a branch *vis-à-vis* its budget parameters. To complement these schemes, Equity has set in place various human resource policies that include the following:

- Compensating staff with competitive salaries and annual salary increments;
- Promoting staff on merit grounds;
- Filling emerging positions, as much as possible, from the existing members of staff;
- Encouraging staff to participate in the ownership of Equity through the purchase of shares (staff members currently own 25% of the company);
- Providing a retirement/pension scheme where the employee and employer contribute equal amounts to the scheme for the employees benefit;
- Providing personal and development loans at concessionary interest rates and without stringent security requirements;
- Providing free medical cover for employees and, in the case of management staff, their immediate family;
- Facilitating education and training opportunities that include (i) staff training and development (ii) reimbursing costs of professional exams passed and (iii) provision of a staff training centre with an equipped library;
- Organising an annual end of year staff party the purpose of which is to bring staff members together to share experiences and discuss common issues and in this way create the feeling of a family;
- Recognising the contributions of staff members in various ways such as letters of recognition; commendation for achieving goals;
- Encouraging open dialogue through regular staff meetings and dialogue across all levels within Equity and involving staff in all activities;
- Providing a Benevolent Fund Scheme i.e. a contributory scheme to assist staff at the time of need such as upon the death of an employee, child or parent; and

- Providing a savings and credit cooperative scheme (SACCO), which enables staff members to save and thereupon borrow up to three times the amount of his/her savings.

Proposed Incentive Scheme

Equity is setting up an incentive scheme that will give awards for winning proposals on:

- Methods by which Equity can mobilise more deposits;
- Ways of retaining customers;
- Opportunities to reduce operating costs/expenditure;
- Enhancing income levels;
- Improving efficiency so that staff members work smarter rather than harder;
- Enhancing security and internal control system;
- Detecting and preventing fraud;
- Enhancing the core values of Equity; and
- Making Equity a better employer.

Experiences With Staff Incentive Systems

As with many staff incentive schemes there are positive and negative aspects. In Equity's experience, some advantages of its incentive systems have been that it encourages teamwork and promotes a sense of belonging among staff members. Over time, the schemes have encouraged creativity and facilitated the evolution of leaders to meet the challenges of situations that Equity faces. Last but not least, Equity believes that its schemes have provided an avenue for individuals within the organisation to develop and realise their career aspirations.

That notwithstanding, Equity recognises that its incentive scheme is facing a number of challenges, and that there are areas in which it could be improved. The external challenges that the incentive scheme faces include:

- Its attractiveness in the competitive labour market;
- The need to continually improve upon the scheme as Equity grows; and
- In the event of a change in the legal framework, the scheme would be under pressure as a result of increased staff costs and other demands.

The internal challenges include:

- The fact that the annual profit-sharing scheme relies on supervisor assessments, and that the scheme should be complemented by more objective performance measurements as well as shorter payment intervals;
- The need to introduce a comprehensive scheme for the credit staff taking into account the productivity and the quality of small business lending operations; and
- The management of the high expectations of staff in view of the rapid growth of Equity.

Equity has learnt a number of lessons through the years with regard to the implementation of staff incentive schemes, and three of these are that:

1. if staff are rewarded fairly and are motivated to focus on the mission of the organisation, the management will not be faced with supervision headaches, labour unrest and so on;
2. an organisation will achieve superior results if it recognises the contribution of staff and fosters teamwork in attaining the organisation's mission; and
3. staff are motivated by ownership of the organisation that they work for.

Overall, Equity's experience has been that a good staff incentive scheme leads to greater productivity, profitability and growth of the organisation.

The Incentive Scheme of Credit Indemnity Corporation (CIC), South Africa
John Staley

The micro-lending industry has existed in South Africa for many decades, mainly as an informal business practice. It is only more recently, with the removal of interest rate ceilings on small loans under R.6,000 that the industry has mushroomed, creating a formal arm to the business. This change appeared as an exemption from the Usury Act (Act No. 73 of 1968), provided for in the Government Notice, No 3451 on 31 December 1992.

Two categories of lenders can been identified, namely informal and formal. They can be classified as follows:

- Informal lenders – typically lenders with no permanent address or listed telephone numbers and normally difficult to trace. The more traditional sources of micro-lending include the *mashonisas* (or township lenders), *stockvels* (that provide rotating credit and informal savings operations) and pawnbrokers. The latter operate under the Second-hand Goods Act.
- Formal lenders – these operate with permanent addresses, listed telephone numbers, official working hours and permanent staff, and in the open from offices in the business areas of towns and cities.

Prior to 1992, the formal credit industry in South Africa primarily consisted of the formal banking sector and retailers, such as the furniture and clothing industries. The industry provided credit to consumers principally as a source of asset-based financing. The provisions of the Usury Act controlled legislation in this era. The yardstick for the effective rate of interest charged, restricted by the Usury Act, was between 24% and 33% per annum (depending on the current prime rate at that time). This maximum effective rate of interest implied that micro-lending was not economically viable. Not only were administrative costs high relative to the small size of loans, but also the risk profile of customers at the lower end of the market was unacceptable to fulfil normal requirements of the formal sector. The latter was primarily due to consumer's inability to provide any collateral or security, a legacy of the apartheid regime. The micro-lenders that did exist were low profile and positioned out of the mainstream business activities.

In 1992 the Government published an exemption to the Usury Act. It was within this framework that the micro-lending industry of South Africa exploded and rapidly took its place as a prominent business activity. It was common knowledge that there were enormous profits being made in the industry and many seized the opportunity to enter the market. The industry justified the high interest charges through administrative costs being high in relation to loan size and the high-risk profile associated with the majority of its customers. In time, the industry was depicted as unscrupulous and acquired the reputation of 'loan sharks'. But the industry was not totally innocent. Many lower income earners were caught in debt traps. During 1999 the micro-lending industry was at the centre of general public and government scrutiny. The outcome of government amendments to the Usury Act Exemption (Notice No 713, 1 June 1999) and numerous court proceedings in 1999 and 2000 were:

  - All moneylenders were to register with the MFRC (Micro Finance Regulatory Council). The MFRC's mandate was to regulate the micro-lending industry as stipulated in the Government Gazette; facilitate increased access to finance; and as well as consumer protection.
  - The prohibition of the retention (as collateral) of bankcards and PINs by lenders.
  - The requirement of disclosing all terms of the contract, including all amounts and charges to be paid by borrowers.
  - The maximum loan size per customer was raised from R6 000 to R10 000.
  - No capping of interest rates was enforced.

Micro-lending in South Africa can be categorised into three main spheres, namely:

- *Short-term lenders* – characterised by 30-day loans at 30% per month interest. The general business practice is still to take the customer's ID documents and ATM card (even though this is illegal). Customers also disclose their personal identity numbers (PIN) and their cards are used as a form of collateral. Examples of short-term lenders include Louhen, Cashwise, Unity and Finaid.
- *Medium term lenders* – characterised by a loan period of 1-12 months. Interest rate charges are 4-15% per month. Generally no form of collateral is taken, emphasis is placed on the customer's ability

to earn income through formal employment and their ability to afford the loan. The main players are *Credit Indemnity* and Consumer Credit.

- *Long-term lenders* – characterised by loan periods between 12 – 36 months. Interest rate charges normally range between 4% and 10% per month. Collection methods are primarily through payroll deductions. Initially, long-term lenders targeted government employees as the government granted lenders access to repayments directly from the Department of State Expenditure through the use of Persal codes. The main players were Altfin and King Finance (now known as African Bank).

Brief History of Credit Indemnity

Tim Kiln, a building contractor from Zambia, and C. Houghting, an estate agent, developed a close working relationship in the Kwa-Zulu Natal Midlands area. In July 1978 they purchased a very small concern, *Credit Indemnity*. The business was more of a concept with basic lending procedures and no customers at this stage. The first branch was opened on the third floor of a Pietermaritzburg office block.

From the beginning, the owners used very strict lending criteria including credit checks in order to approve applications. A manual scorecard system was also developed to assist processing of applications. Cash was paid out and receipted to and from customers from an open desk. All credit control (arrears) letters were hand-written. *Credit Indemnity* basically had the market to itself. Very little competition existed as no one else was prepared to lend money to the disadvantaged majority population. From these humble beginnings the customer base grew and the business grew primarily from retained earnings. In 1983 the second branch was opened in Durban and in 1987 the third branch opened in Pinetown.

It was at the end of the 1980s that the first monthly “profit share” incentive scheme was introduced, and it applied to branch management only. Incentives were based on sales and credit collections. The ‘founding directors’ negotiated a compromise: for the branch management to qualify for these incentives they forfeited annual salary increases. Over the years various other incentive schemes have been developed.

In 1993 the fourth branch opened in Ladysmith with the appointment of Mike Kiln, the first of four sons to enter the business (2 from each director) over the next few years. This re-enforced the family owned business culture. Between 1993 and 1994 three more branches opened – Durban (Plaza), Empangeni and Newcastle. In 1996 the Port Shepstone branched opened. This was the first branch to open on the ground floor and marked a notable shift in the placement and profile of the company. At this stage the company had grown to about two hundred staff.

In 1997, the computer system was upgraded from a LAN (local area network) to a WAN (wide area network), and an advanced ‘Duzi’ program was developed. This program was an on-line system that assisted the decentralised business approach. Loan assessment, loan disbursement and the collection of outstanding loans were all performed at the branch level. This process was integrated into the ‘Duzi’ system.

In October 1998 the two founding directors sold 35% of CI to Nisela (which later became Theta Investment Limited). With this initial sale of part of the company, the owners appointed the following directors: Graham Adie (Human Resources and Development), John Staley (Finance and Marketing) and Mike Kiln (Systems and Risk). In November 2000, Chris Van Rensburg was appointed as Director of Operations. All directors provided enthusiastic inspiration to lead and drive the company’s aggressive strategy to grow from 25 branches to over 100 branches as a national footprint by September 2001. This strategy was adopted to meet the primary objective, which was to achieve profit warranties. The expansion of the branch network also provided many opportunities for internal promotions. In addition, there was a strategy to shift the organisational culture from one that was family based to one that is more corporate in nature. The company successfully achieved these targets within the time frame allocated.

Our Vision

To ensure that *Credit Indemnity* is the market leader in the provision of short-term credit and related financial services

To create a working environment which facilitates superior performance and enables talents, initiative and energy to flourish

Our Mission

To service the credit requirements and financial needs of all South Africans by providing cost effective products combined with efficient Customer orientated Service in an ethical, sustainable, and profitable way

Our Values

We respect the human dignity of all people
We uphold the highest levels of honesty and integrity
We believe in putting our words and plans into action
We encourage personal ambition and advancement
We believe in the development of our people through training
We recognise and reward our Staff Member's abilities, effectiveness and worth

Institutional Data

Products

Credit Indemnity's loan terms and interest rates are detailed in the Table below. Discount on early settlement is given at 2.5% per month pro rata on the capital advance. Interest on overdue amounts is charged at a rate of 10.31% per month. This applies to all loan types.

Term (months)	Loan range	Nominal rate (per month)	Effective rate (per month)	Approximate company split
1	R200 – R700	20.00%	20.00%	0.3%
4	R200 – R6 000	8.75%	13.19%	89.3%
6	R1 500 – R6 000	6.75%	10.68%	7.7%
12	R1 000 – R10 000	5.50%	8.81%	2.7%

90% of Credit Indemnity's business is in four-month loans. The methodology of loan payout and collection is primarily cash-based transactions over the teller counter at the branches. Other modes of payment include the post office, bank payments via individually bar-coded statements and various debit order options.

The customer profile is broad and not limited to specific employment groups. Loans are assessed on the basic principles of customer stability, contactable, credit worthiness and loan affordability.

Supplementary products in the past have been met with limited success. These have included cell phone products and funeral policies. A current supplementary product is a money transfer product using the branch infrastructure. Credit Indemnity is currently looking at developing a savings product and at converting its existing credit product to a credit line product rather than the more fixed process currently being followed.

Customers, Staff and Branches
As of March 2002, Credit Indemnity had 170,000 customers with active loans and no customers with deposits since the organisation does not have a banking license. As of December 2001, CIC had a complement of 1,000 permanent staff members operating in a branch network that currently consists of 110 outlets in 15 areas with continued expansion and growth. Credit Indemnity is represented in all the major regions of South Africa.

Balance Sheet as of September 30, 2001
The following table gives an overview of the most important balance sheet items of CIC.

Table 1: Balance Sheet of CIC as at December 31, 2001 (in US$)

ASSETS	
Customer Advances	163,546,753
Debtors and other asset accounts	22,679,578
Fixed Assets	18,234,365
Total Assets	204,460,696
LIABILITIES	
Other Liability and Accruals	72,124,456
SHAREHOLDER INTEREST	
Share Capital	12,000
Retained Earnings	132,324,240
Total Liabilities and equity	204,460,696

Data on CIC's operational performance and financial ratios are contained in the following table:

Table 2: Operational Indicators and Financial Ratios as at December 31, 2001

Operational Indicators and Financial ratios	
Number of Branches	108
Number of Staff	945
Number of loans outstanding	179,124
Average loan size	995
ROE	48%
ROA	27%

Overview of Staff Incentive Scheme at Credit Indemnity
The Credit Indemnity Staff Incentive Scheme can be divided into three categories:

- Operations (divided into regions, 15 areas, and 110 branches)
- Centralised Collections Department
- Management

Operations
The scheme is structured to cover the three main areas of the current core business:

- Disbursement of Loans

- New applications
- Collections ("Credit Control")

Targets are set monthly and the performance is measured against the target. The inclusion of sales and number of loans as parameters is a simple process in that the target is set and the required performance is 100% in order to achieve a single set incentive payment amount for the month. Credit control is based on percentage levels, i.e. 97%, 98%, 99%, 100% achieved. Each level pays a set increasing incentive amount. The goals for sales and number of loans are managed so that branches generally achieve the target 50% of the time over a 12-month cycle. The credit control target is based on the percentage of instalments due during the period; therefore it is not as easy to manage this particular objective.

The incentive payouts apply equally to all staff in a branch, and they are not affected by any other variable such as position, job description etc. This is intended to create teamwork and also to encourage the more junior staff to take an active role in the process of increasing the business in a branch. The most junior staff can earn 100% of their basic salary for approximately six months of the year for a standard branch structure. The branch managers and loan officers receive approximately 15% of their salaries as incentives**.**

Central Collections Department
The incentive scheme for the central collections department is based on the portion of debtors' book allocated per individual collector and a target recovery percentage set for each individual collector. The incentive payment is based on the amount collected as a percentage of the target, similar to the 'Operations' structure paid to branch staff. Credit Controllers receive approximately 20% of their salaries as incentives.

Management Staff
Management salaries - The salary structure is based on a cost to company basis. The packages are structured so that one third of the cost is variable, and they are based on a percentage of pre-tax profit. There is no maximum to the variable portion. The minimum variable portion is zero. The variable portion of the salary is paid monthly on the profit achieved in the previous month. The monthly incentive is based on a percentage of profit; it is set per individual and based on seniority.

Annual bonus for managers - A substantial amount is paid over three years. The individual amounts per annum are generally greater than a month's salary. For example, after a three-year period on the scheme an individual would receive three different years' worth of delayed bonus. This is designed to create continuity of service and facilitate staff retention.

Positive Aspects of the Incentive Scheme at Credit Indemnity

- Highly motivated staff: generally speaking, employees are very satisfied with the scheme.
- Low staff turnover: in the past year there were no staff resignations.
- Consistent achievement of targets.
- Achieved in excess of 30% growth per annum for the past 20 years.
- Focused staff: Strong focus on controls and procedures, staff is committed to achieving a small set of simple goals.
- Equal payout of bonus increases feeling of equity and spirit of teamwork.

Challenges for the Incentive Scheme at Credit Indemnity
Challenge # 1: Introduction of new products

- Introduction of new products will be essential to broaden customer base and improve long-term institutional sustainability of Credit Indemnity.
- The narrow focus of the current scheme makes it difficult to introduce new products since this would change what the staff members are accustomed to.
- Under the current incentive scheme, it is not easy to maintain take home pay when the insecurity of an alternative source is introduced.

Challenge # 2: Collection targets have become increasingly difficult to achieve

- There has been an overall decrease in collections due to change in granting criteria, increased demand in the market, and deteriorating market conditions.
- Macro-economic effects and effects of world economy, inflation, and a deteriorating Rand /Dollar exchange rate have all contributed to lowering confidence in overall economy.
- The customer base appears to have an increased risk of default – this represents a significant change in systemic risk.
- As a consequence, granting criteria needed to be tightened so as not to increase risk.
- The existing incentive scheme did not provide special rewards for gradual increases in collections. Also, a significant percentage of staff members never became eligible for a bonus.
- Incentive scheme for staff in collections department has been changed so that better performers receive much higher bonus.
- Proposed modifications to the scheme should improve the likelihood of receiving bonuses for all but the weakest employees, and average performance is expected to improve significantly.
- A recent test of the scheme produced significant improvement in overall collections within one month.

An Overview of K-Rep Bank Limited's Employee Stock Ownership Plan
An Incentive Scheme for its Employees

John Kashangaki

Background

The organization that is commonly referred to as K-Rep, actually comprises of a group of companies under a holding company known as K-Rep Group Limited ("K-Rep Group"). The three arms of the K-Rep Group are K-Rep Development Agency (KDA), the research and development arm; K-Rep Bank Limited ("K-Rep Bank"), the financial services arm; and K-Rep Advisory Services Limited ("KAS"), the consulting and advisory arm.

In 1984 K-Rep started out as a five-year project to address the financial, management and technical needs of non-governmental organizations involved in the micro and small enterprises development sector. Over the years its operations split into two i.e. the financial services division and the non-financial services division. The former transformed itself into a regulated bank and obtained its banking license in 1999.

Size

The headquarters of K-Rep Bank is located in Kawangware, a suburban area away from Nairobi 's lucrative Central Business District, a symbolic environ that matches the people it really serves. Plans are underway to open up two further branches in Nairobi. The 5 pre-existing upcountry branches and 21 sub-branches across Kenya are currently marketing outlets for K-Rep Bank. At present, K-Rep Bank has 170 members of staff, 111 of whom are involved in the actual credit operations of the Bank.

