

Principles for Designing Staff Incentive Schemes

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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 the 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 management¹ we can 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.

¹ 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.

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

2. Factors Influencing the Choice of Incentive System²

When deliberating what would be an appropriate system of incentives for a particular organisation, it may be useful to analyse 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 this 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?³ 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 labor 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.⁴
- 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 once staff have received sufficient training. Otherwise the system will penalise mistakes. 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.

² The following typology is adapted from James Baron and David Kreps (1999): Strategic Human Resources, Chapter 2.

³ 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.

⁴ In Bolivia, for instance, this system is called “la prima”.

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 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 for 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.⁵ 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

⁵ Examples for this type of scheme are given in M. Holtmann (2001): “Designing Financial Incentives For Loan Officers: Handle With Care!”

their real contributions to the overall company results.⁶ The credibility of such systems would be at risk since the affected staff members would not perceive them as fair.

From a design perspective, then, individual incentive schemes mostly make sense if:⁷

- 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;
- 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 favor the introduction of a group-based incentive scheme are:⁸

- 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);
- 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.⁹ 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 a 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.

⁶ R.M. Kanter (1987): *Frontiers for strategic human resource planning and management*, p.14

⁷ This section is adapted from Luis Gómez-Mejía and David Balkin (1992): *Compensation, Organizational Strategy, and Firm Performance*, Chapter 9, here: p. 260-261

⁸ Luis Gómez-Mejía and David Balkin (1992): *Compensation, Organizational Strategy, and Firm Performance*, Chapter 9, here: p. 264-266

⁹ Raymond A. Noe, et.al (1997): *Human Resource Management. Gaining a Competitive Advantage*, p. 500

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 identification with the organisation, and a reduction of the barriers between employees (“us”) and owners (“them”).

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 labor 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 the 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 with 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 of 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.¹⁰ 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.¹¹ 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.¹²

¹⁰ If there is no profit center accounting, one could use a variable measuring control of costs instead.

¹¹ Robert Kaplan and David Norton (1996): *The Balanced Scorecard*.

¹² 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.

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 partly simply be a consequence of the data constraints (very few MFIs publish any information on the compensation of their executives), and partly it is a reflection of the nature of top management jobs: CEOs are supposed to engage in long-term planning and the formulation of strategies, tasks that are ill-suited for 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.¹³

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 shortly, without going into more details:

- Failure to incorporate the organisational culture and 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 rather 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

¹³ This field is the topic of an ongoing PhD-project by Valentina Hartarska at Ohio State University.

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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