Designing Staff Incentive Schemes to Balance Social and Financial Goals

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1 Introduction: The Role of Staff Incentives to Balance Social And Financial Goals

At the 2005 conference of the MicroFinance Network (MFN), several members expressed interest in further exploring how MFIs can balance the trade-offs between achieving social and financial goals in order to address possible "mission drift". This paper discusses the role of staff incentive schemes to achieve balance between social and financial goals.

The MFN and CGAP recently conducted a global survey to investigate the utilization, design and managers' perceptions of staff incentive schemes (SIS)[1]. The survey, done in conjunction with qualitative reviews of the incentive schemes, of around 20 leading MFIs revealed that SIS can have significant impact on financial performance and loan officer productivity. However, some of the 147 responding institutions also indicated that SIS contribute to a shift in focus towards wealthier clients or customers in urban areas.

Most incentive schemes are designed to meet two main goals: financial performance and breadth of outreach (number of customers). Little has been done to build SIS to address depth of outreach (targeting poorer segments of customers) or impact (poverty alleviation, empowerment).

This could be a reflection of the increasing commercialization of the microfinance industry. However, staff members at the levels that are usually targeted by incentive schemes only have a limited influence on the balance between social and financial goals at the institutional level. Product design, processes and procedures, and the location of branches are among the more important factors that help achieve the desired balance between social and financial goals.

While it is fairly easy to design incentives that focus on productivity and on the achievement of financial goals, it is difficult to provide staff with powerful incentives to achieve social goals. It is difficult to measure the achievement of social goals in the short term, or to monitor this on a regular basis. However, incentives can be designed to enhance productivity without detracting from social goals, and it is possible to design long-term incentives that directly reward for social achievements.

Based on four case studies among MFN member institutions, including BRAC (Bangladesh), BancoSol (Bolivia), PRIZMA (Bosnia and Herzegovina) and Equity Bank (Kenya), this paper attempts to identify best practices of how staff incentive schemes can be designed to balance social and financial goals. To start, we conceptualize the basic goals of MFIs and explore the degree to which staff can exercise control over the balance between social and financial goals (Section 2). In Section 3 we examine how effective staff incentive schemes can be designed and calibrated to balance social and financial goals[2]. Lastly, in Section 4 we describe the incentive schemes of each of the four MFN members and examine their role in balancing social and financial goals.

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[1] See McKim, Andrew / Hughart, Matthew (September 2005): Staff Incentive Schemes in Practice: Findings from a Global Survey of Microfinance Institutions. The MicroFinance Network (www.mfnetwork.org).

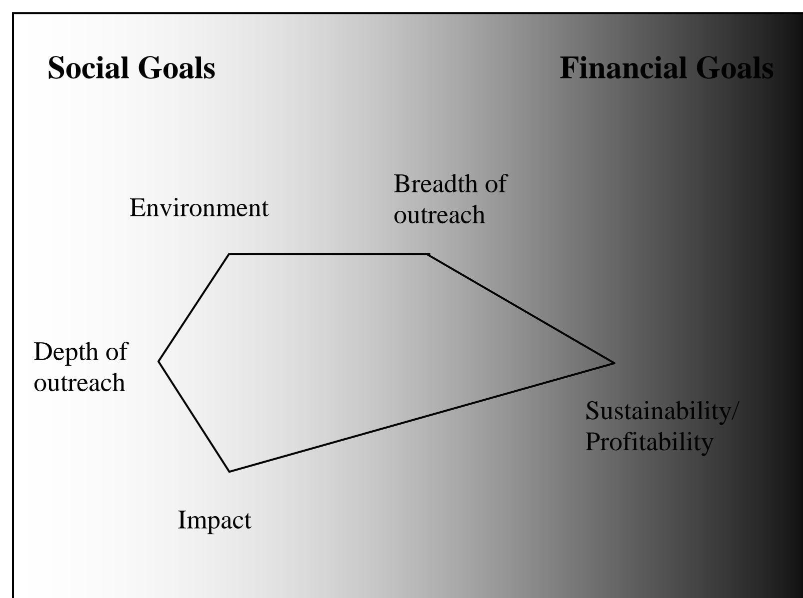
[2] MicroSave has published a more comprehensive guidebook on how staff incentive schemes can be designed as part of its toolkit series. See Holtmann, Martin / Grammling, Mattias (August 2005): Designing and Implementing Staff Incentive Schemes: A Toolkit. MicroSave (www.microsave.org).

2 Balancing Social And Financial Goals

2.1 Social and financial goals of MFIs

The mission statements of MFIs usually include both financial and social goals. While financial goals may include organizational sustainability and profitability, the social goals of an MFI usually include depth of outreach (targeting poor clients), impact (poverty alleviation and/or socio-economic empowerment) and social development outside of the MFI (e.g. social welfare programs, customers' capacity building – some of the MFN member organizations call this "environment"). Breadth of outreach (achieving a high customer base) is important to achieving both social and financial goals. While there are trade-offs between achieving social and financial goals, these goals are also interdependent. Exhibit 2.1 gives an overview of these relationships.

Exhibit 2.1: Social and financial goals of MFIs



Depth of outreach measures the degree to which an MFI reaches poorer segments of society. Because very poor customers take smaller loan sizes, they are less profitable for financial institutions. This trend is further exacerbated since the very poor are often inexperienced at running microenterprises. Furthermore the very poor usually use loans to start up businesses, a venture which is very risky for both the enterpreneur and for the MFI that lends the capital. Many MFIs do not lend to start up businesses as these loans are perceived to be too risky and, hence, can endanger the organization's sustainability and profitability. Some MFIs have developed innovative perspectives and programs in order to serve the very poor population. PRIZMA, in Bosnia and Herzegovina (see Section 4.1), believe they have a competitive advantage serving the very poor as there is little competition to lend to them. Other organizations, such as BRAC in Bangladesh (see Section 4.3), employ special programs that target the "ultra poor" and attempt to graduate them into a regular microfinance program at a later stage. These special programs do not only include microfinance products, but also offer training opportunities and grants to start-up businesses. These programs need to be funded by external sources or subsidized by profits from other microfinance products.

However, targeting very poor customers is not an end in itself. MFIs aim to reduce or alleviate poverty through the provision of financial services. Thus, the products and services offered should have a positive *impact* on the livelihood of the customers. Impact, in the sense of poverty alleviation, is strongly linked to depth of outreach, but far more difficult to measure.

Many MFIs enhance the social *environment*. They do so through capacity building trainings for microenterpreneurs, helping poor customers become accustomed to formal banking

environments, donating portions of earned profits to welfare programs or sponsoring social activities. Training and welfare programs can be offered by a MFI (e.g. by using a "microfinance plus approach") or by an external organization to provide health funds, education activities, cultural or sports events. Frequently, MFIs consider such subsidies or donations to be contributions to the social environment of the country, but at the same time, they can be powerful marketing tools. Thus, providing funds to such programs does not only boost the net profit of the MFI, but also has positive effects on the organization's profitability and breadth of outreach.

The number of customers, or *breadth of outreach*, is important to both achieving social and financial goals. MFIs that serve a large number of customers *can* contribute more to alleviate poverty in the country and have a higher potential to reach poor customers. Organizations with bigger profits can donate more to improve the social environment. From a financial perspective, a large customer base does not only allow one to achieve economies of scale, but also helps to mitigate credit risks.

The key to achieving social goals in the long term is organizational *sustainability*. Sustainable organizations should be able to cover all their costs, including operational costs (adjusted for subsidies) and capital costs (adjusted for subsidies, inflation and exchange rate risks). In order to attract shareholders, institutions might need to generate additional profits. However, MFIs with strong social achievements may also attract socially oriented shareholders and additional subsidized funds.

Finding the right balance between social and financial goals is not easy, especially since many MFIs hardly break even. Whether profits should be spent to increase breadth or depth of outreach is just one of the difficult questions which the board needs to address. Designers of staff incentive schemes need to be very clear about the overall goals of the MFI in order to identify the incentive scheme's objectives. Ideally, SIS can operationalize the goals and quantify the achievement of social goals in monetary terms. In practice, this will not be possible, but incentive scheme designers should have at least an understanding on how much the MFI is willing to spend on staff rewards for clearly defined achievements – both social and financial ones.

2.2 Operational perspectives on balancing social and financial goals

MFIs use various techniques to achieve their social and financial goals. In this section we attempt to identify the relative importance of staff incentives in achieving a balance between social and financial goals. Staff incentives are usually designed around financial goals within a given operational framework which largely predetermines the degree to which "front end" staff can influence the balance between social and financial objectives. Among the techniques which MFIs use to balance their social and financial goals are[3]:

1. *Product design:* MFIs provide a host of loan products which fit different needs and are designed for different clienteles. Depending on the product design, clients will self-select themselves either in or out of an MFI. Rich customers will perceive the interest rates of microfinance products to be too high, and extremely poor customers may not be eligible for most microfinance loan products, e.g. if they were not accepted by other group

[3] This section does not provide a comprehensive list of techniques used to balance social and financial goals. Rather, we assess the topic through the lenses of front end staff (e.g. loan officers) for whom most staff incentive schemes are designed.

members (in solidarity group or village banking approaches) or if they did not have experience as microenterpreneurs (individual lending).