Products and Services

K-Rep Bank provides the following products and services to its clients:

1. *Credit Products*: K-Rep Bank's credit products are divided into group-based and individual-based loans. The group-based loan products make up approximately 89% of the Bank's lending portfolio whereas the individual loans make up about 11%.
   a. Group Based Loan Products: The Juhudi loan product requires 30 member groups to co-guarantee one another; The Chikola loan products requires 20 member groups of pre-existing self-help groups to co-guarantee one another and the Kati-Kati loan product is a new one that is accessible to members of the public in need of loan amounts within the range of Kshs.100,000 to Kshs.250,000. Group size is in the range of 5-10 members. This product alone constitutes 12% of the Bank's loan portfolio.
   b. Individual Based Loan Products: There are personal loans for graduating members of existing K-Rep Bank groups, and the bank offers loans of up to Kshs.500,000 to eligible members of the public. There is no group guarantee backing, hence sufficient collateral is a prerequisite. In addition, K-Rep Bank offers business loans designed for small-scale businesses that require credit up to Kshs.5,000,000.

2. *Savings Services:* As a fully licensed bank, K-Rep Bank now has the possibility to mobilize savings. The products on offer are categorized into the following: -
   a. Involuntary Savings - These are mandatory savings that function as loan security.
   b. Group Savings - This is the pool of savings that must be kept by members of K-Rep Bank groups to act as collateral. It is inaccessible to the members. Members only get access to these savings when resigning from the group, and they must have paid back their loan in full.
   c. Emergency Savings - Compulsory savings kept by groups to assist in difficulties particularly in loan payment and in collapsing businesses. It is accessible by the group members.
   d. Voluntary Savings - Personal Savings: Individually initiated savings open to both the K-Rep bank groups and the public at large.
   e. Liquid Account Savings Product - Savings that are accessible any time but earn no interest and have no cheque-book. It best fits customers who need a place where they can frequently deposit and withdraw their savings.
   f. Regular Savings Account Savings Product - Semi-liquid account where savings are accessible once in a week with a minimum balance.

g. Fixed Deposit Account Savings Product - Term savings account for 3, 6, 9 or 12 months, with attractive interest rates and higher minimum balances.
h. Linked Deposit Account Savings Product - A product that is meant for the wealthier members of the community who are willing to support and promote micro-enterprises in their local communities where K-Rep operates. By making a linked deposit, K-Rep Bank will access micro-enterprises in that area bearing the largest risk of loan management.

3. *Other Services*: K-Rep Bank provides other traditional banking services including the provision of cheque-books and foreign exchange.

Loans
In 2001, K-Rep Bank had total loans and advances amounting to US$ 13 Million, almost three-quarters (74%) of which were microfinance loans. This figure represents a 75% growth of K-Rep Bank's portfolio over the previous year. K-Rep Bank had 22,649 active loan clients by the end of the Fourth Quarter with an average loan size of US$ 600.

Deposits
As at December 2001, total deposits at K-Rep Bank amounted to Kshs 409 Million (US$ 5.18 Million) with 57.2% (Kshs 234 Million) of the deposits being less than Kshs 50,000 (US$ 632[6]). This figure represents a growth of 53% in deposits over the year. The Bank had 27,460 savers.

Financial Performance
The highlights of K-Rep Bank's financial performance are summarized below:-
- Operating Profits: Increased to US$ 800,000 in 2001 up from US$ 150,000 in 2000.
- After Tax Profits: Approximately US$ 550,000.
- Return on Equity: 7.8%
- Return on Assets: 3.7%
- Portfolio Quality: Approximately 4% (PAR from the first day of arrears)

Current Status
The following table provides a short overview of K-Rep Bank Limited's balance sheet:

Table 1: Balance Sheet of K-Rep Bank Ltd. as at December 31, 2001 (in US$)

ASSETS	**US $ Millions**
Cash and balances with Central Bank	0.46
Balances with other financial institutions	1.26
Investments	2.50
Customer advances	9.02
Debtors and other asset accounts	0.44
	13.67
Fixed assets	1.18
Total Assets	14.85
LIABILITIES	
Customer deposits	5.18
Managed funds	0.00
Other liability accounts and accruals	2.71
	7.90

6 US$ 1 = Kshs 79/=

SHAREHOLDER'S INTERESTS	
Share capital paid-up	6.33
Share premium	0.00
Capital reserves	0.00
Capital grants	0.00
Retained profits	0.63
	6.96
Total Liabilities and Equity	14.85

Data on K-Rep Bank Limited's operational performance and financial ratios are contained in the following table:

Table 2: Operational Indicators and Financial Ratios as at December 31, 2001

Number of branches	5
Number of sub-branches	21
Number of staff	170
Number of loans outstanding	22,649
Volume of loan portfolio ($)	9,240,506[7]
Arrears rate (PAR from 1st day)	4%
Avg. loan size ($)	600
Number of depositors	27,460
Volume of deposits ($)	5,177,215[8]
Avg. deposit ($)	218
RoE 2001	7.8%
RoA 2001	3.7%
Capital/Risk Weighted Assets	

The Incentive Scheme

K-Rep Bank`s main staff incentive scheme consists of an employee stock ownership plan ("ESOP"), which permitted eligible employees to own shares in the Bank. The key terms of this scheme are summarized below.

Eligible Employees

Employees that were eligible to participate in the scheme and to acquire shares at the date of the scheme's inception were those members of staff who had completed 36 months of service with the K-Rep Group and/or its subsidiaries and directors of K-Rep Group and/or its subsidiaries. Thereafter, any employee of K-Rep Group and its subsidiaries could purchase and sell shares irrespective of length of service from other shareholders.

Trusteeship Model

The shareholders in K-Rep Bank are the K-Rep Group (32.5%), Shorebank (13.2%), IFC (16.7%), AfDB (14%), Tridos Bank (8.6%), FMO (5%) and the K-Rep Group Welfare Association ("KWA") who own 10% of the total shares in K-Rep, a percentage that amounts to 100,000 shares in K-Rep Bank. These shares are held in trust for Trustees who are responsible for managing the ESOP and ensure that the

[7] Actual loan portfolio amounted to Kshs 730.47 Million. Exchange rate is US$ 1 = Kshs 79/=
[8] Actual deposits amounted to Kshs 409 Million. Exchange rate is US$ 1 = Kshs 79/=

shares owned by KWA are managed in accordance with the ESOP. The ESOP requires the Trustees to create units – each unit to represent one share – and to issue the shares to eligible employees.

Purchase of Units
Eligible employees purchased 90% of the units allocated to them. Most of them took advantage of the loan facility offered by KWA to purchase the units. As an added incentive, eligible employees received one free unit for each unit purchased.

Allocation of Units
The allocation of units was based on a formula based on seniority and length of service. So, for example, based on the formula, the Chairman was allocated 12 units, the Finance Manager 9 units and an Office Assistant 2 units. Even though the units were allocated it still remained at the discretion of the particular employee to opt to purchase the units. Upon purchase of all or part of the units that had been allocated to a person of his job grade, the units would be fully vested in him. As of March 2001, the Trustees had allocated 50% of the shares that had been set-aside for the employees within the K-Rep Group of Companies. The remaining 50% of the shares are to be allocated to new employees as and when they join K-Rep and have worked for a period of more than four years.

Bonus Shares
Trustees have the right to issue bonus shares to eligible employees. Each subsidiary in the K-Rep Group is to develop criteria for the allocation of these bonus shares and thereupon submit names of members of staff to be allocated these bonus shares. The criteria to be used for eligibility would include but not be limited to length of service by the employee and the meeting of performance targets. These criteria are still under development.

Rights of Unit Holders
Each unit holder has a right for his/her name to be entered on the register, which register is open to inspection at all times. In addition, unit holders have the following rights:

- To be issued with a certificate for his/her units;
- To sell or transfer units to other unit holders during the annual trade;
- To income, in the form of dividends, from the units, as and when the Board decides to declare dividends;
- To one free unit for each fully paid unit purchased.

Restrictions on Unit Holders
KWA cannot hold more than 25% of the shares in K-Rep Bank and this therefore restricts the number of units that can be allocated to eligible employees. Other restrictions include the following:

- Unit holders cannot sell, transfer, mortgage, charge or otherwise deal with the units.
- No unit holder can hold more than 5% of the available units;
- Unit holders do not have voting rights.

Redemption of Units
Units are automatically redeemed when:

(a) a unit holder ceases to be an employer within the K-Rep Group;
(b) upon the demise of the unit holder; and
(c) upon bankruptcy of the unit holder.

The redemption proceeds are payable within 30 days. An employee is only entitled to 100% of the proceeds from the free units if he/she has completed five years of service. If the period of employment has been less than five years, then the unit holder will be entitled to a proportion of the redemption proceeds according to a pre-defined formula.

Valuation of Units
The auditors of K-Rep Bank determine the valuation of the units, which valuation is based on the Bank's audited accounts. In the eventuality that K-Rep Bank is listed on the Nairobi Stock Exchange, the value of the shares/units shall be determined by the daily quoted offer price on the Stock Exchange.

Trustees
As mentioned before, the Trustees are obliged to administer the units in accordance with the terms, conditions, rules and regulations of the ESOP. To assist them in the performance of their duties they have full power, control and authority over the units. K-Rep Group and K-Rep Bank appoint trustees, who can be individuals or trust corporations. They can be removed or can resign upon receiving or giving thirty days written notice. The present Trustees are the directors of the K-Rep Group.

Source of Funds
CGAP provided technical assistance and a grant for the purchase of 50% of the shares[9] owned by KWA. The individual staff members contributed the balance of the funds for the purchase of shares when they purchased the shares. KWA manages the ESOP. Currently, the funds raised from the ESOP are managed by Barclay Trust Investment Services.

Experience Thus Far
Until three years ago, the K-Rep Group was one entity. It is now comprises of three distinct legal entities, the research arm, the bank and the consulting arm. Nonetheless, K-Rep has managed to maintain a culture of closeness and continually fosters the principle that although the entities within the Group carry out different functions, the Group is still one family. A key way of fostering this culture of togetherness has been by through the ESOP. The directors, management and employees of the K-Rep Group take a proactive interest in the affairs of the Group, in general, and the performance of the bank in particular.

Secondly, all the units that were allocated at the inception of the ESOP were purchased by all the eligible employees. This indicates that not only were the employees interested in participating in the ownership of K-Rep Bank but also that they were willing to do so using their own funds. The employees of K-Rep Group therefore displayed their level of commitment to the transformation of the K-Rep Group from one to three entities.

Thirdly, as employees join the K-Rep Group of Companies and as they become eligible to join the ESOP, very few of them are opting not to purchase shares. The perception is that the new staff members who opt not to purchase shares are not fully appraised of the availability of the option, or of the benefits of an ESOP and of the investment opportunities it presents. At present, the Board is looking into ways to continually educate new employees about the ESOP.

It is still too early to determine the effect of the ESOP as an incentive to employees of the K-Rep Group. The first test of the ESOP will be at the annual trading session, which should provide some insight into this. Nonetheless, the high subscription rate is a positive sign as the purchase of units was purely at the discretion of the eligible employee. Regarding the management of funds by Barclays, this has proved to be quite expensive and the Bank is presently deliberating on setting up an internal process for doing so. Quite clearly, the ESOP serves mainly to foster a sense of common ownership and thus provides motivation in the long run. In order to boost short-term productivity and increase outreach in operations, the Bank is currently developing a bonus plan for the staff members engaged in credit activities.

[9] Those units which were awarded free to employees who bought units.

The Staff Incentive Scheme at Centenary Rural Development Bank (Uganda)

Willibrord Okecho and Martin Holtmann

Institutional Background

Since the mid-1990s Centenary Rural Development Bank (CERUDEB) has evolved into one of the leading MFIs in Uganda. Following its strong tradition of savings mobilisation, CERUDEB has increased its outreach to more than 280,000 depositors. In this, the bank has benefited from fortuitous exogenous events: The closure of Cooperative Bank and the ongoing restructuring of UCB brought in many new customers. The branch network has expanded to 18 outlets, and CERUDEB is now able to serve most of the regional centres of Uganda. The bank started lending to small and micro businesses in 1993, and has since expanded its product range to include agricultural loans and housing improvement loans. While there are a few larger corporate borrowers, the vast majority of loans are extended to microenterprises in the urban and rural areas. CERUDEB uses an individual lending technology, and over the past few years it was possible to achieve and maintain low delinquency rates (PAR has hovered between 1 and 2.5%).

The following table provides a short overview of CERUDEB's balance sheet.

Table 1: Balance Sheet of Centenary Rural Development Bank as at December 31, 2001 (in US$)

ASSETS	
Cash and balances with Central Bank	7,409,350
Balances with other financial institutions	538,777
Investments	23,468,180
Customer advances	14,210,989
Debtors and other asset accounts	2,451,194
Fixed assets	2,647,289
Total Assets	50,725,781
LIABILITIES	
Customer deposits	40,559,188
Managed funds	370,248
Other liability accounts and accruals	2,838,195
	43,767,632
SHAREHOLDER'S INTERESTS	
Share capital paid-up	2,024,474
Share premium	485,969
Capital reserves	105,882
Capital grants	760,141
Retained profits	3,581,683
	6,958,149
Total Liabilities and Equity	50,725,781

While CERUDEB's microlending activities were initially financed by foreign donors, the significant inflow of customer deposits has created a formidable (and currently not fully utilised) source of local funds. During the last three years, the bank has been highly profitable. In a recent rating by Bank of Uganda, CERUDEB was ranked number 2 in the banking system in terms of asset quality, and number 1 in terms of profitability.

Data on CERUDEB's operational performance and financial ratios are contained in the following table:

Table 2: Operational Indicators and Financial Ratios as at December 31, 2001

Number of branches	17
Number of staff	491
Number of loans outstanding	21,815
Volume of LPF ($)	14,192,925
Arrears rate (PAR from 1st day)	2.11%
Avg. loan size ($)	651
Case load per LO	160
Number of depositors	280,458
Volume of deposits ($)	40,559,412
Avg. deposit ($)	145
RoE 2001	27.90%
RoA 2001	3.73%
Capital/Risk Weighted Assets	34.64%

Overview of Staff Incentive Schemes
CERUDEB uses a staff incentive system that is very comprehensive when compared with other MFIs in the region.

Since CERUDEB started its micro lending activities, loan officers were paid a small bonus that depended on their monthly performance. In 1997, the scheme was made more comprehensive by introducing four variables, namely:

1. quality (PAR)
2. processing speed
3. number of outstanding loans
4. number of approved loans

At that time, there was actually a penalty for high levels of arrears, meaning that loan officers would have to make a payment to the bank for exceeding a maximum arrears rate. This practice was later discontinued, and the scheme now consists of the addition of the four separate variables. The lowest possible bonus is zero, but loan officers who do not earn any bonus during a period of several months are given a warning letter (see Annex A for a numerical exposition of the scheme for staff engaged in lending). Bonuses are paid monthly, and are capped at Ushs.300,000 (approximately US$ 176).

Based on the same set of indicators, heads of loans departments and branch managers can also qualify for a monthly bonus. However, the weights attached to the different components in the bonus formula are different from the loan officer incentive scheme. Again, there is a cap of Ushs.300,000 on the monthly payouts.

Parameter	Weight in Loan Officer Bonus Formula	Weight in Branch Manager Bonus Formula
Arrears	60%	30%
Processing Speed	10%	10%
Outstanding PF (# loans)	10%	20%
Approvals (#)	20%	40%

In addition, branch managers, head office supervisors, as well as the general manager of the head office supervision department participate in a quarterly incentive scheme. In this scheme, five different variables are included as performance indicators:

1. arrears (PAR)
2. an audit score (given by the internal audit department)
3. compliance with the profit goal (derived from the branch budgets)
4. speed of returns (statistics and reports) to head office
5. a customer service score.

Items 1. to 3. receive equal weights, and item 4. is given half the weight of the first three indicators. Item 5., which is hard to measure objectively (although regular surveys are carried out by external consultants), is actually added as a bonus to the score derived from the other variables. The scheme allows a maximum bonus of 45% of quarterly base salaries.

After the introduction of the performance-related incentive schemes for staff engaged in lending operations, pressure built up within the organisation to introduce a bonus scheme for all the other banking and support staff. Consequently, a comprehensive bonus system was designed which covers all levels, from the banking officers and accountants to the drivers, cleaners and tea girls. The maximum bonus level was fixed at 45% of the base salary, and the bonus award is granted on the basis of semi-annual staff evaluations. The immediate supervisors conduct the evaluations, but they are cross-checked by two other senior staff members, including the head of the human resources department. Based on the score obtained, employees receive equal monthly bonus payments for the six months following the evaluation. The evaluations contain a self-assessment by the employee and a structured performance review by the supervisor. In the case of general banking staff, for instance, the criteria are: knowledge of work, quantity of work, quality of work, ability to learn, initiative, customer service, personality and discipline, attendance, time management/tardiness, and (development) potential. Grades range from 1 (poor) to 10 (excellent), and the weight of each category ranges from 0.5 to 1.3. The evaluation criteria have been tailored for each function (for instance, the internal auditors are rated according to their ability to comply with the audit schedule and to detect irregularities and frauds[10]), and they broadly follow the job descriptions[11].

In addition to the individual incentive schemes, there is a comprehensive system of "Merit Awards", including employees of the quarter/year, best performing and most improved branches (semi-annual), as well as unit achievement awards and long-service awards. Prizes range from trophies and commendation letters to cash payouts.

In addition to the systems already in place, the Board of Directors has instructed management to investigate the feasibility of implementing an Employee Stock Ownership Plan (ESOP), which would serve as yet another instrument for providing special incentives to staff.

Examples of Bonus Calculations for Staff Engaged in Lending Operations

This section contains the actual bonus formulae that are used in order to calculate the monthly bonus entitlements for staff engaged in lending activities.

[10] There is a reduction in the score if problems or frauds are detected in a branch or department within a certain period after the auditor has conducted his/her work and failed to uncover the issue.

