MicroSave Briefing Note # 15

Designing Staff Incentive Schemes[1]

Martin Holtmann

There is little dispute among microfinance practitioners that well-designed staff incentive schemes can have positive and powerful effects on the productivity and efficiency of MFI operations. Conversely poorly developed schemes can have serious detrimental effects. This note lays out the principles and steps for designing effective staff incentive schemes.

Essentials to Any and All Incentive Systems:

Of prime importance is that the staff incentive scheme must be, and be seen to be, both 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.

Transparency

"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 make maliciously complicated computations designed to deny us the bonus".

In order to comply with the fairness requirement:

- The goals set out by the scheme must be attainable;
- Better performers must indeed be rewarded with higher salaries;
- Everyone must be able to achieve a higher compensation by working better and harder.

Fairness

"Many of us operate as if there is no incentive scheme. We were sent to this difficult area to solve repayment and drop-out problems. Apart from suffering because we have been transferred to this remote place, we have lost the bonuses we used to make in our previous areas. So any thought of ever getting an incentive is nothing but day dreaming – we've given up!"

Critical Design Issues for Staff Incentive Schemes

If the board and management of an MFI are prepared to implement a performance-based incentive scheme, the There are essentially five main types of incentive schemes: following issues among others, will need to be addressed.

Timing

In general, it is useful to introduce a financial incentive scheme only once staff have received sufficient training. 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

The incentive payout (for instance a bonus), should not be construed by the staff members as an entitlement, and 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. 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. Annual or semi-annual bonus payments do not make much sense: it is more difficult for staff members to relate their reward to any particular efforts.

Weight of Bonus in Total Remuneration

It is important to avoid the extremes: if the variable portion of the monthly or quarterly salary is too high 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 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 for effective incentive schemes the weight of the bonuses for credit officers range anywhere from 20% up to 50% of total compensation.

Participation

"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."

[1] For more details on Designing Staff Incentive Schemes, visit ***MicroSave****'s* website: www.***MicroSave***.net - under the Study Programme and Toolkits sections.

1. Individual Incentive Schemes

Under an individual incentive mechanism, there is a direct link between individual performance and renumeration.

However, they can lead to a rather narrow focus, may reduce staff members' intrinsic motivation and in addition, it is often difficult to distinguish properly between individual and group performance. Individual incentive schemes are often used for credit officers.

2. 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. Group incentive schemes are often used for branch-based activities – in particular savings mobilisation.

3. Employee Stock Ownership Plans (ESOPs)

ESOPs may be attractive tools for motivating staff members because of their positive symbolic and motivational effect. Through an ESOP, employees become owners, so that it should be easier for the staff members to internalise the interests of the firm. ESOPs are, however, typically one-time incentive mechanisms that are probably not very well suited to boost operational performance over the longer term.

4. Profit Sharing and Gain-sharing Schemes

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. Gain-sharing schemes are often used to share the benefits of productivity gains with middle and senior management.

5. Delayed Benefits

These include pension and other social security contributions that a firm makes on behalf of its employees. 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.

10 Steps to Designing An Effective Staff Incentive Scheme

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 Toolkit for costing and pricing of 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, gain-sharing, ownership, or a combination of these mechanisms.

Step 7: ***Technical design work.*** This includes formula development and calibration, as well as spreadsheet 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: ***Pilot 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).

Conclusion

Staff incentive scheme 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 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.