In general, microfinance loans are designed to meet the needs of the poorer segments of society: loan sizes, collateral and guarantees, and techniques used to appraise repayment capacities (assessments in the field with little paperwork) fit their needs and environment.

Some MFIs offer special loan products that target very poor microenterpreneurs, riskier start up businesses, or cases of crisis or emergency. Despite their fairly high effective interest rates, these MFIs may not be profitable and may need to cross-subsidize with other products that target wealthier clients. This applies especially to those MFIs who follow the "microfinance plus" approach and offer more than just financial services (e.g. business and capacity building trainings, health education, etc.).

Virtually all MFIs employ more than one loan product to accommodate different types of customers (e.g. very poor, poor, vulnerable non-poor, non-poor) who have different needs (e.g. accessibility, low costs). Their participation in the programs offered can contribute in different ways to achieve social and financial goals (e.g. depth of outreach, profitability).

Similar to loan product design, the accessibility and other terms and conditions of products offered by MFIs (e.g. savings, money transfer services or microinsurances) are largely designed to meet the demands of the target group. Some of these products are also attractive to wealthier customers (e.g. fixed term deposits).

2. *Branch location:* The location of braches largely determines the type of customers that will be attracted to the MFI. While branches in urban slums or in remote areas will not attract wealthier customers, branches located near local markets can attract large numbers of microenterpreneurs. Farmers may want to bank with organizations operating branches close to their businesses, in rural areas. Some MFIs have developed techniques that allow the delivery of microfinance services in remote areas at relatively low cost. Equity Bank, for instance, reaches customers in rural areas through its "mobile branches" consisting of a fully-equipped jeep and rented office buildings, which are open only a few days a week (see Section 4.4).

3. *Reputation in society*: MFIs have built reputations in the communities in which they work. The MFI's history, legal status, customer service quality, products, branding, branch setup, branch location, marketing and participation in public events are among the factors that influence an organization's reputation. People self-select themselves either in or out depending on their perception of the suitability of the products and services offered by the MFI and the trustworthiness of the organization (or the branch which is in their area). For instance, rich people may consider a MFI too expensive, while poorer people might perceive the same MFI to be an organization that provides accessible and affordable products and services.

4. *Human resources:* Finally, the organization's HR policies and incentive systems can contribute to balancing social and financial goals. When recruiting new staff, MFIs may focus on selecting candidates who have a strong social commitment to achieve its social goals. Other MFIs have found that employing "social workers" as loan officers was not

beneficial as they were too "soft" and unable to recover bad debts. Selected staff should be willing and capable of working with poor customers. MFIs that focus on social goals need front-end staff that have local language skills, a good understanding of poor customers' needs, the willingness to respect them as clients (as opposed to the treatment as "begging beneficiaries"), and the ability to work in the field.

Most operational staff work in more-or-less defined environments that already largely determine the balance between social and financial goals. MFIs offer products, use processes and procedures, and choose the branch location to accommodate the needs of the clients they target – microentrepreneurs and other poor segments of the society. These structures limit the possible impact of staff incentive schemes on the balance between social and financial goals for most functional levels of staff. To analyze the degree to which staff incentives can contribute to achieve the desired balance between social and financial goals, it makes sense to distinguish between (1) senior management, product designers and marketing staff (2) lending staff, (3) front office staff, and (4) back office and support staff:

1. Senior management, product designers and marketing staff can influence the balance between social and financial goals. Staff incentives designed for these functional levels of staff can have an impact on the balance achieved between social and financial goals.

2. Lending staff frequently specialize in certain products or loan size ranges. Hence, the ability of loan officers to balance social and financial goals is already largely determined by the type of product they manage. SME loan officers, for instance, will contribute to financial goals almost by definition. However, staff incentives for loan officers can have powerful effects on staff productivity. Thus, well designed schemes can significantly contribute to the achievement of the MFI's financial goals without reducing the achievement of social goals.

3. Like loan officers and marketing staff, front office staff have an impact on customer satisfaction and the reputation of the organization. Thus, front office staff may have a certain degree of influence on the balance between social and financial goals – although this link is very indirect.

4. Back office and support staff have a very limited influence on the balance between social and financial goals. Incentives for these functional levels of staff should focus on long-term commitment, staff loyalty and, in some cases, productivity. Their impact on staff performance is usually low since individual achievements are difficult to measure.

These stylized facts support the notion expressed in the introductory section: staff incentive schemes will <u>not</u> usually be the <u>primary</u> lever through which the principals and leaders of an MFI will want to direct their staff to focus on a set of social goals. Other factors, such as product design and the location of branches will always play a more important role, and once these parameters have been set, front office staff do not have much freedom to move the balance between purely financial and purely social goals.

However, the growing body of research commissioned and conducted by the MFN and its partner organizations clearly demonstrates that well-designed staff incentive schemes can greatly enhance the motivation and effectiveness of MFI personnel in reaching the overall institutional

goals. Without doubt, SIS can be generally supportive of social strategies, even if their primary focus is usually on shorter-term (and easily measurable) operational targets. It is therefore important to recapitulate some of the most important design features of solid staff incentives.

In the next section, we attempt to provide some guidelines on how to design staff incentive schemes that support the desired balance between social and financial goals.

3 Designing Staff Incentive Schemes That Balance Social And Financial Goals

3.1 Principles for designing staff incentive schemes

If staff incentives are to be effective, they must be accepted by staff and meet at least two requirements: fairness and transparency.

> Requirements for designing staff incentive schemes:
>
> - Transparency
> - Fairness

3.1.1 Fairness

The fairness requirement stipulates that:

1. Goals or benchmarks set out for staff must be attainable. Otherwise, rather than enhancing staff performance, the incentive system may have a detrimental effect on employee motivation and performance.

2. Staff members who increase their efforts and produce better results should receive larger rewards. Usually, rewards are monetary and their size should fairly reflect the additional effort made by the employees.

3. Staff members who perform better than others should be eligible for higher rewards. In practice, this requirement is not easy to meet because staff members work under different operational circumstances. For instance, it might be necessary to have different benchmarks for urban and rural branches.

4. The compensation system should reflect the hierarchical levels within the institution: Superiors should earn more than the staff they supervise.

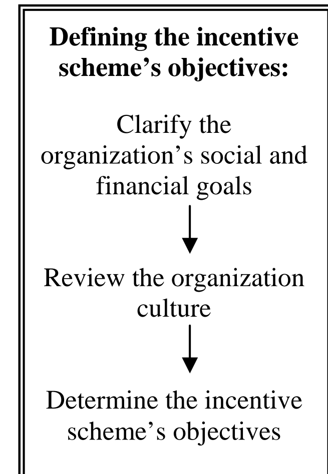
3.1.2 Transparency

Transparent incentive schemes ensure that staff members understand the mechanics of the system. The incentive scheme should be kept as simple as possible and should be explained carefully and in detail to all staff. It helps if employees have access to an “incentive manual” and a spreadsheet which calculates rewards for particular achievement levels. In addition, SIS should neither be changed too frequently nor arbitrarily such that the relationship between performance and rewards becomes unclear to employees. The accrual of rewards should be based on objective performance measurement indicators rather than on subjective performance assessments. As we will see, this target is sometimes difficult to accomplish, especially if the SIS focus on the achievement of social goals which are not as straightforward to monitor as financial achievements.

In practice, it is surprising that incentive schemes are frequently not understood by staff in detail. SIS can only contribute to the desired behavior to the degree to which they are understood and accepted by those who are affected by the scheme.

3.2 Defining the incentive scheme's objectives

Before designing or re-designing incentive schemes, we must be clear about the system's objectives. These will largely depend on the MFI's mission, vision and overall strategic goals as well as the organizational culture. To start, management might want to critically position their institution in the perceptual map in Exhibit 2.1, and then define the desired position. The MFI's strategic goals should be formulated precisely – an exercise which is usually completed in the business plan for profitability and outreach targets. However, if the incentive scheme is meant to balance social and financial goals, the MFI also needs to define its social goals, and operationalize as well as quantify these goals as precisely as possible. The SIS should allocate different weights to objectives to reflect the relative importance of each goal.



Then, a careful review of the organizational culture, which includes clientele, products, processes, techniques, tools, policies, traditions, history, experience, commonly shared values, formal and informal agreements, and existing staff incentives, should be done to identify those areas where (redesigned) staff incentives can contribute to better achieve the social and financial goals of the MFI. We should bear in mind that staff incentives are only one, and probably not even the most important, tool to reach our goals. The best staff incentive scheme will still not lead to the desired results if e.g. processes are not sufficiently standardized, or if products and procedures are not accepted by the targeted clientele.