[11] For cashiers, for instance, the criteria include accuracy, punctuality, and the number of transactions processed (this statistics is supplied by the MIS).

a) *Senior Commercial Loan Officer*
Bonus Formula: Without cap = 300,000 x [(M33*0.6) + (N33*0.1) + (O33*0.1) + (P33*0.2)]

Parameter	Abbreviated	Weighting	Compliance Calculation (%)
Arrears compliance Ratio	M33	60%	5% - Actual / 5% - **2%** **obj.= 2% Arrears**
Processing speed Compliance Ratio	N33	10%	6 – Actual / (6 – **3**) **obj. = 3 days**
Number of O/s Loans Compliance Ratio	O33	10%	**Actual – 150** / **200** –150 **obj. 200 Loans**
Number of Approved Loans Compliance Ratio	P33	20%	**Actual** / **50** **obj. 50 Loans**

Currently the maximum bonus is limited to Ushs.300,000.

b) *Junior Commercial/Agricultural Loan Officer*
Bonus Formula: Without cap = 130,000 x [(M36*60%) + (N36*0.1) + (O36*0.1) + (P36*0.2)]

Parameter	Abbreviated	Weighting	Compliance Calculation (%)
Arrears compliance Ratio	M36	60%	⇒ 5% - Actual / 5% - **1%** **obj = 1% Arrears**
Processing speed Compliance Ratio	N36	10%	⇒ 6 – Actual / 6 – **3** **obj = 3 days**
Number of O/s Loans Compliance Ratio	O36	10%	⇒ Actual / **180** **obj = 180 loans**
Number of Approved Loans Compliance Ratio	P36	20%	⇒ **Actual** / **40** **obj = 40 loans**

Currently the maximum bonus is limited to Ushs.300,000.

c) *Senior Agricultural Loan Officer*
Bonus Formula: Without cap = 300,000 x [(M34*0.6) + (N34*0.1) + (O34*0.1) + (P34*0.2)]

Parameter	Abbreviated	Weighting	Compliance Calculation (%)
Arrears compliance Ratio	M34	60%	⇒ 5% - Actual / 5% - **2%** **obj.= 2% Arrears**
Processing speed Compliance Ratio	N34	10%	⇒ 6 – Actual / 6 – **3** **obj. = 3 days**
Number of O/s Loans Compliance Ratio	O34	10%	⇒ **Actual – 120** / **200** –120 **obj. 200 Loans**
Number of Approved Loans Compliance Ratio	P34	20%	⇒ **Actual** / 50 **obj = 50 Loans**

Currently the maximum bonus is limited to Ushs.300,000.

d) *Corporate Commercial Officer*
Bonus Formula: Without cap = 375,000 x [(M151*0.6) + (N151*0.1) + (O151*0.1) + (P151*0.2)].

Parameter	**Abbreviated**	**Weighting**	**Compliance Calculation (%)**
Arrears compliance Ratio	M151	60%	⇒ 5% - Actual / 5% - **3%** **obj.= 3%Arrears**
Processing speed Compliance Ratio	N151	10%	⇒ 14 – Actual / 14 - **7** **obj = 7 days**
Number of O/s Loans Compliance Ratio	O151	10%	⇒ **Actual** / **100** **obj = 100 Loans**
Number of Approved Loans Compliance Ratio	P151	20%	⇒ **Actual** / **10** **obj = 10 Loans**

Currently the maximum bonus is limited to Ushs.375,000.

e) *Heads of Loans Department & Branch Managers*
Bonus Formula: Without cap = 300,000 x [(L57*0.3) + (M57*0.1)+(N57*0.2) + (O57*0.4)]

Parameter	**Abbreviated**	**Weighting**	**Compliance Calculation (%)**
Arrears compliance Ratio	L57	30%	⇒ 5% - Actual / 5% - **2%** **obj.= 2%Arrears**
Processing speed Compliance Ratio.	M57	10%	⇒ 6 – Actual / 6 – **3** **obj = 3 days**
Number of O/s Loans Compliance Ratio	N57	20%	⇒ Actual / 200 **obj = 200 loans**
Number of Approved Loans Compliance Ratio	O57	40%	⇒ **Actual** / **50** **obj = 50 loans**

Currently the maximum bonus is limited to Ushs.300,000.

A Short Evaluation of the Incentive Scheme

Some of the strengths of the system in place at CERUDEB are:

- The staff incentive scheme is comprehensive, and it includes all staff members. This is a reflection of the fact that CERUDEB is a universal bank, providing a variety of financial services to different types of clients. Thus, one of the common drawbacks of incentive schemes designed only for credit staff has been avoided: other staff members who directly or indirectly support the credit function or provide other services for the target group will feel disadvantaged and de-motivated, which consequently lowers their performance (upon which the lending operations also depend).
- At all levels and for all functions, the incentive scheme is transparent and quite simple, so that it is easy for new and existing staff members to understand the system and the “rules of the game” (this assessment was supported by the interviews held with staff members in February 2002).
- Within the lending activities, the incentives of the different functional and hierarchical levels are broadly aligned. While there are different reference levels for the various credit activities (e.g. between commercial and agricultural loan officers), the basic elements of the bonus formulae are always the same. Branch managers and department heads receive similar incentives as their subordinates.

- In line with CERUDEB's overall policy to train and employ staff capable and willing to perform all banking duties the system does not discriminate in favour of any particular group of employees. All banking and administrative staff can receive a bonus of up to 45% of base salaries. Loan officers receive the same base salaries as banking staff, and their maximum bonus has been capped at 45% of the base salary (i.e.Ushs.300,000).
- Generally speaking, the introduction of staff incentive schemes, and in particular the monthly bonus, has had a positive impact on staff morale and productivity at CERUDEB. The scheme is easy to understand and (at least in lending operations) completely based on measurable outputs. Over the years, the bonus scheme has become an integral part of the bank's organisational culture.

At the same time, several aspects of CERUDEB's staff incentive scheme allow room for improvement:

- During the last two years, loan officer productivity has reached a ceiling of between 150 and 180 outstanding loans per loan officer ("case load"). It is fair to assume that the stagnation in loan officer productivity is closely related to the cap on the monthly bonuses that loan officers can attain. This issue is currently being reviewed by senior management.
- Another, closely related issue is the fact that the total compensation package of the loan officers is closely related to that of other banking staff (e.g. desk officers and counter staff in the branches). On the one hand there are good arguments for implementing a uniform salary structure in banking operations. On the other hand, the question arises whether excellent loan officers should be allowed to reach higher salary levels than other staff members, given that they produce and safeguard the bank's assets and generate its main source of income. Again, this issue is under discussion.
- Thirdly, the current appraisal-based incentive scheme for banking and administrative staff is open to criticism since it invariably contains some subjective elements. One way of improving this system would be to supplement the scheme with monthly bonuses on the basis of branch or unit performance. Performance indicators could include deposit and transaction volumes. The advantage of this type of scheme would be to provide additional incentives for teamwork.

Additional Lessons Learned

Over the years, CERUDEB has accumulated considerable experience in the design and operation of staff incentive schemes. But even the widest experience does not guarantee that one will not make any mistakes. CERUDEB's management learned this fact the hard way when it announced to the loan officers in early 2002 that with immediate effect the calculation of the "arrears" variable would be changed from end-of-month PAR to the average PAR during the whole month. The reason for this decision was that the loan officers tended to focus on end-of-month arrears only, and arrears levels were much higher during the middle of the month. The change of policy almost caused a revolt among the loan officers. Almost all of the credit staff, including their branch managers, wrote letters of complaint, and the dissatisfaction with the new policy was so pronounced that it was subsequently scrapped. The lesson here is that while changes to existing incentive schemes may be justified economically, they must be communicated well and "sold" to the affected staff members. Clearly, that was not the case in this particular instance.

The Staff Incentive Scheme at Teba Bank (South Africa)

Koos Kotze

Historical Background

TEBA, The Employment Bureau of Africa, dates back to the turn of the last century and was established to recruit labour for the mines from as far afield as Malawi and Angola. As part of its primary function of recruiting labour for the mining industry, TEBA played a critical role in ensuring mineworkers were able to transmit funds to the rural areas of South and Southern Africa. Out of this initiative TEBA Savings Fund was born. The Fund was set up in 1976 as a trust, and it operated initially as a voluntary deferred pay system in which some of the miners' salaries were transferred from their employer's payroll for access at more than 100 TEBA Ltd field offices in the Southern African region. The Fund effectively augmented the function of a mine paymaster, thus providing an important service to employers, employees and rural communities dependent on earnings from the mines.

Over the years the Fund extended its basic services to provide mineworkers with savings account facilities, which allowed for the voluntary depositing of earnings at savings outlets on the mines. All mineworkers were then able to withdraw cash conveniently, safely and free of charge at any of the TEBA Savings Fund offices situated on the mines or at TEBA Ltd offices in the labour sending areas. TEBA Savings Fund effectively operated in association with TEBA Ltd in the provision of basic financial services to miners.

Since its inception the Fund operated under a restrictive trust deed whose primary objective was to provide dependable and self-funding financial services to mining employers, employees and their beneficiaries. The Fund was granted an exemption from the Banks Act, 1990 and the Income Tax Act 1996 while it operated in terms of this trust deed.

By the early 1990's the Fund began to experience some difficulties in continuing to obtain the exemption from the Banks Act. At the same time major developments were taking place in the broader political and social arena, which led to a new assessment of the functions performed by both TEBA Savings Fund and TEBA Ltd.

The restructuring of the gold mining industry forced employers to reconsider the role they played in assisting retrenched miners returning to the rural areas where the likelihood of obtaining sustainable employment was poor. Labour in the form of the National Union of Mineworkers (NUM) put pressure on employers to explore various options to assist miners who were facing retrenchment.

A view began to emerge amongst some leading lights in the industry for the need to:

- broaden the financial services offered to the employees and their rural based dependants;
- explore options around the provision of health care and retirement benefits more appropriate to rural realities; and
- consider various possibilities whereby retrenched miners could access the opportunities which exist in the rural areas for self-employment or sustainable economic activity.

In 2000 a decision was finally taken that the Fund should apply for a banking license as part of a broader vision to provide micro-finance services to low-income earners and the poor in and around mining towns and the rural areas. The conversion of the Fund into a bank was also to be viewed within the context of the restructuring and refocusing of TEBA Ltd from an employment to a development agency.

The Mineworkers Development Agency (MDA), on behalf of the NUM, the majority union operating in the mining industry, participated in a working group that was established to look at the transformation of the Fund. It was finally agreed that the fund should be converted into a fully-fledged micro-bank whose focus was to grow the market amongst those previously denied access to mainstream financial services such as savings accounts. An estimated 20% of those living in the rural areas have savings accounts while the demand is estimated to be in the region of 44%.

The Formation of Teba Bank
The awarding of a banking license coupled with the change in the trust deed has paved the way for the establishment of Teba Bank. Instead of providing basic services only to mineworkers, the bank is now able to expand its products and services to those beyond the mining industry. New products will include fixed deposit and savings accounts, micro-loans, housing loans and financial management advice to those previously denied such facilities.

In terms of the changes to the trust deed, the bank's sole shareholder is a non-profit trust, which is jointly controlled by the NUM and the Chamber of Mines. This ownership structure is unique in the South African context and will ensure that the bank fulfils its core mandate of providing affordable financial services to the "under-banked". The trust specifies that the targeted customers of the bank will be all employees in the mining industry, their dependants in the rural areas and mining towns and members of the broader rural communities.

The Chamber of Mines and the NUM representatives to the trust have each nominated three trustees who have appointed a board of directors, which comprises 10 non-executive and two executive members. At present the NUM is the sole representative of labour as it is the union that represents the majority of mineworkers. Any dividends earned by the trust can be reinvested into the bank as development finance for new initiatives. The trust allows for up to 40% of the holding companies equity to be sold to external shareholders.

Current Status
The following table provides a short overview of Teba Banks's balance sheet.

Table 1: Balance Sheet of Teba Bank as at December 31, 2001 (in US$)

ASSETS	
Cash and balances with Central Bank	4,350,057
Balances with other financial institutions	77,050,804
Investments	5,791,708
Customer advances	22,472,499
Debtors and other asset accounts	2,751,256
Fixed assets	2,289,016
Total Assets	114,705,339
LIABILITIES	
Customer deposits	77,418,537
Managed funds	-
Other liability accounts and accruals	7,157,691
SHAREHOLDER'S INTERESTS	
Share capital paid-up	2,026,468
Share premium	18,227,845
Capital reserves	
Capital grants	
Retained profits	9,874,797
Total Liabilities and Equity	114,705,339

Data on Teba Bank's operational performance and financial ratios are contained in the following table.

Table 2: Operational Indicators and Financial Ratios as at December 31, 2001

Number of outlets	80
Number of staff	530
Number of loans outstanding	56,847
Volume of loan portfolio ($)	22,472,499
Arrears rate (PAR from 1st day)	3.45%
Avg. loan size ($)	395
Number of depositors	782,586
Volume of deposits ($)	77,418,537
Avg. deposit ($)	99
RoE 2001	11.73%
RoA 2001	2.81%
Capital/Risk Weighted Assets	63.02%

Products and Services

Currently, Teba Bank handles net salaries that are paid into 252,000 savings accounts, and customer deposits amounting to R1 billion (approximately US$ 90 million). Other services now offered to clients include:

- Money transfers
- Loans
- Fixed deposits
- ATMs
- Debit orders

New products under development include:

- Debit cards
- Funeral policies
- Micro business loans
- Savings based loan product

As at December 31st, 2001 Teba Bank now had 530 employees, and the payroll amounts to R55 million. Teba Bank has 10 mining regional offices, with some 80 outlets and 40 ATMs. The Bank is currently expanding beyond the mining sector: 10 East Cape rural offices have been opened with new products: "Grow With Us" (GWU) accounts. These accounts and services are available to the whole community. The entire Teba Bank network is linked by satellite communication and a WAN network across all branches and outlets.

Staff Incentive Schemes at Teba Bank

Teba Bank's main staff incentive scheme is a gain-sharing scheme that was introduced in 2001. The bank has recently designed a new incentive scheme for sales staff (field agents).

The Gain-sharing Scheme

Definition of gain-sharing: Profits in excess of (the annual) target will be shared between the company and its employees.

Purpose of the scheme: The purpose of the Teba Bank gain-sharing scheme is to improve profitability, market share and growth. The scheme is also expected to facilitate Teba Bank's expansion into new markets and improve client service and satisfaction, while enhancing the company's image. The scheme is also intended to increase productivity as well as reduce costs and wastage. To do this, the scheme is designed to align pay with performance, to promote excellence, and to enhance teamwork and employee participation. It is also hoped that the scheme will facilitate the hiring and retention of high-quality staff.

Participation in the gain-sharing scheme (short-term): All permanent employees (pro-rated) are eligible to participate in the Teba Bank gain-sharing scheme. The scheme is uncapped – there is no pre-defined maximum bonus for staff at any level. Awards are distributed two times per year. Distribution levels are:

1. company
2. business unit
3. individual employee

Business units include each regional office, and head office departments such as Finance, Human Resources, Marketing, IT, Internal Audit, Risk, Treasury, etc. (see diagram below for details of the scheme).

Long-term scheme for senior managers: Top management (Executive Committee) does not participate in the gain-sharing scheme. These individuals should focus on the longer term rather than maximizing short-term performance or profitability. Executive Committee managers receive a bonus that is awarded annually by the Bank's Board of Directors.

Characteristics of the Gain-sharing Scheme: Generally speaking, the gain-sharing scheme was designed for a phase of high growth and high opportunities. Payouts to employees may become less substantial if overall profitability declines. Currently, staff members appear to be very content with their bonuses, so the immediate goal of increasing staff motivation has been reached. The proper functioning of the scheme requires accurate, non-inflated budgeting. This can be considered a drawback of the scheme since staff members may not necessarily have trust in the budgeting process (they may fear that the budgeting exercise could be manipulated by management). Likewise, there may be a temptation for staff members who are affected by the scheme to build "soft targets" into the budget. Management intends to allocate more to the individual performance pool in future, and less to the company performance pool. The reason is that the relatively high importance of the company pool may increase the risk of free-rider behaviour.

For the future, there are plans to change to a "percentage share of profits". Certain targets may also be defined as per balanced scorecard objectives.

Currently, there is no specific incentive scheme for middle managers. An additional incentive scheme for middle management may be designed and implemented in the future.

New Incentive Scheme for Sales Staff

The new sales staff scheme is aimed at field officers who actively acquire clients and their business. For field staff, this scheme is in addition to the gain-sharing scheme. The scheme consists of a small fixed salary as well as a performance-based commission, which is paid for loans and funeral policies. Bonuses are based on incoming premiums only. This should ensure quality and prevent a mere focus on quantity. In addition, basic monthly targets (set by management) must be met for the staff member to qualify for the scheme.

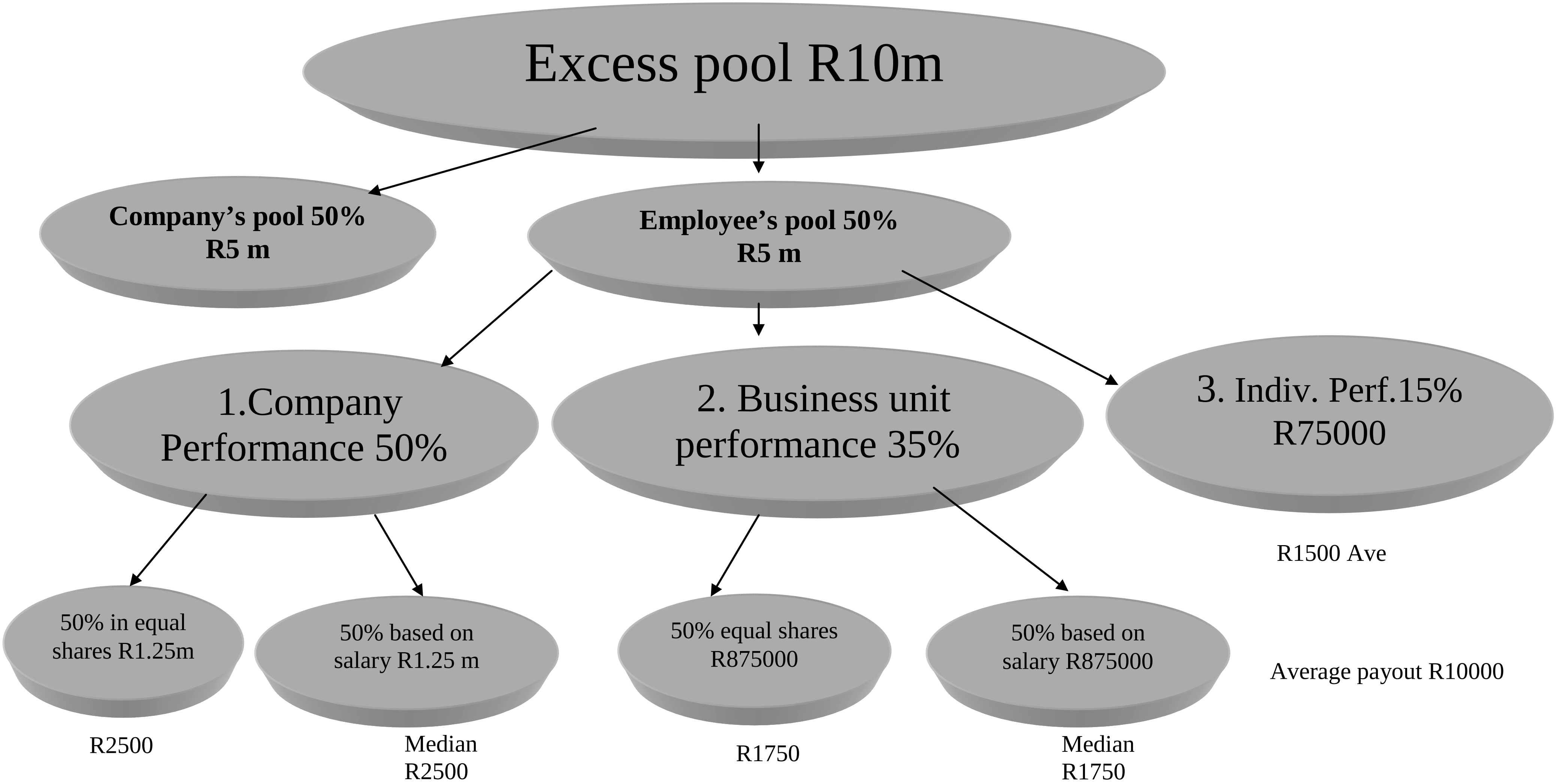
The basic components of the scheme are as follows:

- A high commission for reducing arrears on outstanding loans
- Flat commission on opening a GWU account
- A commission for term deposits comprising a percentage of the interest earned on the investment (regularly reviewed by the finance department)

Regional employees (who are not field staff) share the commission earned on the "walk-in" clients.

Gainshare model

<u>Example</u>: Company profit: R40 Million, Budgeted profits R30 Million. Excess pool = R10 Million



The Incentive Scheme of FINCA Uganda

Paul Segawa

Background of FINCA Uganda

FINCA Uganda is an affiliate of FINCA International of Washington, D.C. It was founded in December 1992 and began its operations in the Eastern part of Uganda. FINCA Uganda provides microcredit to low-income communities, particularly women (who represent 99% of its clients), using mainly a group lending methodology called 'Village Banking', as its core business.

FINCA Uganda is a microfinance institution limited by guarantee and a registered NGO, generally providing non-collateralised credit. The organisation operates in about 50% of the country (26 districts out of 52), mainly in the rural areas.

FINCA Uganda plays an important role as one of the major providers of financial services to disadvantaged women in the country. FINCA can be regarded as a market leader in Uganda, given its outreach of more than 30,000 active borrowers (as per December 2001) and its high market penetration in the regions where it offers services.[12] FINCA boasts of motivated and experienced staff, and a competent management. Generally speaking, FINCA is a success story within the Ugandan microfinance context. There are, however, several significant challenges for the future:

- Uganda has one of the most competitive microfinance markets, at least on the African continent, and several new competitors, as well as some old ones in new clothes, have aggressively moved into some of the regions where FINCA has traditionally offered its services.
- The second, and perhaps much more significant challenge, is the outgrowing of the business model and lending technology that are employed by FINCA - given the very small average loan sizes and the highly structured lending methodology (a reflection FINCA's specific and very successful target group orientation), there is substantial pressure on the organisation to achieve the highest possible levels of productivity and efficiency in order to optimise financial sustainability and provide scope for further lateral (i.e. regional) as well as vertical growth (i.e. portfolio increases in existing regions).
- At the same time, the planned introduction of new, more flexible, and larger lending products can create certain tensions with respect to not losing the original target group focus, which is clearly FINCA's comparative advantage.[13]

Current Status

The following table provides a short overview of FINCA Uganda's balance sheet.

Table 1: Balance Sheet of FINCA Uganda as at December 31, 2001 (in US$)

ASSETS	
Cash and balances with Central Bank	-
Balances with other financial institutions	545,000
Investments	409,000
Customer advances	1,868,000
Debtors and other asset accounts	225,000
Fixed assets	222,000
Total Assets	3,269,000
LIABILITIES	
Customer deposits	33,000
Managed funds	-
Other liability accounts and accruals	976,000

[12] Currently, there are 6 regional offices (Kampala, Jinja, Masaka, Arua, Masindi, Lira)

[13] At USD 62, Finca Uganda's average outstanding loan is exemplary for poverty-oriented financial intermediation.

	1,009,000
SHAREHOLDER'S INTERESTS	
Share capital paid-up	-
Share premium	-
Capital reserves	-
Capital grants	1,027,000
Retained profits	1,233,000
Total Liabilities and Equity	3,269,000

Data on FINCA Uganda's operational performance and financial ratios are contained in the following table:

Table 2: Operational Indicators and Financial Ratios as at December 31, 2001

Number of branches	6
Number of staff	156
Number of loans outstanding	30,457
Volume of loan portfolio ($)	1,906,000
Arrears rate (PAR from 1st day)[14]	27.1%
Avg. loan size ($)	131
Number of depositors	N/A
Volume of deposits ($)	N/A
Avg. deposit ($)	N/A
RoE 2001	5%
RoA 2001	4%
Capital/Risk Weighted Assets	84.4%

Products and Services

The key products provided are mainly the 'Village Banking Loan' product (94% of outstanding portfolio) where loans are provided to individuals in groups of 20 to 40 women, with the group collectively having the responsibility of ensuring that the loan is repaid. The average loan term is 16 weeks, where individuals make weekly repayments to the group and the group pays to FINCA. Group members are also encouraged to save weekly in a group account that is held with a commercial bank. This loan product is also packaged with the provision of portfolio and life accident insurance to all credit clients.

FINCA Uganda is currently testing two other loan products. One is for smaller groups of 5 to 10 members with a significant element of individual flexibility, and the other is an asset-financing product for telecommunications equipment.

As at 31 December 2001, FINCA Uganda had 30,457 active loan clients who were served through 6 regional offices. Though it encourages clients to make savings, FINCA is not a deposit-taking institution.

Overview of the Staff Incentive Scheme at FINCA Uganda

Purpose of Incentive Scheme

FINCA Uganda started working with incentive schemes about six years ago. These were mainly designed for field staff in order to boost their productivity. Field staff constitute 71% of total staff, with the credit officers comprising 60%. The current scheme was introduced in July 2001.The main objectives and

[14] Note FINCA Uganda's Portfolio at Risk at 30 days at December 31st, 2001 was 1.9%

motivation for the current incentive scheme for field officers (credit officers, credit supervisors and branch managers) are:

- To ensure that FINCA increases its actual portfolio yield by having 80% of loan "recaps"[15] as week 16 recaps ("back-to-back recaps") without the risk of losing clients.
- To ensure that there is improvement in and control of portfolio quality.
- To ensure that the credit officers, credit supervisors and branch managers focus on the growth of their programmes in terms of portfolio and clientele.

Currently, FINCA Uganda is testing incentive schemes for support staff and department heads. FINCA Uganda also has a "long services award" as an incentive for working with the organisation for five years.

Design of Incentive Scheme

The performance variables/structure of the incentive scheme is as follows.

Incentive for Credit Officers

- If a credit officer re-capitalises a group in week 16[16] with a minimum number of 30 clients, he/she is paid a bonus of Ush.25,000 per village bank (that is recapped in week 16).
- If a group is recapped in week 17[17] with a loan equal or larger than the group's previous cycle loan and a minimum number of 30 clients, the credit officer is paid a bonus of Ush.20,000.
- Credit officers are paid Ush.25,000 for each group trained and inaugurated with a minimum number of 28 clients.
- Credit officers incur a penalty of Ush.10,000 for any group re-capitalised after week 17. This penalty is accruable indefinitely[18] and is offset against any payable incentive. For example, if a credit officer re-capitalised 5 groups in a given month and all of them were after week 17, the penalty of Ush.50,000 will be carried forward into the following months and is charged off against the earned bonus.
- Currently, the credit officers in the Kampala district area are being requested to recommend some of their clients for the BETA test program of the Self Employment Partnership (SEP) product. Because of the possibility that this will affect their loan amount, credit officers are paid a compensatory incentive of Ush.15,000 for each client they successfully[19] recommend to the SEP program.

Incentive for Credit Supervisors

- Credit supervisors (or someone acting in the position) are paid Ush.10,000 for each group inaugurated with a minimum of 28 clients in their cluster in a month.
- If a group is re-capitalised in their cluster in week 16 with a minimum of 30 clients, supervisors are paid a bonus of Ush.10,000 per village bank.
- If a group in a credit supervisor's cluster is recapped in week 17[20] with a loan equal to or larger than the group's previous cycle loan and with a minimum number of 30 clients, they are paid a bonus of Ush.10,000 for each group.
- Supervisors incur a penalty of Ush.10,000 for any group re-capitalised after week 17. This penalty is accruable indefinitely and is offset against any incentive payable. For example, if only one credit officer in the relevant cluster re-capitalised 5 groups in a given month, and all of them were after week 17, the penalty of Ush.50,000 will be carried forward into the following months until it is charged off by the credit supervisor's earned bonus.

[15] A "recap" refers to the granting of a new loan to an existing group once the 16-week credit cycle is over.
[16] Week 16 recap refers to a recap made any day between week 16 and week 17 (including week 16 but excluding week 17) if the group fully paid up before or in week 16.
[17] Week 17 recap refers to a recap made any day between week 17 and week 18 (including week 17 but excluding week 18) if the group fully paid up before week 17.
[18] The penalty accrued in the prior scheme is to be recovered against earnings in the revised scheme until it is cleared.
[19] A client will be considered usefully recommended if she/he has received a loan under the SEP program. All recommendations must be in writing.
[20] Week 17 recap refers to a recap made any day between week 17 and week 18 (including week 17 but excluding week 18) if the group fully paid up before week 17.

Incentive for Branch Managers and District Supervisors

- Branch managers and district supervisors are paid Ush.5,000 for each village bank inaugurated in their branch or district office.
- If a group is re-capitalised in their branch or district office in week 16 with a minimum of 30 clients, branch managers are paid a bonus of Ush.5,000 per village bank (that is recapped in week 16).
- If a group is recapped in week 17[21] with a loan equal to or larger than the group's previous cycle loan and with a minimum number of 30 clients at the branch or district office, branch and district managers are paid a bonus of Ush.5,000 for each group.
- Managers incur a penalty of Ush.5,000 for any group that is re-capitalised after week 17. This penalty is accruable indefinitely and offset against any incentive payable. For example, if only one credit officer in their branch re-capitalised 5 groups in a given month and all of them were after week 17, the resulting penalty of Ush.25,000 will be carried forward into the following months until it is charged off against the manager's earned bonus.

All bonuses are compiled and paid on a monthly basis. The bonus is paid in the middle of the following month in cash form and included on the payroll at the end of the month as a salary advance. The long service award is paid after 5 years.

This incentive scheme is currently under review. It has had some positive and negative aspects. The negative aspects have compelled FINCA Uganda to review the structure of the scheme.

Positive Aspects of the Incentive Scheme

- The scheme is very simple, easy to understand and implement. Staff know exactly what they need to do to get the bonus.
- The scheme facilitates instant payment of bonuses, allowing for a direct correlation between work done and reward earned, a weakness in some of the earlier schemes used by FINCA Uganda.
- Parameters closely relate to the institutional objectives of increased yield and efficient delivery of services to clients.
- The scheme facilitates performance management on key issues and supports subjective performance reviews.
- The scheme was designed with the participation of credit supervisors, which led to an extensive buy-in by staff members. As a result, when the scheme fell short of expectations in some aspects, there was understanding and patience on the part of staff.

Challenges and Areas that Need Improvement

- Despite the inclusion of the disbursement amount as a parameter in this scheme, it does not specifically address the need to grow and maintain a high portfolio.
- The benchmarks seem to have been set out of range for some of the credit offices in the regions outside of Kampala (the capital). The assumption of generic operations does not hold (see Table 3 below).
- Routine transferring of staff forces some credit officers to take over bad groups. It may take a while for such credit officers to earn an incentive payment, and by that time they may get transferred anyway. This ceases to be an incentive for hard working credit officers (who are the ones that are usually transferred to trouble areas).
- Lack of goal congruence in the different levels - while each level essentially has to try to optimise the same variables, the degree to which they are positively motivated to achieve each of the goals varies.
- The proportion of the performance-based salary is probably too small to provide a sufficient incentive.

[21] Week 17 recap refers to a recap made any day between week 17 and week 18 (including week 17 but excluding week 18) if the group fully paid up before week 17.

Table 3: FINCA Uganda - Bonus Data for Credit Officers, November 2001

Branch	Number of Credit Officers	Number of Credit Officers with bonus	Percentage (%)	Average Base Salary (Ushs)	Average Bonus (Ushs)	Bonus as % of Base Salary
Kampala	34	26	76	466,980	39,423	8.44%
Masaka	12	7	58	512,563	80,000	15.61%
Arua	16	4	25	419,000	38,750	9.25%
Lira	7	0	0	452,714	-	-
Masinde	7	0	0	489,274	-	-
Jinja	28	0	0	457,976	-	-
Total	**104**	**37**	**36**	**467,019**		

Source: own calculations, based on November 2001 payroll data

Lessons Learned From the Design and Use of Incentive Schemes at FINCA Uganda

- Staff respond to incentive schemes. If such schemes are not well thought out and designed, they can have negative consequences.
- The targets set in the scheme should be attainable (though not easily). The scheme must ensure that the credit officer has to go the "extra mile" to earn the bonus. It is also a good idea to aim for a certain percentage of salary that staff can earn as a variable incentive, and - generally - not to cap the bonus.
- Small bonus amounts do not provide sufficient incentives.
- New incentive schemes should always be field-tested/piloted before rollout (not just desk-top testing), in order to ensure that any negative aspects of the scheme are corrected before rollout**.**

Conclusion

Through experience, FINCA Uganda has learned about the benefits of using incentive schemes. Most of the limitations that may come with an incentive scheme can be prevented by proper design and testing it before implementation. Sometimes the scheme may seek to attain certain objectives while compromising others. It is also important to bear in mind that staff may look for an easy way to make the bonus; not withstanding what is being compromised.

The Development of a Credit Officer Incentive Scheme at MF Uganda Ltd[22]
Grace Sebageni

MF Uganda Ltd was established in 1995 and started its Kampala branch lending operation in 1996. The first loan was disbursed in May 1996. It is among the top ten microfinance institutions in Uganda. Outreach currently stands at 11,000 clients, with an outstanding portfolio of Ush.2.2 billion (approx. US$ 1.3 m). MF Uganda Ltd has a high market penetration along the Kampala, Entebbe and Mukono corridor.

This paper focuses on the incentive scheme of MF Uganda Ltd and addresses the following issues:
- Why the scheme was introduced
- How it has developed
- Key lessons that have been learnt along the way

Introduction
It has been a long established and proven fact that incentive schemes (or performance based remuneration) directly impact employee performance. In the microfinance industry this is critical because the industry is labour intensive. All microfinance institutions look to increase or maximize productivity and become sustainable and profitable. Critical to achieving this objective is the commitment of staff at all levels, but more especially the staff at the profit centres of microfinance institutions (the branches). It was for these reasons that MF Uganda Ltd introduced the incentive scheme presented in this paper.

The First Incentive Plan (Plan 1)
An experimental incentive-based pay plan was started in the last quarter of 1998. The plan was implemented and tested through June 1999 and evaluated in July. The incentive plan was initially introduced only at the front line level (credit officer level) and rewarded three measurable areas of performance (see Table 1 below):
1. Number of active loans
2. Effective on – time repayment rates
3. Timely and accurate completion and submission of weekly reports to the data processing centre

As a first model, these levels of performance were measured and the incentive payment due was calculated on a monthly basis, but financial remuneration was paid quarterly. At the same time that the incentive scheme was introduced, minimum performance standards were set for credit officers (based on 1-year, 2-year and 3-year levels). It was anticipated that the incentive scheme would drive credit officers and motivate them to reach these performance standards. At this point, it was also made clear that increments on incentive payments would replace ordinary salary increments i.e. the credit officer remuneration would be based on a fixed pay and a growing incentive system that would reward a credit officers performance rather than years of service. The reasoning behind this was that as the incentive scheme kicked off and started growing, better performance would automatically attract a higher take home package. In effect, incentive pay increments were to replace normal salary increments.