This is also the stage in which to appraise the degree to which staff can increase their performance to meet the incentive scheme's objectives and how much the organization is willing to spend for a certain achievement level. It is helpful to be as precise as possible, e.g. by defining that the organization is capable to pay US$ 10,000 during the year if outreach increased by 10% due to the incentive scheme, or if 25% of the new borrowers earn less than a $1 day.

3.3 Identifying staff members to target

Once the incentive scheme's objectives are defined, we need to identify those staff members who play a key role in the achievement of these goals and, thus, should be targeted by the SIS. For instance, if our main objective was to expand outreach, we may want to target field staff rather than head office staff.

Identify those groups of staff who contribute most to the achievement of the scheme's objectives:

- They should be targeted by the SIS
- It may become necessary to employ SIS for other functional levels of staff as well.

Often, the introduction of an incentive scheme at one occupational level creates a demand for a scheme at another level for both operational and motivational reasons:

1. The different tasks of the various levels of staff are frequently linked to one another. For instance, if

management decided to employ a bonus scheme for field staff, the workload of support staff (e.g. data typists) may also increase due to the enhanced productivity of field staff. If the remuneration system neglects these links, the SIS might negatively influence the performance of the targeted employees who depend on the support of others.

2. Even when tasks are completely independent, it may be useful to consider introducing some kind of incentive scheme for all organizational groups since employees will usually compare their efforts, status and remuneration with that of their colleagues. If monetary incentives are only implemented for targeted levels of staff, other staff may feel neglected and lose motivation. For instance, if a bonus scheme is introduced for loan officers, it might be necessary to implement a reward system for their direct superiors to ensure that the entire remuneration system is congruent with the organization's hierarchy. Or, if the incentive scheme's overarching goal is to provide loans to the very poor, it might be necessary to reward not only those loan officers who manage small loan sizes, but also their peers from the SME department.

In practice, it is not necessary to design incentive schemes for all organizational units at the same time. Rather, managers should concentrate on those functional levels which contribute most to the achievement of the scheme's objectives. At a later stage, incentive systems for the other units and departments can be planned and employed. The incentive schemes for staff who are not targeted by the incentive system (e.g. support staff) can usually be kept more simple or fundamental.

3.4 Determining the incentive scheme's main features

3.4.1 Performance-based and non-performance based incentives

Non-performance based incentives include all benefits that staff receive regardless of their performance. Virtually all institutions employ some non-performance-based incentives, such as leave, a good and motivating working environment, allowances, health insurance or a pension scheme. While non performance-based incentives enhance the intrinsic motivation, loyalty and commitment of staff, their impact on short-term performance is indirect and usually rather weak in comparison with performance-based incentives.

While linking achievements to pay can have extremely high positive effects on staff performance, a motivating organization culture, supported by non-monetary incentives is crucial to live the mission and vision.

Performance-based incentives closely link the rewards to the performance of individual employees, teams or the entire institution. Among the most popular performance-based incentive systems are short-term bonus systems for branch staff and annual profit-sharing schemes. Depending on their design, such incentives can have very strong impacts on staff performance, both positive and negative.

While this paper attempts to provide guidelines on how to design performance-based staff incentives to meet institutional goals, it is worth mentioning that organizational culture is just as important as monetary incentive schemes. Institutions that focus on the achievement of social goals (which is naturally more difficult to measure than financial results) must especially focus on developing a motivating culture since they need staff who work for more than just money.

3.4.2 Short term and long term incentives

Incentive scheme designers must decide on the frequency of reward accruals and payouts. The appropriate term depends on the kind of behavior that the incentive scheme intends to encourage.

The term should depend on the incentive scheme's objectives and their measurability

For instance, if the incentive scheme is to enhance staff productivity, breadth and depth of outreach, loan portfolio quality or high disbursements - short term (monthly or quarterly) incentives may be the best solution as they ensure a close connection between staff efforts and the rewards.

Mobilizing savings is a medium- or long-term effort as institutions need to foster the trust of customers. Hence, quarterly or semi-annual incentives may be more appropriate for savings mobilization staff.

Incentive schemes that focus on impact (e.g. poverty alleviation), staff loyalty, staff overall commitment or organizational development, should be designed over the long term (e.g. annually). In these areas, achievements naturally cannot be measured in the short term. Short-term performance appraisals might even be counterproductive as they tend to narrow the employees' perspectives.

The advantage of short-term incentives is the disadvantage of long-term ones; as the link between performance and reward becomes more indirect, staff is less likely to spend efforts in order to increase their bonuses. However, as we will see below, organizations that wish to focus their incentive scheme on the achievement of long-term social goals should also consider the employment of long-term incentives. A mixture of both short-term and long-term incentives is possible but staff will primarily tend to focus on the short term incentives.

3.4.3 Choosing between individual incentives, group incentives, and tournaments

Among the most-discussed topics with respect to incentive scheme design is the question of whether team-based or individual incentives should be employed. While the best solution largely depends on the organizational culture, there are a number of general guidelines which one should consider in deciding on the right level of reward accruals.

Whether an MFI employs individual or group based incentives, and/or tournaments largely depends on the organization culture

Individual incentives ensure a direct relationship between the individual's efforts and the remuneration. Hence, they usually translate best into improved performance. They are good for institutions in which individual output is measurable, teamwork is not so important, individuals have a high degree of autonomy in their work and organizational culture is individualistic.

To avoid pitfalls of individual incentive schemes, including a narrow focus on maximizing individual payouts and self-interested behavior which may negatively affect institutional goals and teamwork, some organizations prefer to employ *group-based incentive schemes*. Such schemes reward teams or units (e.g. branches, lending staff, tellers) based on their common output. Group incentives are also useful if individual performance cannot be measured. One of the main drawbacks of team incentives is the phenomenon called

"free rider effect" in which individuals find that they can shirk work without getting punished. Other group members anticipate such behavior and, consequently, the group's outputs decline.

Tournaments are contests between individuals or teams. Employees or units are ranked according to their outputs and the best performers are identified and rewarded. They are frequently used in environments where monetary incentives cannot be used, such as in public sector organizations, or to identify and punish free riders in group-based schemes.

3.4.4 Forms of incentives

Cash incentives are most frequently used by financial institutions. They typically include bonus schemes, profit-sharing plans, gain-sharing plans or merit-pay systems.

- *Bonus schemes* are the most common cash incentive. Bonuses are usually accrued using a more or less complex bonus formula which links a small number of key performance indicators. Bonus schemes are usually employed to foster staff productivity. *Spot bonuses* can be used irregularly by senior management to reward outstanding achievements.
- Under *profit-sharing plans* staff receive a certain portion of the organization's semi-annual or annual profit. This portion is distributed among the employees according to some form of allocation criteria. As long-term incentives, profit-sharing plans foster staff loyalty and commitment.
- *Gain-sharing plans* follow the same pattern as profit-sharing schemes, but the bonus pool is calculated as a portion of the organization's gain (such as by decreasing a certain cost category). Both profit and gain sharing schemes can be linked to social performance as well. For instance, the percentage of the profit which is allocated to staff could be determined as a function of social achievements.
- Most institutions employ *merit-pay plans* under which staff can receive annual salary increments based on qualitative performance assessments and/or tenure. Their main objective is to retain committed staff.

A small typology of SIS:

1. Cash incentives
   - Bonus schemes
   - Profit-sharing plans
   - Gain-sharing plans
   - Merit pay plans
2. ESOPs
3. Delayed benefits
4. Symbolic rewards

Symbolic rewards such as commendation letters or branded gifts are usually awarded to the "winners" of tournaments or in addition to other forms of incentives. They formalize and emphasize the acknowledgement of high performance, but their impact on outcomes is less than that of bonus schemes.

Employee Stock Ownership Plans (ESOPs) involve the participation of employees in the institution's share capital. Although their administration can be quite complex and their impact on productivity is rather low, they have become quite popular. ESOPs focus on long-term commitment of staff and are sometimes linked to delayed benefits.

As most public pension schemes do not provide an adequate coverage after retirement, some MFIs offer their employees an additional benefit at the time they retire, or provide their staff with an additional private pension scheme. Such *delayed benefits* focus on longer term staff

motivation and retention. Some employees are willing to forego short-term monetary benefits in order to receive a higher income after retirement.

When deciding on the right incentives, we should keep in mind that the scheme needs to fit into the organization's culture. As the case of Prodem[4] illustrates, it is better to have no incentive scheme at all than one which contradicts the organizational values or one which is poorly designed.

3.4.5 Weight of the variable portion in the total remuneration

An important question is how much weight the variable component should have in total employee remuneration. While very low incentives will not lead towards the desired behaviour, excessively high incentives may attract "risk seekers". The basic salary should be high enough to cover at least the employees' basic needs so that they do not depend on their bonus to make a living.