Table 1. PLAN 1 (Figures used are for illustrative purposes and do not represent actual figures)

No	Incentive payment	Incentive amount for repayment rate					Data Processing Centre	Range of incentive payment		Base Salary
Loans	Loans	96%	97%	98%	99%	100%	Time	Low	High	
25	5000	5000	10000	15000	20000	25000	2000	5000	32000	250000
55	10000	10000	15000	20000	25000	30000	4000	10000	44000	250000
85	15000	15000	20000	25000	30000	35000	6000	15000	56000	250000
115	20000	20000	25000	30000	35000	40000	8000	20000	68000	250000
145	25000	25000	30000	35000	40000	45000	10000	25000	80000	250000
165	30000	30000	35000	40000	45000	50000	12000	30000	92000	250000
195	40000	35000	40000	45000	50000	55000	14000	40000	109000	250000
225	50000	40000	45000	50000	55000	60000	16000	50000	126000	250000
255	60000	45000	50000	55000	60000	65000	18000	60000	143000	250000
285	80000	50000	55000	60000	65000	70000	20000	80000	170000	250000
305	90000	55000	60000	65000	70000	75000	22000	90000	187000	250000
335	100000	60000	65000	70000	75000	80000	24000	100000	204000	250000

[22] MF Uganda is the disguised name of a real MFI.

The incentive payment represents the amount that was paid to the credit officer for the number of outstanding loans at the time the payout was made (in this case, at the end of every month). The incentive payment due to a credit officer was calculated at three levels:

1) ***The number of outstanding loans*** If the credit officer had 54 outstanding loans, he would receive a bonus of Ushs.5,000 using the above scale. If however the officer had 55 or 56 outstanding loans, based on this indicator, he would receive a bonus of Ushs.10,000.
2) ***The repayment rate*** If the credit officer with 54 outstanding loans had a repayment or recovery rate of 100% (meaning that all that was due for the period had been recovered) he would receive an additional bonus of Ushs.25,000.
3) ***Submission of forms on time*** Delays in data processing were taken very seriously by management as they had far reaching negative repercussions in the Operations Department that could range from delayed loan disbursements to delayed tracking of fraud. If the same credit officer with 54 outstanding loans submitted all his forms and paperwork to the Data Processing Centre on time, he would receive an extra bonus of Ushs.2,000. Late submission of any document cancelled the timely submission benefit.

The "range of incentive of incentive payment" refers to the range of payments that a credit officer with a given number of outstanding loans could receive. **Note that the level of all benefits was derived from the number of loans outstanding**. A credit officer with less than 25 loans out would receive no incentive pay, whilst a credit officer with 285 loans would receive between Ushs.80,000 and Ushs.170,000 depending on performance.

***Example*:** If Tom, had 193 outstanding loans with a recovery rate of 96% and had submitted two forms late to the data processing centre, his incentive payment would be Ushs.30,000 (loans out) PLUS Ushs.30,000 (repayment rate) PLUS Ushs.0 (timely submission). If the recovery rate were to drop to 95% for the period, Tom would only receive a bonus of Ushs.30,000 based on the number of outstanding loans.

Problems with Plan 1

The plan seemed to work well for the newer staff but not the older ones. Although growth was steady in the beginning, problems soon developed. The older staff in particular complained about the failure to recognise portfolio size. They argued that they were managing bigger risk yet some newer loan officers with many small size loans would take home more money than the older staff.

Whereas this plan rewarded on-time repayment and growth, no one took the time to consider how these incredible repayment rates that were now being seen were being achieved. A later analysis showed that the rate of "tapping" compulsory savings to make up repayments had gone up significantly and was threatening the cohesiveness of some groups. One example is given below.

Peter's Problem

Peter, always seen as an excellent credit officer on the payment rate indicator (consistently at 100% effective on-time repayment rate) suddenly had a portfolio-at-risk indicator of 18%. The entire management team took notice. How could a solidarity group credit officer with a repayment record consistently at 100% suddenly exhibit such a high level of portfolio-at-risk? Closer examination of his portfolio showed that his clients' savings deposits had dropped considerably as he continually tapped into the savings to cover late repayments.

Although tapping client savings was always meant to be a last resort measure, he had obviously made it a habit to use it as a first resort measure. The one time he failed to tap his clients' savings, the portfolio-at-risk indicator shot up dramatically without any prior warning. His personal interest had overshadowed his commitment to the group and the organisation. His intention was to get the maximum incentive payment possible at all costs. Management then began to examine other credit officers' portfolios and similar tendencies were found in a significant number of them. In response to this situation, and to the overall evaluation of the plan, Plan 2 was launched.

Plan 2

This plan was similar to plan 1 but had one new addition, the "Group Internal Default rate" indicator. This indicator was developed to track default and arrears within groups where loans have been paid up through credit officer transactions authorising the tapping of client savings. The MIS tracked how a loan was closed (ie. whether it was closed by the client finishing off their liability themselves or whether the solidarity group made the payments by transfer from their savings accounts, a process normally called "tapping"). The rate of tapping was referred to as the Group Internal Default rate and was highly discouraged because though it was always the easier option for a credit officer dealing with a defaulting client, especially when driven by an incentive scheme, excessive tapping could potentially destroy group cohesion

Table 2. PLAN 2 (Figures used are for illustrative purposes and do not represent actual figures)

No	**Incentive payment**	**Incentive amount for repayment rate**					**Data Processing Centre**	**Group Internal Default Rate < 2%**	**Base Salary**
Loans	Loans	96%	97%	98%	99%	100%	Time		
25	5000	5000	10000	15000	20000	25000	2000	3000	250000
55	10000	10000	15000	20000	25000	30000	4000	6000	250000
85	15000	15000	20000	25000	30000	35000	6000	9000	250000
115	20000	20000	25000	30000	35000	40000	8000	12000	250000
145	25000	25000	30000	35000	40000	45000	10000	15000	250000
165	30000	30000	35000	40000	45000	50000	12000	18000	250000
195	40000	35000	40000	45000	50000	55000	14000	21000	250000
225	50000	40000	45000	50000	55000	60000	16000	24000	250000
255	60000	45000	50000	55000	60000	65000	18000	27000	250000
285	80000	50000	55000	60000	65000	70000	20000	30000	250000
305	90000	55000	60000	65000	70000	75000	22000	33000	250000
335	100000	60000	65000	70000	75000	80000	24000	36000	250000

The computation in the above table is exactly the same as in Table 1. The only difference was the introduction of the GID rate, where tapping stayed within the 2% limit an additional bonus was given out to the credit officer.

Problems with Plan 2

The credit officers were at this point growing their portfolios significantly and they began to make strong demands that their portfolio sizes also be considered for reward in the incentive plan. They argued that based on the incentive system that did not factor in the portfolio size, the difference in incentive pay between a credit officer holding a portfolio of Ush.100 million and a credit officer holding a portfolio of Ush.40 million was not significant. Moreover, if the Ush.40 million portfolio was made up of very many small loans and the Ush.100 million portfolio had a mixture of small and big loans, the credit officer with the Ush.40 million portfolio could earn a bigger incentive than the credit officer with a Ush.100 million portfolio. At this point in the development of the incentive scheme, the more mature credit officers started leaving the organisation. It was clear that something had to be done quickly. The "lean, mean and profitable'' strategy that MF Uganda Ltd had adopted was not working.

Plan 3

Plan 3 was developed in an attempt to try and address the above concerns. This plan represented a fundamental and significant shift in the development of the incentive scheme.

Incorporated in this plan were the following (see Table 3 below):

1. Portfolio size was recognised for the first time and rewarded.
2. Portfolio-at-risk, which had by now been understood to be a better measure of portfolio quality than the repayment rate, was used.
3. The base pay was improved.
4. The incentive was to be paid on a monthly basis.

Table 3. PLAN 3 (Figures used are for illustrative purposes and do not represent actual figures)

No	**Incentive payment**	**Incentive amount for P.A.R (1 – 30 days)**					**Data Processing Centre**	**Port. Size (000s)**	**Incentive for port size**	**Base Salary**
Loans	Loans	4%	3%	2%	1%	0%	Time			
25	15000	5000	10000	15000	20000	25000	2000	5000	5000	350000
55	20000	10000	15000	20000	25000	30000	4000	10000	10000	350000
85	35000	15000	20000	25000	30000	35000	6000	15000	15000	350000
115	40000	20000	25000	30000	35000	40000	8000	20000	20000	350000
145	45000	25000	30000	35000	40000	45000	10000	25000	25000	350000
165	50000	30000	35000	40000	45000	50000	12000	30000	30000	350000
195	60000	35000	40000	45000	50000	55000	14000	35000	35000	350000
225	70000	40000	45000	50000	55000	60000	16000	40000	40000	350000
255	80000	45000	50000	55000	60000	65000	18000	50000	45000	350000
285	90000	50000	55000	60000	65000	70000	20000	60000	50000	350000
305	100000	55000	60000	65000	70000	75000	22000	70000	55000	350000
335	100000	60000	65000	70000	75000	80000	24000	80000	60000	350000
350	120000	65000	70000	75000	80000	85000	26000	90000	65000	350000
365	130000	70000	75000	80000	85000	90000	28000	100000	70000	350000

By the time Plan 3 was launched, all the credit officers were on the verge of stopping work. They had actually threatened to take a collective strike action. The relationship between credit officers and management was at an all time low, staff morale had collapsed and management was facing a crisis.

In Table 3 above, the Portfolio at risk rate replaced the repayment rate. The portfolio at risk rate was regarded as a more inclusive measure. Another significant change was the rewarding of portfolio size.

Example: Going back to Credit Officer Tom. Assume that his performance under the third scheme shown above was exactly the same as it was in the first table example given above ie. 193 loans out with 96% recovery rate and late submission. Assume also that he had a portfolio worth Ushs.15,000,000 and a portfolio at risk rate of 5%. His incentive would be calculated as follows:
Ushs.50000 (loans out), PLUS Ushs.0 (P.A.R), PLUS Ushs.0 (timely submission), PLUS Ushs.15,000 (portfolio size). The recovery rate would not be considered.

In all cases, the incentive payment was then added to the credit officer's base salary. Because the monthly payroll had to be prepared on time, the incentive due was always paid out one month in arrears so that the December payroll would include November's incentive payout. There was limited room for a supervisor's or branch manager's discretion when authorising an incentive payout if a credit officer's performance had very obviously been affected by circumstances completely out of their control (eg. natural disasters or catastrophes such as floods, fires etc).

Did Plan 3 perform better than the first two plans?
Plan 3 performed significantly better than the first two plans. The net effect was that it made a significant difference to the take home pay of the credit officers, for the first time portfolio size was rewarded. Although the group internal default rate indicator was removed, branch managers as they calculated credit officers' incentive payments, were reminded to look out for this indicator as an added measure of the overall health of a portfolio. Credit officers were encouraged by the new plan to keep a healthy mix between portfolio size and spread (number of loans out). The new plan allowed at maximum capacity for the credit officer to take up to 95% of their salary in a given month in incentive payments (creating a possibility for a loan officer to almost double their salary). The targets set were challenging and difficult but not impossible to reach.

Recent Developments in MF Uganda Ltd's Incentive Scheme

Following positive trends in the productivity levels of solidarity group portfolios directly related to the incentive plan, incentive schemes have also been designed for the following categories of staff:

1. Individual Loan Credit Officers
2. Relief Credit Officers
3. Branch Managers
4. Operations Managers
5. Support staff in the Data Processing Centre

This paper does not go into the finer details of the development of these other staff incentives. They were all developed in recognition of the need at the operations level of the institution.

Individual Loan Credit Officers

The individual loan was introduced in June 2001. The best solidarity group credit officers were selected and trained to handle this product, the dynamics of which are quite different from the solidarity group loan. An incentive scheme was developed for this category of credit officers in November 2001. It is still being tested and changes may be made depending on how it performs. The major difference between this scheme and the solidarity group scheme is that more weight has been attached to the portfolio size than to the portfolio spread. Although both are rewarded, the emphasis in this scheme is significantly on the portfolio size indicator. To understand this difference, look again at Plan 3 and triple the figures in the incentive for portfolio size column.

Relief Credit Officers

The relief (or stand in) credit officers do not have a portfolio, but each branch has a minimum of one relief credit officer at any given time. The relief credit officer steps in when credit officers are sick, on leave, off duty or out of office for any other reason. The relief credit officer also plays a critical role in quality control of portfolios, checking on their status in the absence of the regular credit officer in charge. MF Uganda Ltd recognised the importance of this position and attached a bonus compensation to this it. The bonus compensation is a fixed amount over and above the normal monthly salary that is paid out to the relief credit officer on condition that:

1. the quality of the portfolio that is being covered is maintained or improved, but not lowered during the absence of the regular credit officer; and
2. the relief credit officer hands in all relevant paper work, accurately done to the Data Processing Centre on time (i.e. accurate and timely submission of paperwork for data input.)

Credit Officer Supervisors and Branch Managers

Incentive schemes were developed for these supervisory levels in 2001. They have been grouped together because they capture and measure the same indicators and are linked. These indicators are:

1. Branch targets met - portfolio
2. Branch targets met - number of active loans
3. Branch targets met - number of loans disbursed in a month
4. Portfolio at risk
5. Average group internal default rate at the branch

The operations manager in consultation with branch managers set performance targets for branches. The branch manager and credit officer supervisor planned how to grow the branch to meet these performance targets. The supervisor's and manager's incentive payments are paid quarterly as at this level strategic decisions are made and the effects of these decisions, including their success or failure can only be judged over a longer period of time.

Linked Incentive Penalties

A recent development on the incentive scheme at the operational level has been the linking of incentive penalties. Specifically, if a single credit officer attains a portfolio at risk of 5% and above, the credit officer loses any incentive payment due that month. More significantly however, if a branch returns an average branch portfolio at risk of 5% and above, no staff member in that branch, not even the manager, receives any incentive payment for the given month.

The measure was brought in to revive teamwork and a joint approach to problem solving in the branches, both of which appeared to have been forgotten when the incentive scheme was launched. With the introduction of the first incentive scheme, some of the better performing loan officers had started acting like lone rangers. This did not improve when the scheme became more attractive. The result of the linked incentive penalty has been a new team spirit in problem solving and performance accountability.

Operations Manager

Like the branch manager, the operations manager is rewarded for the overall performance of the branches. Incentive criteria are as for the branch managers and supervisors.

Support staff in the Data Processing Centre

Because timely and accurate reports are important for the profit centres, an incentive scheme has also been introduced in the data processing centre, to encourage staff to produce accurate and timely reports for use by credit officers and managers. An accurate and timely reporting system is critical to most successful microfinance institutions.

What are the key lessons that have been learnt about the development and implementation of incentive schemes at MF Uganda Ltd?

- *Incentive schemes improve performance*

There is an obvious relationship between performance and incentive based remuneration. Apart from the experience at MF Uganda Ltd there is a lot of literature and experiential evidence to support this.

- *Incentive schemes should be developed by a team*

There is great benefit in using a team-based approach in the development of these schemes. This approach, apart from the obvious (or not so obvious in some cases), involvement of both top and middle managers, is the involvement of the operations department. It is equally important to get feedback from the staff members who are supposed to work with the scheme.

- *If the institution is focusing on mass outreach, the driving force in an incentive scheme should be the number of loans out*

This indicator should be weighed more heavily than others. This approach is suited to microfinance institutions that have real concerns about mission drift as they seek to attain sustainability.

- *Individual loan officers are better rewarded by an incentive scheme where the greater weight is placed on the portfolio size indicator*

However, this should be balanced against their portfolio spread (albeit with a smaller weight) so as to reduce the risk of having too few clients with extremely large loans.

- *The incentive payment should always be separated from the normal salary payment.*

Credit officers at MF Uganda Ltd explained to management that where the incentive payment and the salary payment were not clearly separated, the “feel good factor” from performing well on the incentive scheme was reduced. If not changed, this would render the scheme ineffective.

- *Poorly designed incentive schemes can have negative results*

Incentive schemes that reward repayment rates can pose a considerable threat to solidarity groups as credit officers are tempted to use clients’ savings to solve repayment problems each time. This seriously undermines savings mobilisation and threatens group cohesion. Managers or supervisors managing staff where this indicator is measured need to constantly monitor the overall health of the groups to ensure that tapping clients’ savings is only used as the very last resort. This may mean that a credit officer loses some money as attempts are made to deal with payments in arrears.

- *Management should make an effort to ensure that an incentive scheme does not kill the spirit of team-work*

Linking incentive schemes encourages common problem solving. One person’s problem becomes everyone’s problem. The institution gets the benefit of many minds, especially when dealing with complex situations. From MF Uganda Ltd’s experience, it may even minimize the risk of fraudulent behaviour in the relationship between front-line staff and clients.

- *Incentive schemes work best in an environment with healthy communication channels*

Apart from management monitoring the effect of these schemes on overall performance indicators of the organisation, it is important that when staff members complain about any aspect of the scheme, management listens. At MF Uganda Ltd, in the days of the first and second incentive schemes (Plan 1 and 2), complaints from credit officers were very common. After Plan 3, these complaints reduced considerably and what is happening now at MF Uganda Ltd is that the changes being made are only improvements (i.e. in cash benefit amounts) and not major changes to the overall presentation of the scheme. Getting to this stage has taken a good amount of time (about three years). Management has learned to listen and respond to problems as they arise.

- *Incentive payments due should always be paid on time*

Delayed payments affect staff morale, especially where, as is common in the microfinance sector, salary levels are not high.

- *Incentive schemes should be transparent, easy to understand and compute*

A staff member should be able, based on the calculation models developed (copies of which should be made available to all the concerned staff members), to calculate their own expected incentive payment before they receive it. Once received it should tally with what they were expecting. Any difference should be addressed expeditiously to see where any error could have occurred. At MF Uganda Ltd, incentive payments due at the branches are displayed for all the staff members to see. All staff members at comparable levels should be able to calculate each other's incentive payments due. This has not only promoted a healthy competitive spirit amongst the staff, but also exhibits high levels of transparency and equity.

Areas of expected future development

In conclusion, it must be understood that the design, development and implementation of an effective incentive scheme is an on-going process. This is so because organisations are dynamic and always changing, as is the market place.