- ♦ Basic salaries should cover the employee's basic needs.
- ♦ Field officers ideally receive a high variable portion of their total pay.
- ♦ For other staff the variable portion could be lower.

The optimal weight of the bonus in the total remuneration will largely depend on the organisational culture, the nature of the staff members' tasks and the incentive scheme's objectives. As a general guideline, field staff whose performance can be measured easily should receive rather high incentives (e.g. 30% - 50% of the total pay) because their work effort is difficult to control by other means, and they have a high level of discretion in deciding on their quantity of work. Other functional levels of staff may receive somewhat lower incentives (e.g. 15% - 30% of the total remuneration). The latter also applies to incentive schemes which are designed over the long term (e.g. annual schemes) and focus on staff commitment and loyalty rather than on productivity.

3.5 Selecting the right performance measurement indicators

3.5.1 Requirements of good performance measurement indicators

Selecting the right performance measurement indicators is a critical and important step in designing staff incentive schemes. The performance measurement parameters used in a financial incentive scheme which provides significant rewards to staff should meet at least four requirements:

Performance measurement indicators should …

- Adequately reflect the incentive scheme's objectives;
- Be objectively measurable;
- Be comprehensive;
- Not be too many.

1. *Adequacy*: The performance measurement system should adequately reflect the incentive scheme's objectives. We should not only select key indicators, but also be aware of indicators that we do not select. For instance, if we decided to measure the performance of lending staff as a function of the number of disbursed loans, field staff might seek poorer customers who are more likely to apply for small loan sizes which are simpler and quicker to disburse. Thus, the fact that the outstanding loan portfolio volume is not rewarded may help to achieve the social goal of lending to poorer people.

[4] See Bazoberry, Eduardo: We Aren't Selling Vacuum Cleaners: PRODEM's Experiences With Staff Incentives. In: MicroBanking Bulletin 6 (2001); www.microbanking-mbb.org

2. *Measurability*: The indicators upon which we base the rewards must be measurable in an objective, simple, cheap and timely manner. Ideally, achievements in each of the performance measurement indicators should be retrieved from the MIS. Supervisor's appraisals or 360 degree appraisals are frequently not accepted by staff as the basis for bonus calculations since employees suspect biases in the performance assessments. It may be impossible to utilize some indicators though they reflect goals because they cannot be captured regularly or at reasonable costs. This is true for many indicators of social goals, such as impact or poverty outreach.

3. *Comprehensiveness:* The set of performance measurement indicators should be as exhaustive as possible to reflect the multiple tasks of the targeted employees or teams. For example, imagine what might happen if we rewarded loan officers for the volume of disbursed loans without considering the loan portfolio quality.

4. *Simplicity:* While incentive schemes should be as comprehensive as possible, they should also be simple enough for staff to understand. If there are too many performance-measurement indicators, staff may become confused – especially if the indicators involve many trade-offs for staff. In addition, the size of the monetary rewards decreases (and thus becomes less attractive) as the number of performance measurement indicators increases. It is not necessary to select the same number of performance indicators for each of the incentive scheme's main goals because the importance of each indicator can be weighted (see Section 3.6.1).

Most of the performance indicators used in practice meet these requirements. Box 3.5.1 includes a selected list of indicators which are widely employed by MFIs.

Box 3.5.1: Performance measurement indicators used in practice

- *Lending:* MFIs usually use the loan portfolio quality (PAR) and some of the following indicators: the number and volume of loans disbursed (sometimes with different weights for new and repeat customers), the number and volume of outstanding loans, the number of active customers or groups, client retention, loan application processing speed, period of time between last installment and new disbursement (in village banking), write-off rates, loan loss provisions, profitability, and the number of loans disbursed to poor customers.

- *Savings mobilization:* the number of active savers (sometimes with different weights for different products), the net increase in the number of active savers, the savings balance, tellers' transaction speed, customer service quality.

- *Microinsurance:* the number of policies sold (with different weights for different policies), the value of policies sold, customer retention.

- *Branch-based incentives:* Profitability and/or the achievement of targets in the areas mentioned above.

- *Management:* Parameters linked to profitability, growth, outreach, market saturation, human resource development.

Obviously, most of the performance measurement indicators are selected around staff productivity, profitability and breadth of outreach. There are only a few MFIs that consider social goals explicitly (see the case study on PRIZMA in Section 4.1). This begs the question if "mission drift" towards financial goals is occurring or if MFIs use other mechanisms ensure that

they achieve their social goals as well. As discussed in Section 2.2, front end staff, for whom incentives work best, have little influence on the balance between social and financial goals in comparison to the design of the products they manage, branch location, and the MFI's reputation. Hence, the objectives of the incentive schemes of most institutions include productivity and profitability – but within a framework which already largely balances social and financial goals. However, this assessment may not apply to all institutions, and certainly not to stakeholders who decide which type of clientele to target, design products and processes, pick branch location, make business plans and participate in decisions on how to use profits.

So the question arises: How we can measure social performance explicitly, and in a way which meets the requirements of performance-measurement indicators for staff incentive schemes?

3.5.2 Tools to measure social performance for staff incentive schemes

It would be beyond the scope of this paper to discuss the advantages and drawbacks of all the tools used to measure the social performance of MFIs. For our work, it is sufficient to divide these tools into two categories: those that are capable of measuring social achievements regularly and over the short term, and those that measure social performance only occasionally and over the long term.

All MFIs measure regularly their breadth of outreach, and this incicator is used in most staff incentive schemes. A few institutions, such as PRIZMA and BancoSol, also measure their depth of outreach on a regular basis:

- PRIZMA uses a "poverty scorecard" which appraises the poverty level of their customers as a function of 7 indicators, including (1) the customer's educational level, (2) the number of household members, the ownership of a (3) CD player and (4) a vehicle, (5) the location of the residence, the average number of times the customer eats (6) sweets and (7) meat per week. Respective data are gathered by the loan officers as a part of the general loan analysis. PRIZMA not only tracks their depth of outreach but also includes this indicator into a team-based annual incentive scheme (see Section 4.1).

- BancoSol employs a "social scorecard" to categorize their customers into 3 clusters based on their household's monthly per capita expenditure. Respective data are collected during the analysis of the customers' repayment capacity. In contrast to PRIZMA, BancoSol does not utilize its scorecard in its incentive scheme (see Section 4.2).

Both scorecards are relatively easy to manage as data are gathered in the loan officer's regular assessments. However, such a technique limits the use of these scorecards within SIS: if loan officers received significant rewards based on their depth of outreach, they could easily "polish" respective data on their customers in order to receive higher bonuses. It would be difficult to uncover this potential type of fraud as loan officers have some discretion in their assessments and may also cooperate with customers if rewards were large enough. Hence, it might not be wise to incorporate such approaches into a short-term powerful incentive scheme targeted at those staff who gather the data upon which their rewards depend. Factoring such scorecards into medium- or longer-term team-based incentives where data manipulation is not worthwhile might send the right signals to staff. However, as discussed in the previous sections, the impact of such

incentives on staff performance is rather weak, especially if staff receive additional and more powerful short term incentives which focus on breadth of outreach and profitability.

Standardized scorecards that measure depth of outreach could be a valuable performance measurement indicator in longer-term incentive schemes for senior management.

The second set of tools that measure social performance are used occasionally, usually by external researchers. Naturally, the results of this research can neither be used in short-term incentive schemes nor in annual incentive schemes as they are not conducted regularly. Impact studies measure long-term changes in the customer's wealth and are thus not very useful for incentive schemes that closely link rewards to achievements. However, special bonuses could be paid to all staff based on such a social performance assessment. While it cannot be assumed that staff members work hard to achieve good results in such occasional studies, providing them with some rewards if the MFI receives good assessments should indirectly enhance their motivation as they realize that social achievements are also recognized and valued.

To summarize, if we utilize long-term, occasional social performance measurement tools, we cannot employ short-term and powerful incentives which strongly link staff performance and reward. However, such tools could be used to build long-term team-incentives, or long-term incentives for senior management. It might not be worth starting to implement complex social performance measurement indicators – rather, institutions should attempt to incorporate existing tools into their incentive scheme.

If social performance measurement tools are not compatible with short-term incentives, how can we ensure that MFIs provide their field staff with effective short-term bonus schemes that are designed around staff productivity but still address social goals?

1. The easiest way is not to reward for the achieved "volumes" (e.g. the outstanding loan portfolio volume, the volume of loans disbursed, the savings balance, etc.), but only for the achieved "numbers" (e.g. number of loans disbursed or outstanding). This will reward breadth of outreach, and there is a good likelihood that it will support depth of outreach since loan officers find it easier to disburse smaller loan sizes.

2. Organizations that perceive loan size to be a good indicator of depth of outreach may want to reward lower initial loan sizes more than higher ones (e.g. by providing an incentive of $2 for disbursing a loan of <$500 to a new customer, and by offering a commission of $1 on each disbursed loan >$500[5]).

3. Finally, the operational framework (see Section 2) already largely predetermines the balance between social and financial goals. Hence, it should not be necessary to measure social achievements if staff are specialized on certain products and have only little discretion in selecting their customers. These organizations may rather want to focus their staff incentive scheme on staff productivity. If customers can "graduate" to programs which are designed for wealthier clients (e.g. as in BRAC, see Section 4.3), loan officers

[5] It might be necessary to consider the loan term if institutions offer loans with highly dispersed loan terms: It makes a difference whether $500 are repaid in 1 or 5 years if we were to use the loan size as poverty indicator.

could receive a reward for each customer graduated to the "higher level program or product".

3.6 Conducting the technical design work

The selected performance measurement indicators need to be linked by a formula to calculate a "performance score" or bonus. In addition to variables for the achievements in each of the performance indicators, such formulas usually include weights, reference values and, sometimes, minimum requirements.

Incentive formulas make use of:

- Weights that calibrate the incentive scheme's objectives.
- Reference values or targets that represent a solid or expected level of performance.
- Minimum requirements which are baselines for which no incentives are provided. (optionally)

3.6.1 Weights

Weights are allocated to each of the performance-measurement indicators. They should adequately reflect the importance of the indicators for the institution and, hence, balance the different organizational goals which are defined by the incentive scheme's objectives. Weights of the indicators will usually add up to 100%. In some cases, management may want to allocate special weights to some performance measurement indicators. These special weights are directly linked to the performance in other areas. For instance, BancoSol has set two special weights to its entire bonus scheme for loan officers: The calculated bonus is multiplied by weights that are generated as a function of the branch team performance and the outstanding loan portfolio volume (see Section 4.2).

Table 3.6.1.1: Defining the weights (example)

Performance measurement indicator	Weight
Number of outstanding loans	50%
Outstanding loan portfolio volume	20%
PAR	30%
Total	*100%*
Special weight for PAR	No bonuses are earned if PAR was > 4%

For instance, consider an MFI that employs a monthly bonus scheme for its credit officers. It might define 3 performance measurement indicators, namely, the number of outstanding loans, the outstanding loan portfolio volume and the portfolio at risk rate. To meet its social mission, it decided to put the highest weight on the number of outstanding loans and a lower weight on the outstanding portfolio volume. The weight for the portfolio at risk is set in between, but an additional special weight is allocated to this parameter to ensure that loan officers who manage a poor loan portfolio quality do not receive any bonus at all (see Table 3.6.1.1).

Large organizations may want to set different weights for different outlets or products if management feels that the challenges for each are sufficiently different.

Organizations that want to emphasize the *balance* between different goals and that employ ambitious staff could think about linking the weights to achievements in key areas. For instance, consider an MFI that intends to focus its incentive scheme on balancing social and financial goals. Management could believe that small average loan sizes are a good indicator for achieving its social goals, and that the outstanding loan portfolio volume is an adequate reflection of profitability. The incentive system would then categorize the loan officers based on the average loan size in their portfolio, and allocate different weights to the relevant performance

measurement indicators, e.g. the number of outstanding loans and the outstanding loan portfolio volume as demonstrated in Table 3.6.1.2.

Table 3.6.1.2: Example of setting weights as a function of achievements

Performance measurement indicator / Category	**A (if the avg. loan size was < $500)**	**B (if the avg. loan size was $500 - $1,000)**	**C (if the avg. loan size was > $1,000)**
Number of outstanding loans	20%	35%	50%
Outstanding loan portfolio volume	50%	35%	20%
PAR	30%	30%	30%
Total	*100%*	*100%*	*100%*
Special weight for PAR: No bonuses are paid if PAR was >4%			

Under this scheme, loan officers with a low average loan size have a stronger incentive to disburse larger loans and, thus, become more profitable, while those who manage large portfolios can increase their rewards by increasing their outreach. Loan officers who balance social and financial goals (in this example those who maintain their average loan size between $500 and $1,000) are best off if they proportionally increase both the number of customers and the outstanding loan portfolio volume. Of course, this technique can also be applied to other functional levels of staff or different performance measurement indicators. However, such schemes should only be employed if it can be ensured that staff understand them and, thus, cope with them.

3.6.2 Reference parameters and targets

Reference parameters are benchmarks that represent a solid level of performance that management can reasonably expect from their staff. They are set for each performance measurement indicator. To ensure that reference values are set in a fair way, it may be necessary to calibrate them differently for different regions or according to the tenure of staff. MFIs that manage more than one product and employ product specialists (e.g. SME loan officers) usually adjust the reference parameters to their particular product. Then, a “reference bonus” can be defined as the reward which staff receive for achieving the reference values.

For instance, management decides that a microcredit officer should manage 300 loans, maintains a loan portfolio volume of $200,000, and ideally keeps his PAR at 1%. The MFI may offer loan officers who meet these reference values $150. While better achievements will lead to higher bonuses, weaker performers receive lower rewards and very poor performance is not rewarded at all.

If it is difficult to quantify reference parameters, for instance because institutions operate in extremely heterogeneous environments or need to cope with a very high growth rate, management could set regular *targets* instead of using reference values. However, targets should only be used in team based incentive schemes to avoid that staff suspect biases in the target setting process.

3.6.3 Minimum requirements

Some institutions use “minimum requirements” which are benchmarks that staff need to meet in order to become eligible for rewards. They should be set adequately low so that virtually everyone can achieve them and, thus, participate in the incentive scheme. The main advantages of minimum requirements are that there is a baseline for which no bonuses are earned and that the

incentive scheme becomes more sensitive to changes in performance[6]. However, such minimum requirements increase the complexity of the scheme and, hence, decrease the likelihood that staff can cope with it. As we will see below, it is helpful to set the minimum requirements as a percentage of the reference values (e.g. 50%) to avoid that the scheme's weights are reshuffled.

For example, if a MFI sets minimum requirements of 150 outstanding loans and an outstanding loan portfolio volume of $ 100,000, then Table 3.6.3.1 summarizes the weights, reference values and minimum requirements for that individual.

Table 3.6.3.1: Example of reference values, minimum requirements and weights

Performance measurement indicator	Reference values	Minimum requirement	Weight
Number of outstanding loans	300	150	50%
Loan portfolio volume	$ 200,000	$ 100,000	20%
PAR	1%	4% ("special weight")	30% + special weight
Reference bonus	$ 150		

3.6.4 Constructing incentive formulas

Once these parameters are set, they can be combined to a bonus formula. Here, we introduce two simple techniques which are frequently used in practice[7]. For instance, an MFI could calculate a "compliance ratio" or score for each performance measurement indicator as indicated in Table 3.6.4. These scores are then added up. The total score is multiplied by the reference bonus. Hence, staff members who achieve the reference values to exactly 100%, receive the defined reference bonus. Higher or lower performance is rewarded proportionally more or less, while the weights ensure that the incentive is higher for those goals which are considered more important to the institution's mission. Of course, the same calculation technique could be employed for virtually all types of performance measurement indicators.

[6] For instance, if an MFI is willing to offer a bonus of $ 50 for a loan officer who manages 300 loans, each outstanding loan would be "worth" $ 50/300 = 0.17. If a minimum requirement of e.g. 150 loans was incorporated into the scheme, the loan officer would receive $ 50/(300-150) = $ 0.33 for each outstanding loan above the 150th loan. Hence, the scheme reacts more sensitive to changes in performance and, thus the incentive effect will be higher.

[7] There a number of other techniques, and depending on how the formula is designed, the weights might be slightly reshuffled again, thus changing the balance between the importance of the different performance measurement indicators.

Table 3.6.4: Example of a bonus scheme for loan officers

Performance measurement indicator	**Number of outstanding loans**	**Outstanding loan portfolio volume**	**PAR**
Calculation of compliance ratio	$\frac{ach. - min.\ requirement}{ref.\ val. - min.\ requirement} \times weight$	$\frac{ach. - min.\ requirement}{ref.\ val. - min.\ requirement} \times weight$	$\frac{min.\ requirement - ach.}{min.\ requirement - ref.\ val.} \times weight$
Example	$\frac{Achievement - 150}{300 - 150} \times 50\%$	$\frac{Achievement - \$100{,}000}{US\$200{,}000 - \$100{,}000} \times 20\%$	$\frac{4\% - Achievement}{4\% - 1\%} \times 30\%$
Achievement for one sample loan officer	*340*	*$ 190,000*	*1.5%*
Compliance ratio for sample loan officer	$\frac{340 - 150}{300 - 150} \times 50\% = 0.63$	$\frac{\$190{,}000 - \$100{,}000}{\$200{,}000 - \$100{,}000} \times 20\% = 0.18$	$\frac{4\% - 1.5\%}{4\% - 1\%} \times 30\% = 0.25$
Total score of sample loan officer	0.63 + 0.18 + 0.25 = 1.06		
Reference bonus	$150 ($0 if PAR was > 4%)		
Total bonus for sample loan officer	Total score x reference bonus = 1,06 x $150 = $159		

Obviously, this incentive scheme is quite complex, and whether loan officers are able to cope with it will largely depend on the organizational culture. Usually, MFIs employ more than just three performance indicators, which increases the complexity of the scheme further. Hence, it may be wise to think about ways to simplify the system. For example, we could transform the rewards offered for each unit above the baseline into commissions (see the case study on BancoSol in Section 4.2). Or, we could design a "staged scheme" based on our bonus formula as demonstrated in Exhibit 3.6.4.