As of February 2002, management at MF Uganda Ltd is looking at the following as regards the incentive scheme:

1. *Rewarding for client retention:* This is designed to reduce the client exit rate – a perennial problem for East African MFIs.
2. *Larger cash benefit jumps at critical performance indicator benchmarks*: This would make a high-performing credit officer take a significantly different value based pay package than a low- or middle-performing credit officer. Until now, the cash benefit jumps have been more or less uniform. Where they are not uniform, they are still not significant enough.
3. *Negative incentive for late or inaccurate paperwork*: This would include taking away money for late or inaccurate documentation, which disorganises the reporting system and delays or inconveniences other staff members in the process.
4. *Branch rewards*: Over and above the normal incentive payment, a proposal is being looked at for rewarding the best branch (quality) with a cash benefit to be shared among the staff. The definition of what constitutes the best branch is still a matter of debate because at any given point in time, some branches are more mature than others. An alternative proposal has been that a reward be given to all branch staff from a small, pre-determined percentage of the profits the branch makes in a given year. Both proposals will be studied by the management team and recommendations will be sent to the Board of Directors for a final decision.

The Evolution of A Staff Incentive Scheme: What Did Staff Think?
Case Study of Finance For All (FFA) - A Microfinance Institution Operating in Africa

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Background
MicroSave conducted research at a leading African MFI interviewing 20 selected staff members. For reasons of confidentiality we shall refer to this MFI as Finance For All (FFA). FFA currently has over 30,000 clients offering a solidarity group loan as their main product. The average group size is of 30 members and the loan term is 16 weeks.

Staff interviewed included loan officers, two supervisors and two branch managers. The team conducted research in three branches covering both rural and urban locations. The team used individual interviews, focus group discussions and an open-ended self-administered questionnaire.

The research objective was to understand staff knowledge and attitudes towards the three incentive schemes FFA has used and to obtain their suggestions for improving the current scheme.

At the time of the interview FFA had modified its incentive scheme over three times with mixed results. They are currently in the process of revising their latest incentive scheme with the help of ***MicroSave***.

This paper will be divided into two:

- A description of the evolution of the staff incentive scheme, staff attitudes towards the scheme and their suggestions for improving it.
- Major findings and lessons for designing staff incentive schemes.

The Evolution of the FFA Incentive Scheme and Staff Attitudes at Various Stages
FFA introduced the first incentive scheme 5 years ago after becoming aware that staff incentive schemes have proved to be invaluable across many companies seeking to achieve selected corporate goals.

The First Incentive Scheme
The first scheme was designed to motivate staff to work towards achieving a sustainable portfolio; build teamwork between credit officers and supervisors; maintain a low portfolio at risk; and reduce the high levels client attrition (exit). The staff was enthusiastic and got ready to cash in on the opportunity.

First Incentive Scheme
The first scheme faced severe problems, partly because it was too complicated but also because it was introduced whilst FFA was migrating to a computerized MIS system. The variables for measurement included the value of the portfolio (with adjustments for rural, peri-urban, and urban groups); portfolio re-capitalization in week 17; the number of clients; and the repayment rate. The greatest weight was attached to portfolio size. The incentive scheme was designed to reward both the individual loan officer and the team, so that 50% of the payment went to the loan officer with the rest going to the team.

Staff indicated that they were extremely enthusiastic however, that initial excitement was dampened by the slow speed at which the MIS and finance department calculated and paid the incentive payouts. They became disinterested and dismissed the scheme, working as if there was no incentive scheme. After about 12 months FFA suspended the scheme.

The process of data compilation was so laborious that it was impossible to pay the bonus on time. Many loan officers were suspicious that the MIS and Accounts departments were deliberately sabotaging them because they were not beneficiaries to the scheme. This was made worse by the fact that the incentive scheme generated more work that had to be delivered expeditiously.

Discussions with the management revealed that the problem stemmed from the complexity of the scheme. The scheme had too many variables. This was exacerbated by the on-going conversion from manual to a computerized system, which not only produced inconsistent calculations but also stretched MIS staff time.

Although the scheme failed, a good proportion of staff interviewed felt that the concept design had some fine points. Sharing a portion of the incentive scheme as a group, though susceptible to the "free rider" syndrome, encouraged a team spirit. They, however, felt that the 50% portion going to the group was too high and suggested a reduction to 25%-30%. This would address the free rider problem and tilt the scheme towards rewarding individual effort.

Staff also felt that the emphasis on portfolio size in the first scheme was tempting many loan officers to hastily issue increasingly larger loans with little regard to risk assessment. In some areas, this caused high PAR that took many months, if not years, to clean up. Loan officers expressed the opinion that the first scheme failed to balance the variables that drive FAA's overall corporate strategy.

Credit with Reckless Abandon

"Some of the loan officers engaged in recklessly extending large loans as they strove to achieve the incentive. This was an easy strategy for the unscrupulous among us because of the periodic rotation policy. They knew they would not be around the same area long enough to pay for their sins. The resultant problems were felt for a very long time especially by those dispatched to clean up the mess"

- A loan officer at an upcountry branch

Second Incentive Scheme

The second incentive scheme sought to address the shortcomings of the first scheme. It was a simpler, more transparent scheme, which loan officers could easily compute, and the MIS department could compile with greater speed. The new scheme offered rewards based on the timeliness with which groups were given new loans after completing the old loans, otherwise known as "re-capitalisation" and growth in number of clients served. It also sought to include the supervisor and branch manager.

The Second Incentive Scheme

If a group received a new loan within in week 16 (i.e. immediately after completing the last loan), the loan officer earned a $10 dollar bonus. The bonus was $7 for disbursements made in week 17. A penalty of about $3 was levied for every group re-capitalised after week 17. Loan officers were also given $15 for each new group they inaugurated.

In terms of simplicity and transparency, most staff felt it was a remarkable improvement from the first incentive scheme. Loan officers could easily tell how much bonus they were owed without waiting for the finance and MIS departments.

Keep It Simple

"It was extremely important for us to be able to calculate the bonus ourselves. Some of us had become suspicious of the finance and MIS people. We feared they would maliciously make complicated computations designed to deny us the bonus. You see they were doing a lot more work yet were not benefiting from the scheme. Some of them were jealous".

- A loan officer in the city

The downside of the second scheme was the minimal attention it paid to portfolio size and how open it was to manipulation. In order to get the incentive payment, loan officers would quickly "exit" (i.e. dropout) all clients with delayed payments in order to recap within the coveted 16 weeks. This opened a floodgate of dropouts - perhaps the highest rates FFA has ever experienced – all largely driven by the loan officers forcing out any clients with delayed repayments.

Clients Outs – Bonus In!!!!

"Although this scheme had some improvement, it was open to disastrous manipulation in terms of balancing off client savings as well as increasing exits. The new scheme was completely insensitive to the need for maintaining client numbers and portfolio size. Many loan officers started expeditiously "exiting" clients with delayed payments. With the incentive payment in sight, patience was suddenly in short supply. Others opted to tap client savings in order to cover arrears. This strained client-staff relations and client loyalty in some groups hit an all time low. We were set for a crisis at some branches."

- Branch manager

Branch managers and supervisors were given a target of forming seven new groups in their geographic territory each month. They were to be rewarded with $70 if they achieved this target. If less than seven new groups were inaugurated there was no reward. For each new group inaugurated in excess of the target seven the supervisor received an additional $10.

Supervisors received a penalty of $7.00 per group re-capitalised after week 17. However, because this penalty was cumulative and could only be offset by earned bonus, the incentive scheme eventually lost its power to influence the actions of some supervisors. This was even harder for those officers stationed in perennially difficult areas (since the target of seven was set for all regions) where groups were prone to delayed "re-capitalisation".

Another problem was that the best officers were often sent to solve problems in tough areas – where they were less likely to earn incentive payments. Thus officers who hitherto were getting incentives were forced to lose them – essentially because of their excellent performance. This was clearly a negative incentive and could potentially have pushed some officers to under-perform for fear of being "promoted" to tough areas. Most staff felt that the incentive scheme needed to be differentiated according to the peculiar territorial challenges. They believed that those deployed to resolve problems should be compensated for the opportunity cost of moving to a difficult area. In addition, they felt that they needed to be incrementally rewarded for progress made in problem solving.

De-motivation, Disincentives and Day Dreaming

"Many of us operate as if there is no incentive scheme. We were sent to resolve problems. Apart from losing potential incentives, we were buried so deep under the "negative cumulative incentive" that any thought of ever getting an incentive is nothing but day dreaming"

- A supervisor in a historically difficult area.

Third Incentive Scheme

Realising the shortcomings of the second scheme, FFA embarked on a new design. Unlike the previous schemes designed solely by top management, there was a radical departure because the third scheme was designed in a much more participatory way - involving branch managers and various levels of supervisors.

Staff felt that the participatory approach was very important. Unlike in the past, staff felt they were in position to take credit for the success of the scheme and responsibility for its weaknesses. Some staff felt that this approach could have been even more consultative, involving a good number of loan officers.

The Need for A Participatory Approach

"The staff incentive scheme design should be participatory. The people at headquarters are out of touch with the field realities and therefore cannot design a successful scheme. Although the consultation could have involved a few more people and was a little long, we applaud them for adopting a more inclusive approach. Then we share in its success and the responsibility if it fails."

- Loan officer at an upcountry branch

The scheme primarily sought to continue pursuing the goal of timely re-capitalisation of groups while at the same time placing new emphasis on portfolio growth and client numbers (to attempt to address FFA's perennial drop-out problem). These two factors had been inadvertently ignored in the previous schemes and were progressively moving towards a crisis situation.

The salient features in the new incentive scheme design included a focus on client retention, timely repayments, portfolio quality and growth, and the need to graduate good clients to a new product[23].

The Third Incentive Scheme

For groups recapped at 16 weeks with a minimum of 30 members and a loan size equal to or larger than the previous amount, the loan officer received an increased incentive payment of about $18. A slightly smaller reward was given for a re-capitalisation in week 17. Loan officers were rewarded with $18 for each new group inaugurated with a minimum of 28 clients.

Although many loan officers believed this was a move in the right direction, they were equally unanimous in adding that it was a very difficult goal to achieve and therefore undermined the intention of the incentive scheme. Most loan officers believed that groups with such a large number of clients were only achievable in some urban areas. However, the fact that it stopped the tendency by loan officers to aggressively "weed out" clients was not in doubt and this was recognised and applauded by most of the field staff.

To emphasize the need for growth in client numbers, loan officers were rewarded with $18 for each new group inaugurated with a minimum of 28 clients. This was according to most officers, an equally steep challenge that very few were able realise.

Noble Causes …

"It was a noble ambition, however, getting 28 people is not easily achievable."

– A loan officer

In order to maintain the focus on timely re-capitalisation, the penalty for re-capitalisation after week 17 was increased to $7. This penalty was cumulative and would be offset by future earned bonuses. Staff views regarding this remained ambivalent. A good proportion felt that just as it was in the beginning, a cumulative penalty ultimately works against staff motivation for most people working in tough areas. A smaller proportion felt it forced them to work harder.

There are several loan officers who felt that unlike the first incentive scheme, which focused on profitability as reflected by portfolio size, this scheme focused on profitability as reflected by the group size. They felt that the portfolio size needed to be factored back into the design in order to have a balanced range of considerations that impact the strategic direction of FFA.

Profits DO Matter...

"It is true that the first scheme had an undue emphasis on portfolio profitability. However this is an important variable. It should be factored back into the scheme".

– A long serving supervisor

The third incentive scheme also sought to encourage staff to recommend their good clients to a new and more attractive product – Loan for Smaller Groups (LSG). Each successful transfer earned the officer $8 per client. There were various reactions to this including resentment as a result of the special status (including a higher salary) the LSG staff were accorded and the arrogance projected by some of them as a result.

Several loan officers were unabashedly clear they would never promote the LSG product under the present arrangement. Many felt they could only promote LSG if they themselves were given the chance to offer the product. "It is a superior product to the ordinary [large group] product and gives FFA a

[23] This new loan required smaller groups (five) and offered longer and more flexible term structure. It was offered by a special unit independent of the main unit operating the large group loans

chance to be more competitive" In fact many expressed the fear that it would eventually "kill" the large group loan product.

Why We Cannot Promote the New and Superior Product

"Under the present arrangement, I cannot transfer my good clients the LSG team. Good clients glue the group together and give me hope for earning a bonus! There is a local saying 'Why eat the egg instead of waiting to have a whole chicken'. Besides the LSG officers are pampered. Unlike us, they do not go to the trenches and slums chasing after clients. They simply wait in their comfortable air-conditioned offices for us to hand them our best clients. And what do we get in exchange? a few shillings and a lost chance to get an incentive payment. And what do they get? – A higher salary and a bigger incentive".

- A loan officer in the City

Additional Observations and Lessons

This section covers a few additional observations and general lessons learnt from the entire experience.

Although most staff reported that the financial incentive scheme system was a good idea, only 25% of the staff interviewed indicated they were motivated by the incentive scheme bonus. One should not conclude that most FFA staff is not motivated by financial rewards. In-depth interviews revealed that the reasons for this low figure were:

1. The design of the incentive scheme; and
2. The nature of loan officers FFA recruits

Because most of the schemes were designed with very high, almost unachievable goals, most of the staff eventually lost interest and disengaged from the financial incentive scheme. They were motivated more by factors other than financial rewards.

Many staff reported being motivated by the sense of being part of a team empowering communities and making a difference among poor hard-working women. For many of the loan officers, the big boost to morale comes from clients expressing appreciation for the services. Others felt that the challenge and opportunity for self-supervision was a motivating factor that enables them to realise personal growth. Transport and medical allowances and participating in FFA organized social events were also very important motivators for the majority of staff.

Beyond Monetary Incentives …

"When a client says, 'thank you teacher for the services you render' and I see them able to finance their needs! That keeps me going!"

- Loan officer

Related to the above, it was clear that a good proportion of the staff FFA attracts and retains feel called to work to alleviate poverty and therefore *financial gains, though important, often become secondary*.

FFA staff are also motivated by other factors. FFA should explore *non-financial incentives* like recognition awards. This might include such things as certificates of achievement that track a variety of performance variables and recognise branches that have made significant progress towards achieving these. Although non-financial incentives are not a perfect substitute for financial rewards, they will go a long way in making staff feel appreciated and recognized for work well done.

In addition, many FFA staff believed that the incentive scheme pushed them into a *higher tax bracket, which wiped out not only the bonus but also part of the previous earnings*. Discussions with management however, indicated that this was a misconception, partly because most of the staff had never qualified for an incentive. FFA needs to design a scheme with achievable targets so that staff can evaluate it based on their own experience.

Also, most FFA staff interviewed believed that schemes go wrong when they do not *involve staff in the design process* but are instead handed down from headquarters. Although schemes can go wrong even with the involvement of staff – as is the case with the current scheme – it helps to involve staff because they take ownership of the scheme and therefore share in the blame if it just does not work right. For this reason, it is very important to involve staff at all levels even when they have limited technical knowledge needed to design an effective scheme.

Get Staff Involved

"Staff at the head office feel they know it all. The bad news is that they do not! Excluding us (field staff) resulted in overlooking the need to balance and track critical factors like – size of portfolio, number of clients – thus leading to high drop out rates, a host of ghost clients and other problems we could have avoided"

– An upcountry loan officer

Staff felt it was extremely important to design the scheme in a manner that *makes it easy for staff to compute the expected payment and enhance transparency*. As indicated earlier, a large number of staff interviewed viewed the finance and MIS staff who computed the incentive payments due with great suspicion.

Equally important to staff was the need to have a *different incentive scheme for difficult markets*. Otherwise "staff in such areas might never taste the bonus" until they are transferred. This is especially true for top performers sent to sort out problems in troubled branches. The scheme should be designed to incrementally reward small progressive achievements. This will also help address, to a certain extent, the prevalent perception within FFA that there is favouritism when staff are assigned to new territories. "If the management does not like you they send you to Siberia until you shape up and become likeable."

A good number of staff advised, "*a good incentive scheme cannot redeem a non-competitive product.*" FFA should reflect on the need to re-design the large group product offering or allow all staff to offer the Loan for Smaller Groups. Many staff members indicated that the FFA product was not as attractive as the competitor's offering especially in the urban areas. There is evidence that clients are already moving to competitors who offer more user-friendly products. This means that even with the best incentive scheme, a non-competitive product is an impossible proposition.

Finally staff felt that it is extremely important for FFA to *examine the impact of introducing any new product under the existing incentive scheme*. Staff will only promote products that do not work against their interests. Such was the case with the LSG. FFA needs to pay close attention to the impact of introducing new products under existing incentive schemes especially during the product design and pilot-testing phases.

Conceptual Issues

Staff Incentive Schemes – The International Experience

Martin Holtmann

There is little dispute among microfinance practitioners that a well-designed staff incentive scheme can have a positive and powerful effect on the productivity and efficiency of the MFI's operations. Nevertheless, despite the practical relevance of the topic, very little systematic research has been carried out to date. This is perhaps symptomatic for the whole topic of human resources in microfinance, which has by and large not been awarded much prominence in the microfinance literature. The ***MicroSave***/ECI workshop in Pretoria is the first international conference of microfinance practitioners (and of a network) focusing exclusively on staff incentive systems.[24] This paper attempts to give a short (and necessarily selective) overview of the international experience with staff incentive schemes.

Staff Incentive Schemes Outside the Microfinance Industry

In many of the more "traditional" industries, monetary and non-monetary performance-related incentives for employees are a common element of compensation policies. To name just a few examples:

- Computer and software firms such as IBM have long used sales compensation plans that pay employees' commissions based on individual performance.
- Procter and Gamble, now one of the largest consumer goods companies in the world, introduced a profit sharing plan for staff in 1887 (!)
- Sear's Auto Centres (a division of Sears, Roebuck & Company) were forced to change their incentive compensation program in 1992, after there was an avalanche of customer complaints. Employee compensation had been based on the amount of repairs that customers authorised. It is not surprising that staff became adept at "detecting" problems so that in many cases unnecessary repairs were carried out.[25]

Also, the widespread use of special incentive schemes for senior management, especially in the form of stock option plans, has caused considerable (and often controversial) public debate. A few months before the (in)famous Enron Corporation became bankrupt, one of its top managers cashed in on stock options worth US$61 million that he had been awarded as part of a long-term executive compensation plan. Recently, it emerged that the former CEO of ABB, a huge power and engineering conglomerate, had received a retirement package worth €100 million.[26] The ensuing scandal forced him to return the "bounty" to his former employer. While such excesses (or horror stories) will force shareholders and directors of large corporations to scrutinize and possibly revise the bonus and benefits packages offered to their senior managements, there is no question that performance-related pay will remain an important element of the compensation strategies of most major firms and corporations.