Exhibit 3.6.4: Example of a staged incentive scheme

PAR / Outstanding loan portfolio volume (in US$)	**< 1%**	**1.0% - 1.9%**	**2% - 2.9%**	**>3% - 3.9%**
100,001 – 150,000	$ 60*	$ 45	$ 30	$ 15
150,001 – 200,000	$ 75	$ 60	$ 45	$ 30
200,001 – 250,000	$ 90	$ 75	$ 60	$ 45
> 250,000	105	$ 90	$ 75	$ 60

* Bonus amount in $: calculated by: {[(((150,000 - 100,001) / 2 + 100,001) - 100,000) / (200,000 - 100,000) X 20%] + [(4% - ((1% - 0%) / 2 + 0%) / (4% - 1%) X 30%]}X $150 = $60

Outstanding number of clients	**Bonus (in $)**
151 – 200	13**
201 – 250	38
251 – 300	63
301 – 350	88
> 350	113

** Calculated by ((200-151) + 151) X 50% X US$150 = $ 13

The total bonus is calculated by adding up the respective bonuses of the 2 tables.

Loan officers who do not maintain a PAR rate below 4% are not eligible for any bonuses.

While such staged schemes are easy to understand by staff, they have a number of drawbacks. If there are only a few stages, staff will not see any scope to graduate to the next stage within the period in which the incentive is calculated, and, thus, will not respond to the incentive scheme.

The same applies to a "cap" on the bonus: Someone who has already achieved the highest possible bonus will not be rewarded for higher achievements. Conversely, an employee who is still far from reaching the minimum requirements might consider the requirement unattainable and not perceive an incentive to work better or harder. These risks can be mitigated by a careful calibration of the scheme and by including more stages.

Incentive schemes that are to set to reference values and/or minimum requirements, should be calibrated to ensure that the vast majority of staff earn bonuses and that everyone has an incentive to increase his efforts – regardless of whether a linear bonus formula or a staged incentive scheme is employed. It is helpful to apply the bonus formula to the previous performance of staff to identify the "winners and losers" of the scheme as well as "structural outliers", such as rural branches, new branches, senior employees, or product specialists. It might be necessary to calibrate the incentive scheme differently for these employees to ensure that the fairness requirement of incentive schemes is met. Many institutions also have a special incentive policy for staff who are transferred between branches.

Although the examples provided above reflect short term bonus schemes for loan officers, the same techniques can be applied to most other kinds of incentive schemes. The case studies in Section 4 demonstrate, for instance, that Equity Bank in Kenya and PRIZMA in Bosnia and Herzegovina have used similar approaches to design team-based and long-term incentives that balance social and financial goals.

3.7 Analyzing benefits and costs

Before (re-designed) incentive schemes are implemented, we should conduct a cost benefit analysis to ensure that their benefits outweigh their costs. While it is already fairly difficult to appraise the financial benefits and costs of incentive schemes, it is even more complex to estimate their social ones. Furthermore, we should also consider the indirect financial benefits and costs that are related to the achievement of social goals, such as easier access to "soft loans" or donor grants.

The structure of a cost benefit analysis is fairly straigthforward: We conduct two performance scenarios, one "normal scenario" and one "incentive scenario". In the normal scenario we assume that business develops as usual. In the "incentive scenario" we assume that an incentive scheme is implemented and, consequently, staff react to it and improve their performance according to the incentives offered[8]. The benefit of the incentive scheme is then predicted by a simple formula:

(Benefits – costs under the incentive scenario)
– (Benefits – costs under the normal scenario)

The different scenarios should be based on those performance indicators used in the incentive scheme as well as on relevant key indicators that are not included in the calculation of the rewards. For instance, if an MFI decided not to include the outstanding loan portfolio volume into its set of performance measurement indicators to foster breadth and depth of outreach, the cost-

[8] It is advisable to conduct more than just one incentive scenario as it will be difficult to appraise the effects of the incentive scheme – especially for MFIs that have not yet gathered experience with staff incentives. For instance, incentive scheme designers might want to conduct a conservative, an expected, and an optimistic scenario.

benefit analysis should also consider that the average loan size and, thus, the interest income may decrease due to the incentive scheme's impacts on staff performance. Interviews with the staff affected by the scheme and their direct superios will help in designing respective scenarios. The results of a pilot test (see Section 3.8) would also be valuable in predicting the scenarios as accurately as possbile.

In practice, it will not only be difficult to predict an employee's behavior and performance under the two scenarios, but it will also be almost impossible to assess the social benefits and costs in monetary terms. Hence, we suggest running a financial cost benefit analysis as suggested in the formula above while adjusting the respective monetary result by an appraisal of the social benefits and costs which might be caused by the incentive scheme.

Financial benefits usually include all kinds of income from customers: Interest and fees for loans, fees and transfer prices from savings mobilisation, or commissions earned on selling insurances.

Financial costs include costs of funds, loan losses and administrative costs (including staff costs and incentives).

Among the *social benefits (or costs)* induced by the incentive scheme are increased (or decreased) depth of outreach, breadth of outreach, or impact (e.g. poverty alleviation). Institutions that expect easier access to grants or subsidized loans due to higher social impact may also want to estimate and add the value of these additional income sources. Although it will not be possible to quantify these benefits and costs in monetary terms, predicting the various types of effects and analyzing whether they are positive or negative for the MFI's mission and vision is crucial.

3.8 Implementing and monitoring incentive schemes

Before implementing incentive schemes or making fundamental adjustments to existing schemes, they should be pilot tested in a small number of outlets for a few periods. Especially when they significantly influence the remuneration of staff, changes to or withdrawals of incentive schemes can be extremely difficult to communicate to the employees as changes usually include additional hardships and / or a lower remuneration. Hence, it is wise to pilot test the scheme on a small scale to ensure that nothing was overlooked, that there are no negative side-effects, and that the scheme meets the transparency and fairness requirements.

Of course, not all incentive schemes can be pilot tested. For instance, it will not be possible to apply an annual profit sharing scheme for head office staff to some employees for some periods (years). In these cases, it helps to be very careful in the design process, and to roll it out with the notice that it is subject to be changed or withdrawn after the initial periods.

Implementing and monitoring SIS:

- Pilot test (redesigned) SIS.
- Make sure that staff understand and can cope with the SIS.
- Monitor the scheme regularly and make adjustments occasionally.

Carefully communicating the incentive scheme is crucial. Many institutions put a lot of effort in selecting the right performance-measurement indicators and in designing and calibrating the formula that calculates the rewards. Many of these efforts simply fall flat since staff do not understand the calculation techniques. Some MFIs that utilize complex incentive schemes have overcome this by providing staff with spreadsheets that calculate the rewards for their (future)

achievements. However, it is not only essential that employees can calculate their bonuses, but that they understand the message underlying the scheme. It is up to staff to transform all the formulas into real incentives, apply the incentives to their daily tasks and know how to increase their incentives and, thus, organizational benefits available. For institutions that focus on impact or breadth of outreach, longer-term team- or institution-wide incentives should be employed to ensure that staff understand the underlying message: that everyone works towards meeting the institution's vision and mission and that incentives are not only monetary rewards to enhance short term productivity, but symbolic acknowledgements for their efforts throughout the year.

Monitoring the incentive scheme's performance regularly and adjusting it occasionally will ensure that it meets its objectives even as organizational goals, operational challenges, processes, products, tools, and overall economic conditions change. It is possible to carefully monitor short-term or individual incentive schemes at reasonable costs if the achievements of staff and the bonus calculation is included in the MIS or if these data are available in a database. When adjustments are deemed essential, it is often not necessary to change the entire incentive formula. In most cases it is sufficient to re-calibrate the reference values, weights and minimum requirements. Adjustments should not be conducted frequently nor arbitrarily to avoid that staff feel "tricked out". On an average, MFIs adjust their incentive scheme once in one to two years. Employees usually need some time to adjust their behavior to changed incentives, and such changes frequently create additional hardships and/or lower bonuses. Hence, remember that changes and their reasons should be well communicated to staff so that they are accepted.

4 Case Studies

4.1 PRIZMA, Bosnia and Herzegovina

4.1.1 Institutional Overview

PRIZMA is a registered not-for-profit microcredit institution which operates throughout Bosnia and Herzegovina. It was founded after the war, in 1997.

The organization's mission is to "improve the well being of large numbers of poor women and their families by providing long-term access to quality financial services".

PRIZMA focuses on poverty outreach and social impact. Almost all of PRIZMA's customers are women, and through its 36 outlets, it reaches remote rural areas of the country. The organization perceives its social objectives to be a strategic advantage since other MFIs in the country compete for a different clientele, namely wealthier customers.

Table 4.1.1: PRIZMA at a glance (as at April 2006)

Number of branches	6
Number of total outlets	36
Number of total staff	83
Number of loan officers	41
Number of borrowers	18,604
Outstanding loan portfolio volume (in US$*)	13,286,033
Avg. loan size (in US$*)	930
Case load per loan officer	454
Adjusted RoA Dec. 2004	8.3%
Adjusted RoE Dec. 2004	13.3%
* Exchange rate: 0.65 US$/BAM	

Source: PRIZMA, own calculations

PRIZMA's strong social commitment is reflected by its product design and simple, customer-friendly lending technology. Loan sizes, fees, interest rates and the location of some braches make PRIZMA less attractive to wealthier customers. The organization regularly monitors its depth of outreach using a "poverty scorecard" which appraises and tracks the poverty level of new and existing clients. The scorecard is comprised of 7 variables that were identified as good indicators to measure wealth in the local context. In addition, the scorecard creates a way for external institutions such as AIMS or Imp-Act to conduct impact and poverty outreach studies with PRIZMA. As we will see in the next section, PRIZMA has implemented an incentive scheme which not only focuses on productivity, but also supports the organization's social objectives in a more direct way than most incentive schemes.

4.1.2 Overview of Staff Incentive Schemes

PRIZMA uses two types of performance-based staff incentive schemes, namely an annual branch-based SIS for all staff and a monthly individual bonus scheme for loan officers.

To foster team work and motivate staff, PRIZMA utilizes a *team-based incentive scheme*. The branches as well as headquarter staff are considered as teams. Under that scheme, team members can earn bonuses if the following requirements are met:

1. PRIZMA generates an annual profit of at least KM 100,000;
2. The $PAR_{1\text{-}180\text{ days}}$ is below 5%;
3. Bonuses are approved by the board of directors;
4. The individual team member achieved satisfactory results in all of the 3 qualitative performance appraisals which are conducted during the year (those who achieved only 2 satisfactory appraisals qualify for 50% of their bonus share).

The branch bonus pool is calculated as a function of the branches' achievements in 6 core areas as demonstrated in Table 4.1.2.1. Weights (in percentages) are allocated to each of the 6 performance measurement indicators according to the preferences that management defines for each branch. Depending on their achievement of benchmarks, teams can earn scores of 0, 1/3, 2/3 or 1 in each of the 6 evaluated areas. These scores are then multiplied by the respective weight. The final branch score is calculated by adding the 6 weighted scores.

Table 4.1.2.1: PRIZMA's branch based incentive scheme

Performance measurement indicator	Operationalization	Weight	Calculation of the branch score
Depth of outreach	# new poor[9] clients during the year / Total new clients during the year	16.67%	Branches can earn sub-scores of 0, 1/3, 2/3 or 1 according to their achievement on benchmarks which are set for each of the 6 performance measurement indicators. These scores are then multiplied by the respective weight.
Breadth of outreach	(# active clients at end of year) – (# active clients at end of last year) / # active clients at end of last year	16.67%	
Customer dropouts	# clients who could have taken a repeat loan within 120 days of paying off their previous loan / # clients who could have taken a repeat loan within 120 days of paying off their previous loan	16.67%	
Productivity	# active clients at the end of the year / # paid employees at the end of the year	16.67%	
Administrative efficiency	Administrative expenses / Avg. outstanding gross portfolio during the year	16.67%	
Write off	Loan amounts written off during the year / Avg. outstanding gross portfolio during the year	16.67%	
Total		100%	Sum of the weighted sub-scores

Headquarter staff receive the average score which the branches have earned. The total bonus pool, which is the greater of either 10% of the annual profit or one monthly payroll, is then distributed among the employees as a function of their team's score and the number of days they worked during the year. All staff receive around 60% of their team bonus share in December, and the remaining 40% at the beginning of the consecutive year, after audited results are available.

The additional *monthly bonus for loan officers* is calculated as a function of four performance measurement indicators to which different weights are allocated as indicated in Table 4.1.2.2:

Table 4.1.2.2: SIS for loan officers at PRIZMA

Performance measurement indicator	Weight in % of the maximum bonus offered
1. Portfolio at risk 31-180 days	50%*
2. Number of loans disbursed with 3 different benchmarks for solidarity group loans, individual loans with loan sizes < KM 1,000 and individual loans with loan sizes => KM 1,000, respectively	22%
3. Number of active clients with different benchmarks for the 3 types of loans (see above).	19%**
4. Dropout rate	9%

* In addition, loan officers must maintain a PAR at below 1.5% to become eligible for any incentives.
** In order to participate in the incentive scheme, loan officers must manage at least 25 individual loans with loan sizes > KM 1,000, or 300 individual loans with loan sizes < KM 1,000, or 200 solidarity group loans.

PRIZMA's incentive scheme for loan officers follows a staged pattern, which means there are a number of "trigger points" for each of the performance measurement indicators which lead to a certain bonus. With this simple, but powerful incentive scheme loan officers can earn up to 50% of their basic salaries.

[9] A "poor client" is defined by the use of PRIZMA's poverty scorecard. With this scorecard, PRIZMA assesses the poverty level of its clients as a function of 7 indicators, namely (1) the education level, (2) number of household members, (3) ownership of a CD player and (4) a vehicle, (5) location of residence, average number of times the customer (6) eats sweats and (7) eats meat per week.

4.1.3 The Effects of SIS on Balancing Social and Financial Goals

Both PRIZMA's non-financial incentives and financial incentives support the organization's mission. Staff understand PRIZMA's social orientation, and the good working environment motivates them to achieve both the organization's social and financial goals. While the annual team-based incentive scheme supports this intrinsic motivation, the monthly bonus scheme for loan officers focuses on productivity and portfolio quality without significantly reshuffling PRIZMA's balance of social and financial goals.

The six performance measurement parameters used to accrue the team-based bonus represent a reasonable mixture of social and financial indicators: Administrative efficiency, productivity and portfolio quality reflect profitability and sustainability; breadth of outreach and customer retention support both social and financial goals; and incorporating a parameter that measures depth of outreach is remarkable since it is one of the rare attempts to reward staff explicitly for achievements in poverty outreach.

Individual staff members do not believe they can influence the team reward significantly because they are part of a larger team. This bonus is quite unpredictable as most staff do not understand the adjustment techniques used in the audited reports. Not very surprisingly, staff reported that they did not work hard in order to increase their annual bonus, but nevertheless indicated that this incentive supports their intrinsic motivation, team spirit, commitment, loyalty, and sense of identification with PRIZMA as they feel that their contributions are recognized. These values are very important for organizations to achieve their missions – especially when missions include different and maybe contradicting objectives such as financial and social goals.

In contrast, the individual incentive scheme has a more direct impact on staff performance for essentially three reasons: Firstly, staff are individually accountable for their own achievements and, thus, free riders cannot reduce the rewards for the efforts spent. Secondly, the monthly bonus payouts ensure a close link between performance and reward. And thirdly, the bonuses offered are significantly higher than the awards of the team-based incentive scheme.

PRIZMA's individual incentive scheme has a strong focus on portfolio quality (50% of the maximum bonus) and breadth of outreach (41% of the maximum bonus). Service quality and, maybe, impact are indirectly incentivised through customer retention, but with a lower weight (9% of the maximum bonus). In practice, the scheme also enhances depth of outreach (or at least, ensures that loan officers do not seek the wealthier customers), and the weights outlined in Table 4.1.2.2 are slightly shuffled from a loan officer's point of view:

1. A high loan portfolio quality is clearly vital to institutional sustainability and, thus, is crucial to meeting financial objectives. The large weight on this parameter not only ensures that loan officers attempt to recover loans in arrears, but also that care is taken in loan analysis so that customers are less likely to become overindebted. It was also found that incentivising PAR can have indirect effects on depth of outreach: on one hand, some staff indicated that poorer customers are more reliable in their repayments, and on the other hand, some staff members who did not achieve the eligibility requirement related to PAR reported that they preferred to seek wealthier customers to disburse larger amounts in order to reduce their PAR.

2. The parameter which counts the number of loans disbursed contributes to a high level of loan officer productivity, which is directly related to financial objectives as well as breadth of outreach. At the same time, the volume of loans disbursed is not considered. Loan officers reported that it is easier to disburse smaller loan sizes and, thus, their strategy is not to actively seek wealthier customers. Some prefer to acquire poorer customers, and others are indifferent as they try to promote whomever they can reach.