Staff Incentive Schemes in MFIs

As was pointed out in the introduction, staff incentive schemes are still something of a "blind-spot" in microfinance. Most of the available data are anecdotal and limited to specific MFIs, and so far no systematic research has been conducted on this topic. The MicroBanking Bulletin, for instance, does not collect any systematic data regarding staff remuneration and incentive schemes. Apart from Marguerite Robinson's contribution to the 1997 MicroFinance Network conference and Craig Churchill's description of some staff incentive schemes as examples of success factors in individual lending, not much has been written about the subject to date.[27]

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[24] The 1997 Annual Conference of the MicroFinance Network in Alexandria, Egypt, included a session on staff issues in microfinance.

[25] Noe et al. (1997): 488

[26] Financial Times, February 18, 2002

[27] M.S. Robinson (1997): Staff: preliminary thoughts on how to retain good staff in MFIs. Paper presented at the MFNs 5th Annual Conference, held in Alexandria, Egypt: http://www.bellanet.org/partners/mfn/egypt/staff.html, C.F. Churchill(1999): Client-Focused Lending. The Art of Individual Lending. Toronto and Washington, D.C.: Calmeadow. An early contribution to the topic was: C. Stearns (1993): Monetary Incentive Schemes for Staff. Bethesda, MD: GEMINI and USAID.

Among microfinance practitioners, however, the issue of appropriate incentive schemes for staff has occupied a not insignificant degree of prominence for a long time.[28] Also, it seems that a recent debate in the MicroBanking Bulletin has somewhat renewed the industry's interest in the subject.[29] In any case it is a promising sign that a network of the calibre of ***MicroSave*** is beginning to develop a toolkit for the development of staff incentive schemes.

Some Basic Industry Parameters

Microfinance has evolved as one of the most popular development and poverty reduction tools. Apart from such "pioneers" as BRI, BancoSol and Grameen Bank, there are countless microfinance organisations worldwide: the 1997 Microfinance Summit in Washington counted more than 1,000 MFIs with more than 1,000 clients each. While the industry is still dominated by NGOs, there has been an increasing trend towards formalisation. Recent data from the MicroBanking Bulletin, probably the most comprehensive compilation of industry data, highlights the fact that while some progress has been made in achieving the two main goals of microfinance, namely outreach and sustainability, a lot still remains to be done. Out of the 148 participants from 53 countries (who on average represent a rather strong subgroup of the total industry membership) 57 are financially self-sufficient. The average financial self-sufficiency ratio stood at 89.8%, and the average portfolio yield at 38.1%. Average expenses as a percentage of the loan portfolio amounted to 30.4% - a significant improvement when compared with the early 1990s, but still very high. An even more substantial improvement is denoted by the average portfolio at risk above 90 days of arrears of (only) 2.1%. Still, the average adjusted return on assets was –3.7%, a proof that there is still a long road to achieving full sustainability. In light of the strongly positive relationship between staff productivity and (financial) efficiency a closer study of the design and efficacy of staff incentive schemes appears more than appropriate.

The International Experience

Introduction

In the absence of any systematic research and empirical data on staff incentive schemes in microfinance, the following sections attempt to derive insights as well as some basic lessons from the study of a sample of MFIs that the author has been able to study and gather data on.[30] Hopefully, the future will bring more complete compilations of such data. Nevertheless, the following case studies, which make extensive use of stylised facts, should help us to draw at least some tentative conclusions regarding the use of staff incentive schemes in MFIs. The following sections contain several empirical findings as well as a set of (preliminary) conclusions.

Empirical Finding # 1: Many Leading MFIs Use Staff Incentive Schemes

A cursory study of the microfinance industry suggests that many of the leading organisations use staff incentive schemes. To economise on space, this article draws on a selection of examples from Asia (BRI and Acleda Bank) and Latin America (Banco Ademi and several MFIs in Bolivia). Also, most of the ***MicroSave*** partner organisations (Action Research Partners) in East and South Africa have implemented some form of staff incentive scheme. Another noteworthy fact is that MFIs in Asia seem to use monetary staff incentives schemes to a smaller extent than their counterparts in Latin America, Africa, and Europe. Nevertheless, there is ample evidence that many (and probably the great majority) of the most productive organisations have employed staff incentive schemes.

Empirical Finding # 2: There Is a Wide Variety of Incentive Schemes in Use

If we research the issue beyond the mere fact whether an organisation uses any staff incentive scheme and inquire as to its exact nature, we will realise that there are many different systems in use. In fact, no two organisations use exactly the same scheme, even if they belong to an international or regional

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[28] As evidenced by the fact that the topic is included in Bob Christen's Microfinance Handbook: R. Christen (1997): Banking Services for the Poor: Managing for Financial Success. Washington, D.C.: Acción.

[29] E. Bazobery: We aren't selling vaccum cleaners: PRODEM's experiences with staff incentives, and: M. Holtmann: Designing financial incentives to increase loan officer productivity: Handle with care!; both articles were published in the MicroBanking Bulletin 6 (2001); http://www.microbanking-mbb.org

[30] This work is part of an ongoing research project by the author of this article at the Universities of Frankfurt and Trier, Germany.

network. In order to demonstrate the enormous variety of staff incentive schemes at the international level, the following short case studies present a number of short facts about some leading MFIs.

Bank Rakyat Indonesia (BRI) – Unit Desa System

- 4,007 Unit Desas (microfinance outlets)
- 2.65 million borrowers (all individual loans)
- More than 12 million depositors
- High degree of product standardisation
- Basic performance measure: unit profits
- New units given two years to break even
- Extremely decentralised structure (Head Office: 64 staff members, 4,000 units with more than 21,000 staff members)
- Main staff incentive scheme: profit sharing plan
  6% of unit profits are shared among unit staff (typically 4), up to 2.5 times monthly salary
- Also: Intensive Development Program
  Awards semi-annual cash prizes based on achievements
- Heavy emphasis on training

Acleda Bank, Cambodia

- 14 branches, 671 staff members
- 77,000 borrowers (mostly groups)
- Loan portfolio: US$ 21 million
- 1,700 depositors (savings product only introduced recently)
- Staff incentive schemes:
  1. Annual Merit Pay
  2. Profit Center Bonus (if RoE>20%)
  3. Employees (400) hold approx. 6% of share capital
- Relatively high staff turnover, profit goal difficult to achieve for business units

Banco Ademi, Dominican Republic

- 27 branches, 240 staff
- 18,000 borrowers (individual loans)
- Loan portfolio: US$ 55 million
- 16,227 depositors
- Staff incentive schemes:
  1. Performance-based monthly bonus for loan officers (staged scheme)
  2. Profit sharing: 10% of annual profits distributed to all employees
  3. Employee Stock Ownership Plan (ESOP): Staff hold 20% of share capital and have seat on Board of Directors
- Average RoE during last three years: >50%
- Staff turnover: almost nil.
- Good example of a very simple bonus system that appears to have performed remarkably well.

Illustration: Components of Bonus Formula at Banco Ademi

The monthly bonus for the loan officers is calculated on the basis of three variables:

1. Delinquency: Above a portfolio at risk of over 4%, loan officers do not earn any bonus on this variable. Starting at 4%, an ascending bonus is paid for each full percentage point less (i.e. <4%, <3%, etc.).
2. Number of outstanding loans: Starting at 130 outstanding loans, a bonus is paid. Again, this bonus is increased in stages as loan officers build up larger numbers of outstanding clients. The maximum bonus is reached at 151 clients and above.
3. Volume of outstanding portfolio: Similar to point 2 above, except that the monetary value of the outstanding portfolio is used to measure loan officer performance.

The bonus is added up every month and paid out in addition to the base salary.

The Bolivian Microfinance Industry, December 2001

- With Bangladesh, Bolivia (especially La Paz) is one of the most competitive microfinance markets
- The industry leaders are BacoSol, Caja Los Andes, FIE and Prodem, all of them highly productive

- Recent institutional data (December 2001) show impact of delinquency crisis

	Number of loans	**Loan Portfolio ($m)**	**PAR > 30 days**
BancoSol	61,338	81.1	12.67%
Los Andes	43,530	52.6	5.97%
FIE	23,173	27.5	7.12%
Prodem	22,534	33.6	4.51%
Source: Asofin			

- Staff incentive schemes: all of the leading Bolivian MFIs have staff incentive schemes
  BancoSol: Monetary incentives for loan officers, plans for an ESOP
  Caja Los Andes: Individual incentive scheme for loan officers and branch managers, profit sharing scheme for top management and regional managers
  FIE: Individual incentive scheme for loan officers (was recently changed from quarterly to monthly payout)
  Prodem: Reject short-term monetary incentives (bad experiences), opted for long-term incentives instead (see article by Eduardo Bazobery in MicroBanking Bulletin)

Partner Banks of IMI AG

- IMI is an investment company, funded by private and public shareholders (www.imi-ag.de)
- Currently, the company holds shares in approximately 20 MFIs
- Staff incentive schemes:
  1. All of the investee MFIs use performance-based bonus schemes for credit staff
  2. Some banks have developed schemes for other banking operations (deposits, money transfers, cashiers, desk officers)
  3. Some banks are experimenting with schemes for middle management, especially branch managers
  4. One bank has introduced a scheme for top managers

Empirical Finding # 3: The Introduction of an Incentive Scheme Can Have Dramatic Effects on Institutional Performance

Again we will make use of a set of short case studies to derive some stylised facts and a set of conclusions.

Example #1: WWB Cali, Colombia

- After introducing a performance-based bonus system for the loan officers, productivity improved significantly and now stands at the top of the industry (644 outstanding clients per loan officer, individual lending)[31]
- Simultaneously, other important changes were introduced (individual lending technology, regional zones for loan officers, new MIS)
- Effect of new staff incentive scheme is therefore impossible to isolate, but most likely very positive (based on interviews at the time of implementation of the scheme)

Example #2: Constanta Foundation, Georgia

- Group-based lending technology, approx. 10,000 clients (one of the larger lenders in the former CIS)

[31] T. Farrington (2000): Efficiency in Microfinance Institutions. In: MicroBanking Bulletin, 4 (February 2000), pp. 18-23

- Following worrying delinquency problem in 2000 (PAR reached 9%), introduced performance-related incentive scheme for field staff; heavy emphasis on portfolio quality
- Result: dramatic reduction in overall delinquency, down to 1.5%
- Side effect: Salaries of excellent loan officers make it unattractive to apply for supervisor job

Example #3: Downscaling Commercial Banks in Russia and Kazakhstan

- EBRD-sponsored downscaling programs attempt to reach the target groups of small and microenterprises through a number of participating commercial banks
- Introduction of performance-related bonus pay in participating banks has had very positive effects on loan officer productivity (on average 30-50%)
- Important side-effect in downscaling: changes in loan officer remuneration may force bank to re-engineer the whole salary structure

These cases are only a small sub-sample of all the many instances in which staff incentive schemes were introduced by an MFI in order to deal with a perceived problem or to improve staff performance. In interviews with managers of microfinance institutions the following objectives are commonly mentioned as reasons for introducing staff incentive schemes:

1. Reducing loan delinquency[32]
2. Enhancing productivity and efficiency
3. Improving outreach and ability to cover costs (profitability)
4. Attracting and retaining excellent staff

Summary of the International Experience

Given the dearth of systematic empirical data on the subject it would be inappropriate to give a definitive summary of "the" international experience. The use of staff incentive schemes in microfinance is as varied and heterogeneous as are the organisations that provide microfinance services to their clients. Nevertheless, based on the available evidence and the research carried out by the author, we can make a number of preliminary conclusions:

Worldwide, many (but not all) of the leading and most productive MFIs use some form of staff incentive scheme. This notion, however, is not supported by the Asian context, where a much smaller percentage of MFIs employ some form of monetary incentive program. It seems that the majority of schemes in place were designed to enhance asset quality and staff productivity. Generally speaking, all of the leading and most productive MFIs have excellent and highly motivated staff, and there is some evidence that well-designed staff incentive schemes can be useful and powerful motivators. Finally, while there are many similarities between the staff incentive schemes that we encounter in practice, no two are the same. In other words: ***while highly productive MFIs seem to be homogeneous in that they use a staff incentive scheme, these schemes themselves are extremely heterogeneous***. A lot of further research will be needed to produce more insights into this topic.

[32] Centenary Bank's first implementation of a loan officer incentive scheme was motivated by similar external pressures as the one at Constanta Foundation: The scheme was primarily designed to cut back delinquency, and indeed, PAR was reduced dramatically subsequent to its implementation (see case study on CERUDEB in this reader).

Principles for Designing Staff Incentive Schemes
Martin Holtmann

This article attempts to summarise what might be termed the “state of the art” in the design of incentive schemes for staff members of microfinance institutions. We do not ask here under which circumstances such schemes are necessary or appropriate, or what might be the advantages and disadvantages of monetary incentive schemes as opposed to other incentive mechanisms. Rather, we investigate what would be the most important principles for the design of monetary staff incentive schemes, once the decision has been taken to implement such a scheme. After introducing some basic definitions from human resource literature, we will look at factors that influence the choice of staff incentive schemes. The following section presents several critical design issues for incentive schemes. After developing a simple typology of incentive schemes we then make an attempt at suggesting adequate schemes for the different occupational groups in MFIs. We conclude with a list of common mistakes in the design of incentive mechanisms and an effort to derive some basic lessons.

1. Concepts and Definitions from the Human Resource Literature

If incentive schemes are to be effective, they must be accepted by those who will be affected by them. From the rich body of literature on human resources management[33] we learn that the following factors are important criteria that staff members take into consideration when judging their own remuneration:

- *Distributive fairness*: Here an employee might ask: ”How much do I receive – and how much do I receive in comparison with my peers?”
- *Procedural fairness*: “What is the process that was used in order to decide how much I receive?”
- According to the *equity principle*, employees believe that they should be paid according to their contributions to the organisation.
- The principle of *status consistency* demands that salaries should (at least roughly) reflect the staff members’ positions in the organisational hierarchy. In other words, superiors should receive higher salaries than their subordinates.

Obviously, some of the concepts mentioned above are related not so much to economics but to social psychology. As a matter of fact, human beings are not only motivated by money but also by social status (here: their status within an organisation). The design of an organisation’s compensation system can then have important effects on the overall motivation of its employees. One example of this phenomenon is the issue of *salary dispersion* versus *salary compression*. In a system of salary compression, the difference between the highest and the lowest salary in the organisation is smaller and not allowed to go beyond a certain limit. For example, at Ben & Jerry’s (a famous and very successful ice cream manufacturer), the ratio of the highest to the lowest salary was not allowed to go above 7:1. Clearly, this type of compensation policy is supposed to signal to all staff members that “we are all sitting in the same boat”, and that there are no (or at least fewer) barriers between management and ordinary employees.

If we adapt the insights of human resource theory to the specific context of incentive schemes for MFIs, we can postulate that such incentive mechanisms should be transparent and fair.
The *transparency* requirement means that:

- Staff members affected by a bonus scheme should easily be able to understand the mechanics of the calculation, i.e. the system should not be overly complex
- The scheme should contain as many objective factors and as few subjective variables as possible
- The “rules of the game” should be made known to everyone and should not be changed arbitrarily

In order to comply with the *fairness* requirement:

- The goals (or reference standards) set out by the scheme must be attainable (for the average performer and at least in the medium term)

[33] Examples are: Raymond A. Noe, et.al (1997): Human Resource Management. Gaining a Competitive Advantage; James Baron and David Kreps (1999): Strategic Human Resources. Frameworks for General Managers; Charles Greer (2001): Strategic Human Resource Management. A General Managerial Approach; Luis Gómez-Mejía, David Balkin and Robert Cardy (2001): Managing Human Resources; and Gary Dessler (2001): Human Resource Management.

- Better performers must indeed be rewarded with higher salaries (and this must be perceived by all staff members)
- Everyone should be able to achieve a higher compensation by working better and harder

2. Factors Influencing the Choice of Incentive System[34]

When deliberating what would be an appropriate system of incentives for a particular organisation, it may be useful to analyze the following factors:

- *Technology*: Are that tasks interdependent or independent from each other? Can the tasks (and thus the performance of individual employees) be measured? For example, according to these criteria, there are substantial differences between the delivery of credit under an individual lending technology (mostly independent and measurable tasks) and the provision of deposit facilities in a branch setting (tasks may be interdependent and difficult to measure).
- *Composition of Workforce*: What is the occupational mix of the workforce (i.e. what levels of education and professional training)? What is the demographic composition? How long have the staff members served in the organisation? For instance, university graduates may be motivated by different factors than staff members with only a basic education. Young, unmarried staff members may seek different rewards than older staff members who have to take care of children.
- *Culture*: What is the value that is placed on openness and transparency? Do staff members enjoy self- management?[35] What is the importance of money? Some cultures may place a very high value on money while its prominence may be reduced in others. Again, this may have consequences for the choice of compensation and incentive system.
- *External Environment*: Examples are the levels of unionisation, social norms, and a host of other legal issues, including labour laws and worker co-determination. For example, some Latin American MFIs have introduced profit sharing schemes for their employees - not because they wanted to provide special incentives to their staff members but because they were legally forced to do so.[36]
- *System of Governance and Strategy*: Finally, it is important to study the system of governance in the particular organisation as well as the institutional strategy. Who defines the mission and direction of the MFI and what are the mechanisms of control? What is the degree of decentralisation? Care must be taken to design an incentive scheme that will support the respective institutional strategy.

Careful analysis of the above items will most likely help to prevent costly mistakes and unnecessary revisions of incentive schemes. Mapping the particular MFI according to this framework will provide useful clues as to the proper design of incentive mechanisms.

3. Critical Design Issues for Staff Incentive Schemes

In this section we will look at some basic design parameters of staff incentive schemes. In other words, if the board and management of an MFI are prepared to implement a performance-based incentive scheme, the following issues will need to be addressed, among others:

Timing

In general, it is useful to introduce a financial incentive scheme only when staff have received sufficient training. Making (and correcting) mistakes is, however, an essential part of the training process. Practical experience suggests that staff should become eligible for participation in bonus schemes approximately six months after joining the organisation. Before that, they should just receive a fixed (trainee) salary.

Frequency of Incentive Payout

Here the important point is that the incentive payout (for instance a bonus) should not be construed by the staff members as an entitlement, i.e. as a fixed and regular part of the monthly salary. Rather, there must be a clear understanding that the payout is entirely dependent on the performance of the individual (or group) during the reference period for which the bonus is awarded. Obviously, shorter time intervals such

[34] The following typology is adapted from James Baron and David Kreps (1999): Strategic Human Resources, Chapter 2.
[35] This issue is related to the point above: university graduates may place a higher value on self-management than staff members with lower educational levels.
[36] In Bolivia, for instance, this system is called "la prima".

as monthly bonus payments increase the risk that staff members might consider the performance-related pay component as an entitlement. But it is also fair to assume that the impact of a bonus pay on staff productivity will be higher if the reference and payment intervals are shorter. In practice, we observe that monthly and quarterly bonus payments dominate. If the bonus formula is elastic, (i.e. if it reacts strongly to changes in output), staff members will receive different bonuses from month to month, so that the risk of an "entitlement mentality" should be controllable. Under the assumption that the goal for introducing a bonus system is to make a positive impact on productivity, annual bonus payments would not make much sense. It would be more than difficult for staff members to relate their

reward to any particular efforts during the time period for which the bonus was paid. The same argument applies to semi-annual bonus schemes.

Weight of Bonus in Total Remuneration

This is a rather complex issue, and the answer depends to a considerable extent on cultural factors, such as the willingness of present and future potential staff members to accept risks. Clearly, it is important to avoid the extremes: if the variable portion of the monthly or quarterly salary is too high (therefore creating a high degree of income risk for the staff members) most "normal" people would not want to work under such a system. As a consequence, extreme risk seekers would be attracted to the job – such phenomena (called "adverse selection" in the economic literature) are obviously not desirable for MFIs. On the other hand, if the variable part of the salary is too insignificant, the bonus system as such will simply not have any influence on the behaviour of the staff members – which would also not be a desirable result of the incentive scheme. In practice, we find that the weight of the bonuses for credit officers ranges anywhere from 20% up to 50% of total compensation. For non-credit staff, the weight of the bonus is typically not quite so high, but again it needs to be significant in order to have an effect. A final note on this issue is that – if given a choice – most of us would prefer a smaller degree of risk regarding our income streams rather than more uncertainty. But experience in Eastern Europe (where employees had previously received very uniform fixed salaries) shows that credit officers often enthusiastically support a well-designed performance-related incentive scheme once they realise that there are indeed substantial rewards for above average performers. A little psychology can also help: managers are well-advised to introduce incentive schemes gradually and with ample notice and information to all affected staff members.

4. Typology of Incentive Schemes

The following simple typology is intended to acquaint readers with some of the basic forms of incentive schemes for staff members in MFIs. Given the space constraints, this overview is bound to be selective. We will concentrate on those mechanisms that are most commonly used in practice.

Individual Incentive Schemes

Under an individual incentive mechanism, there is a direct link between individual performance and remuneration. A simple example would be a monthly bonus that loan officers can receive based on their lending performance.[37] Individual incentive schemes can have several drawbacks:

- They can lead to a rather narrow focus, i.e. the affected staff members will tend to maximise their own output and income. Such self-interested behaviour may negatively affect the common goals of the organisation.
- The focus on individual income (maximisation) may reduce staff members' intrinsic motivation.
- It is often difficult to distinguish properly between individual and group performance. Measurement problems can compound this difficulty.
- There is evidence that merit pay (the best performers receive a pay raise) is often linked to the position of the affected staff members in the organisational hierarchy: those on the higher levels may receive bigger salary increases simply because of their position and not so much because of their real contributions to the overall company results.[38] The credibility of such systems would be at risk since the affected staff members would not perceive them as fair.

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[37] Examples for this type of scheme are given in M. Holtmann (2001): "Designing Financial Incentives For Loan Officers: Handle With Care!"

[38] R.M. Kanter (1987): Frontiers for strategic human resource planning and management, p.14

From a design perspective, then, individual incentive schemes mostly make sense if:[39]

- The output of the individual is easy to measure;
- Employees have a certain degree of autonomy;
- There is no need for close cooperation between staff members, and competition between them is even beneficial for the whole organisation; and
- The organisational culture favours the achievement of the individual.

Clearly, these factors will apply mainly in an individual or group lending environment, where loan officers bear full responsibility for building up and maintaining a portfolio of clients and loans.

Team-Based Incentives (Group Incentive Schemes)

The goal of group-based incentive schemes is to increase the social cohesiveness of the staff and to foster good cooperation and team effort. Among the most important drawbacks of such schemes is the free-riding effect: If the payout of the individual depends on the performance of the whole group, there is a huge temptation to reduce the individual contribution. While smaller groups can usually effectively identify and deal with "free riders", the issue is much more difficult to control in larger groups. Another potential drawback of group incentive schemes is that intergroup rivalries may now substitute the individual rivalries that are an outgrowth of the individual incentive schemes. Neither type of rivalry will be very beneficial for the organisation.

Again, from a design perspective, some factors that favour the introduction of a group-based incentive scheme are:[40]

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

Employee Stock Ownership Plans (ESOPs)

In the world outside of microfinance, ESOPs are widely used in order to enable employees to acquire partial ownership of their firms. In 1992, there were 11 million employees in the United States who were part of an ESOP. Also, more than 90% of all Japanese firms with a stock market listing have an ESOP in place.[41] ESOPs may be attractive tools for motivating staff members because of their positive symbolic and motivational effects. Through an ESOP, employees become owners, so that it should be easier for the staff members to internalise the interests of the firm. However, from the point of view of risk diversification, ESOPs may not make much sense: effectively, they compound the risk of the individual employee in the case of bankruptcy. Apart from losing their job and regular income, staff members who are shareholders will also lose some of their individual wealth. Another potential criticism of ESOPs is that they are typically one-time incentive mechanisms that are probably not very well suited to boost operational performance over the longer term. In the microfinance industry, the experience with ESOPs is still rather new and scant. More time and research will be needed before any conclusions can be made on their efficacy.

Profit Sharing and Gainsharing Schemes

Profit sharing has a long tradition (a profit sharing scheme was introduced by the U.S. American firm Procter & Gamble in 1887) and is institutionalised in some Latin American countries. Positive effects of profit sharing schemes can be an increase in the sense of identifying with the organization and reducing the barriers between employees ("us") and owners ("them").

[39] This section is adapted from Luis Gómez-Mejía and David Balkin (1992): Compensation, Organizational Strategy, and Firm Performance, Chapter 9, here: p. 260-261

[40] Luis Gómez-Mejía and David Balkin (1992): Compensation, Organizational Strategy, and Firm Performance, Chapter 9, here: p. 264-266

[41] Raymond A. Noe, et.al (1997): Human Resource Management. Gaining a Competitive Advantage, p. 500

But profit sharing schemes also have a number of potential problems. They provide a very weak connection between the performance of the individual and his/her reward. Individuals are not able to exercise any control over the generation of the annual profit, and free rider problems will invariably arise. Also, institutionalised profit sharing plans reduce the flexibility of the organisation to send positive monetary signals to its employees in order to roll out new products or services, since a part of the potential rewards is already tied up. Still, a profit sharing scheme may be useful if it is bundled with other incentive schemes.

The same arguments that apply to profit sharing schemes can also be made for gainsharing plans. Under gainsharing the firm shares productivity gains, rather than annual profits, with its employees. One advantage compared to profit plans is that the payouts are usually made more frequently.

Delayed Benefits

Examples of benefits are pension and other social security contributions that a firm makes on behalf of its employees. Most MFIs that the author of this paper has come across only fulfil the legal obligations in their country of operations, i.e. whatever is prescribed by the labour laws. It may, however, be useful for MFI managers to regard their benefits policies as a potential incentive mechanism. Since pension benefits and contributions typically rise with tenure, they can help to reduce turnover and to attract a more stable workforce. Intelligent benefits plans can also help to increase motivation and reduce turnover at the middle management level – typically a scarce resource in microfinance.

5. Incentive Schemes for Different Occupational Groups in MFIs

The following section provides a very short outline of what might be considered “adequate” incentive schemes for different occupational groups in microfinance. Because of space constraints, only the most important design features will be presented. The material is necessarily selective, and it is possible to think of even better incentive mechanisms for each of the functions presented here. Readers are thus invited to embark on their own process of thinking!

Credit Staff

For credit staff, as for all other MFI staff, there are two major goals: there should be full accountability of the loan officers, and the interests of the loan officers should be fully aligned to those of the organisation. Since output and performance in lending operations are relatively easy to measure, the task of designing an appropriate incentive scheme is actually quite simple. Bonus schemes for loan officers typically include such variables as the portfolio size and the number of loans (in each of these categories, both the stocks and the flows). In addition, there is normally a quality component in the form of an arrears indicator such as the portfolio at risk (PAR). Other criteria, such as the percentage of new clients, can be added if necessary. Experience with incentive schemes for loan officers suggests that:

- linear systems are better than staged or stepped systems,
- the capping of bonuses usually generates negative incentives,
- it is better not to define a maximum performance level and to use reference levels instead, and
- arrears should be heavily penalised.

For all other staff engaged in the credit process (such as support staff, computer operators, supervisors, etc.) it is highly advisable to align their incentives directly to those of the loan officers (for instance by paying them a certain ratio of the total incentive package received by the loan officers).

Staff Engaged in Deposit Mobilisation

Deposit mobilisation poses a number of challenges from the point of view of incentive scheme design: as opposed to the loan officers, measurement problems make it much more difficult if not impossible to identify individual contributions, so accountability becomes a problem. At the same time, there is a substantial value for teamwork in deposit mobilisation, so that an incentive scheme would ideally support good cooperation between team members. Consequently, an appropriate incentive scheme for staff engaged in deposit mobilisation would be a team-based scheme with a monthly or quarterly payout. We could include such variables as “net increase in number of accounts” (in order to prevent a focus only on new accounts without regard to good service to existing customers) as well as the outstanding balance of deposits at the end of the period. Other savings and financial products such as money transfers could also be included in the formula. The group bonus could then either be paid out to the individuals according to their base salary or simply be divided equally in order to foster an equitable team spirit. It might also be a good idea to conduct regular customer surveys in order to gauge client satisfaction. If one were able to compute some form of simple customer satisfaction index, this could also be used as an input for the branch or department bonuses.

Managers should take note that these types of incentive schemes can usefully be combined with regular "tournaments" between branches. Such tournaments would measure branch performance on a number of variables and then pay out certain rewards to the best branches, the most improved branches, the "steadiest" good performers, etc. In fact, such schemes could even be used by government-owned banks, such as the postal savings banks, where it is more difficult to establish the flexible salary scales that are necessary for individual incentive pay.

Middle Management and Branch Managers

Branch managers and other middle managers such as department heads are probably the most critical scarce resource in microfinance. Given the special role of this occupational group in guiding and controlling a network of decentralised branch operations, it is somewhat surprising that most incentive schemes for middle managers appear somewhat unimaginative. Typically, middle managers receive a fixed salary. Another empirical observation is that in many cases, the incentive schemes for the branch managers (if such schemes exist) are detached from those of the staff members whom they supervise.

Clearly, it is important that middle managers and branch managers engage in longer-term planning, so it would not make much sense to provide them with the same short-term incentives for reaching certain operational goals as the loan officers. Indeed, this is a good reason for paying very decent base salaries and for a reduced role of the bonus component in the total compensation package. However, the author contends that the compensation of middle managers should always include a variable, performance-related element.

For branch managers, for instance, one recommendation would be to align their incentives with the incentives of the staff whom they supervise by paying them a percentage of the total bonuses received by their subordinates (this would also give a special reward to those who manage larger branches or units). This bonus component would take care of the important operational role of branch managers.

In a second step, we could add a profit-sharing component, which would be based on branch or unit profits.[42] Middle managers have a considerable impact on overall profitability, so it would make sense to provide them with an incentive to optimise the usage of resources and generation of income.

Management could use a "balanced scorecard" approach to add additional goals to the incentive system of the branch managers.[43] Such goals could include market share, growth, and other items that are typically defined in the branch or unit business plans. Finally, a subjective assessment by upper management could be added in order to account for special factors as well as "soft skills" such as the quality of human resources management.

In terms of frequency of measurement and payout, quarterly or semi-annual schemes would appear more opportune than shorter or longer intervals. For active readers it should not be overly difficult to figure out the reasons for this notion.[44]

Top Management

It appears that the participation of top managers of MFIs in structured incentive schemes is even less prevalent than is the case for middle managers. This may be partly a consequence of the data constraints (very few MFIs publish any information on the compensation of their executives), and partly a reflection of the nature of top management jobs. CEOs are supposed to engage in long-term planning and the

[42] If there is no profit center accounting, one could use a variable measuring control of costs instead.
[43] Robert Kaplan and David Norton (1996): The Balanced Scorecard.
[44] The key point here is that upper management would like branch managers to focus on two different time horizons simultaneously: Optimizing branch performance requires careful planning over the medium term, while output maximization in branch retail operations is a short-term goal. The proposed frequency of quarterly or semi-annual payouts is a compromise that avoids an undue emphasis of either of these goals.

formulation of strategies, tasks that are ill-suited to standard incentive schemes. In addition, the effort and performance of CEOs and other top managers are very difficult to measure. Nevertheless, some organisations have begun to design incentive schemes for their top managers. Typically, such schemes would be based on the balanced scorecard approach mentioned above, and the weight of the bonus in total executive compensation would be more modest, for instance 10-20% of total pay. Also, the payouts would typically be made only once per year. It is hoped that the future will bring more data and models for the performance-related compensation of top managers in MFIs. The same reasoning and prospect applies to the members of boards of directors. While many practitioners agree that such schemes are lacking and that in many cases the boards of MFIs have not functioned properly, there seem to be very few tangible ideas as to how to construct appropriate incentive mechanisms.[45]

6. Some Common Reasons for Failure

When talking to practitioners, one is regularly confronted with stories where an incentive scheme either did not work properly (i.e. did not produce the intended effects to the extent expected), or produced severely adverse side effects. For future design work it might therefore help to be aware of some common causes for the failure of incentive schemes. We will simply list them without going into more details:

- Failure to incorporate the organisational culture, history and the social fabric ("what is keeping the place together?")
- Divergence between the effects produced by the incentive scheme and the MFI's strategic goals
- Incentive schemes are inflexible and not equipped to deal with external contingencies
- Failure to calibrate the incentive scheme to the nature of the work
- Use of purely algorithmic pay systems when the quality of the work is important
- Letting outsiders (and compensation consultants) do all the work – the design team must include insiders!

7. Lessons (So Far)

Before we attempt to derive any lessons from this short exposé, it should be pointed out again that despite the great practical relevance of the topic there has been very little systematic research on incentive scheme design in microfinance so far. Thus, any lessons that can be summarised at this stage will be preliminary, and surely there is a need for additional theoretical and empirical work.

As far as the design of incentive schemes is concerned, one fundamental lesson seems to be that for any incentive mechanism to be effective, it must be fully integrated into the organisation. Thus, incentive schemes must be adapted to the:

- Culture;
- Clientele;
- Products; and
- Processes

of the MFI. They must be tailor-made, since there is no "one size fits all". It is important to remember that an incentive system is only one part of the organisational "architecture", and that even the best incentive scheme cannot compensate for flawed products or procedures. Good incentive schemes are fair and transparent, and all incentive mechanisms should be reviewed regularly by management. The design of an incentive scheme is such an important step that it requires the full attention and involvement of senior management. Also, the design of such schemes is a modular process. It would be unreasonable to implement a scheme for all members of the organisation at once and to expect it to work properly. Generally speaking, we should first focus on those areas where output is easy to measure (such as lending operations) and then move to the more complex areas. It is important to keep incentives schemes simple and to allow flexibility so that changes can be made when necessary. Remember that MFIs operate in dynamic environments that may force them to adapt and make changes to their operations and products. Invariably, such changes will also have effects on the incentive schemes. Finally, let us remember the old saying: "If it ain't broke, don't fix it". In other words, think very carefully before (re-) designing an incentive scheme!

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[45] This field is the topic of an ongoing PhD-project by Valentina Hartarska at Ohio State University.

10 Steps to Designing An Effective Staff Incentive Scheme

In designing staff incentive scheme, practitioners are generally faced with two alternative situations: improvements (or redesign) of an existing staff incentive scheme or complete design of a new staff incentive scheme.
While the first case may be more common in practice, the second case allows us to delineate more clearly the steps that need to be taken in the design phase.

Step 1:
Definition and clarification of the strategic goals of the MFI. This is such a fundamental and important process that it requires the participation of management (and often also of the board of directors).
Step 2:
Analysis of culture, clientele, products, and processes. We need to know the operations of the MFI as well as the mentality and concerns of the staff. At this point it may also be helpful to conduct statistical analyses and costing exercises (see for example ***MicroSave***'s Costing of MFI Financial Services).
Step 3:
Definition of the objectives of the incentive scheme – what are we trying to achieve, and which results do we expect? Also - what problem are we trying to fix?
Step 4:
Decision on how much are we willing to spend. This is the point where we need to conduct a proper ***Cost-benefit analysis***.
Step 5:
Decision as to the ***staff members and occupational levels to be affected*** by the scheme. Hint: 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!
Step 6:
Choice of incentive mechanism(s): merit pay, incentive pay, perquisites, benefits, profit sharing, gainsharing, ownership, or a combination of these mechanisms.
Step 7:
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 8:
Field test in a controlled environment. Based on test results, make the necessary adjustments.
Step 9:
Sell the scheme to the staff. Of course, if staff members participated in the design, this task will be made easier.
Step 10:
Monitor the performance of the scheme. Make adjustments based on regular reviews (for example, semi-annually).

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