3. The facts that the number of active clients is rewarded and the outstanding loan portfolio volume is not considered in the scheme have the same impacts - productivity and breadth of outreach is enhanced while there is a slight incentive for loan officers to seek poorer customers. In addition, loan officers can achieve a larger customer base if they disburse longer-term loans.

4. Including the dropout rate in the scheme provides an incentive for good customer service, and low dropout rates can significantly reduce administrative costs. Some may also argue that entrepreneur retention is an indicator for social impact because customers grow their business from loan cycle to loan cycle.

4.2 BancoSol, Bolivia

4.2.1 Institutional Overview

BancoSol, founded in 1992, was the first private commercial bank to provide microfinance services. In the initial stages, BancoSol worked closely with Prodem, a local NGO, inheriting some of the NGO’s branches, staff and customers. The first staff consisted primarily of sociologists and social workers with an NGO background. Currently, many staff members (including the top-management) come from a commercial banking background.

BancoSol managed to overcome the recent financial crises in Bolivia, and is now serving over 65,000 loan clients with an outstanding loan portfolio of almost 140 million US$.

To achieve long-term sustainability and to increase profitability, BancoSol focuses on solvency and growth. It strives for large loan portfolio volume. Using and developing automated technologies such as ATMs, handhelds as well as statistical credit scoring, the bank is steadily increasing its efficiency.

The innovative products and services of BancoSol help it to increase its market share in an extremely competitive environment. The wide range of products and services includes 7 loan products (both individual and solidarity group loans), savings accounts, fixed term deposits, and also affordable microinsurance policies (life, accident and health insurances), cheap money transfer services, debit cards (VISA Electron), bank guarantees and tax and bill payment services.

BancoSol's mission ("We are the bank that gives the opportunity for a better future to the lowest income sectors, by giving them high quality and integral financial services") clearly shows the bank's focus on serving the lower income sectors. Institutional sustainability, and, hence, profitability is crucial to achieving this goal. The bank has a strong social commitment and it can afford to serve poorer and less profitable clients. BancoSol donates portions of its income to welfare programs such as a health fund, sponsors a number of socio-cultural events (sports, arts) and contributes to educational activities. It offers small loan sizes which hardly break even and regularly tracks its poverty outreach using a "social scorecard" which classifies the bank's customers as a function of their households' monthly per capita expenditures. At present, the bank is designs a new loan product which offers loans of less than US$ 500 to very poor microenterpreneurs.

Table 4.2.1: BancoSol at a glance (as at April 2006)

Number of outlets	43
Number of staff	792
Number of credit officers[10]	246
Number of borrowers	65,264
Outstanding loan portfolio volume (in US$)	138,345,266
Portfolio at risk (PAR) > 1 day	3.9%
Write off ratio 2005	1.4%
Avg. outstanding loan size (in US$)	2,120
Case load per credit officer	265
Case load per total staff	82
Number of savings accounts	91,660
Savings balance (in US$)	23,802,618
Avg. savings balance (in US$)	260
Number of fixed term deposits	4,925
Fixed term deposit balance (in US$)	77,910,946
Avg. fixed term deposit balance (in US$)	15,819
Return on avg. Assets 2005	2.8%
Return on avg. Equity 2005	22.4%

Source: BancoSol

4.2.2 Overview of Staff Incentive Schemes

BancoSol employs performance based staff incentive schemes for virtually all branch staff. Since the scheme for loan officers is the bank's most important and powerful one, this case study focuses on the reward system for loan officers.

All loan officers receive monthly individual bonuses that are calculated as a function of their performance in three key areas: Disbursements, outstanding loan portfolio, and loan portfolio quality. BancoSol employs 5 different types of loan officers who manage different initial loan sizes (see Table 4.2.2.1.). While the structure of the incentive scheme is the same for all loan officers, the scheme's calibration considers the different targets and institutional goals for the different types of loan officers. The bonus calculation is rather complex. It is calculated by:

(DP – A) x G x V, where:

DP (Portfolio) is a bonus for achievements in disbursements and the outstanding loan portfolio
A (Arrears) is a deduction for arrears
G (Group) is a factor which is calculated as a function of the branch achievements in selected areas

[10] Excluding normalization and recuperation agents, credit supervisors and data typists.

V (Volume) is a factor which is calculated as a function of the outstanding loan portfolio volume

1. **DP (Disbursements and Portfolio)** is operationalized by 4 performance measurement parameters: the number of loans disbursed, the volume of loans disbursed, the number of outstanding loans, and the outstanding loan portfolio volume. For each of the 4 performance measurement parameters the bonus is calculated by a simple formula:
   Bonus = achievement / target x weight x reference bonus,
   where the reference bonus refers to the achievement of the targets which represent a solid level of performance as defined by management.
   The weights are outlined in Table 4.2.2.1., and reflect management's preferences.

Table 4.2.2.1.: Weights for disbursements and outstanding loan portfolio by type of credit officer

Type of loan officer	Loan sizes managed by this type of loan officer (in US$)	Weights for disbursements		Weights for outstanding portfolio		Total weights
		# loans	Vol.	# loans	Vol.	
Micro A	Up to 3,000	60%[11]	20%	16%	4%	100%
Micro B	3,001 – 6,000	48%	32%	13%	7%	100%
Micro C	6,001 – 15,000	40%	40%	10%	10%	100%
Small enterprise	15,001 – 25,000	28%	52%	6%	14%	100%
Medium enterprise	> 25,000	20%	60%	5%	15%	100%

For all types of loan officers, BancoSol offers the largest incentives for disbursements (80% of the reference bonus). With increasing loan sizes managed by the loan officers, the weights for the volumes increase and, consequently, the weights for the number of loans decrease.

2. **A (Arrears):** The amount A by which the bonus earned for the disbursements and the outstanding loan portfolio (DP) is reduced, is calculated by a function of three indicators: the average PAR during the month, a staged PAR report at the end of the month and the loan loss provisions. The staged PAR report considers both the number of customers in arrears and the outstanding portfolio volume of delinquent loans. Again, different weights which reflect management's preferences are allocated to each of these parameters as indicated in Table 4.2.2.2:

Table 4.2.2.2: Weights for different parameters related to loan portfolio quality

Type of loan officer	Staged PAR report									Avg. PAR	Loan loss provisions	Total
	1-30 days		31-60 days		61-90 days		>90 days		Sub-total			
	No.	Vol.	No.	Vol.	No.	Vol.	No.	Vol.				
Micro A	20%	5%	7%	2%	5%	1%	4%	1%	45%	20%	35%	100%
Micro B	16%	9%	6%	3%	4%	2%	3%	2%	45%	20%	35%	100%
Micro C	12%	12%	5%	5%	3.5%	3.5%	2%	2%	45%	20%	35%	100%
Small enterprise	9%	21%	3%	8%	2%	6%	2%	4%	55%	15%	30%	100%
Medium enterprise	8%	23%	3%	8%	2%	6%	1%	4%	55%	15%	30%	100%

[11] For type A microcredit officers, the number of loans disbursed to new customers has a lower sub-weight (40%) in relation to the number of loans disbursed to repeat clients (60%). This differentiation does not apply to other loan officers.

The amount A is then calculated by a simple formula:

A = (reference bonus x 50%) x ∑ (weight x achievement / reference value),

where the reference bonus is the same as in the calculation of PD, the weights are indicated in Table 4.2.2.2 and the reference values were set at the average achievement levels when the scheme was calibrated.

3. **G (Group factor):** This factor represents the branches' achievements on targets and is meant to foster team work. The scheme considers targets in 3 areas, namely the number of outstanding loans, the outstanding loan portfolio quality and the portfolio at risk. Targets are provided by the head office and broken down to branch level by regional management.

4. **V (loan portfolio volume):** To avoid that senior loan officers, who manage large loan portfolios with a somewhat poorer loan portfolio quality than junior loan officers, are disadvantaged, BancoSol has factored in an additional parameter which is calculated as a function of the loan portfolio volume. This factor takes values between 0% and 100%.

At a first glance, the incentive scheme for credit officers looks fairly complex. However, the description presented here is the designer's point of view. BancoSol made a big effort to create a presentation that is easily understood by staff. It transformed the bonus calculation of the parameters DP and A into a commission-based format. Loan officers are told that they receive a certain commission in Bolivianos on each disbursed and outstanding loan as well as on each US$ 1,000 of the outstanding loan portfolio volume and the volume disbursed. Likewise, they receive a "negative commission" in Bolivianos on each loan in arrears, on each US$ 1,000 in arrears and on each US$ 1,000 which are provisioned. The exact values of the commissions differ for the different types of loan officers and the different parameters. All loan officers have access to an Excel spreadsheet which calculates their bonus for the level of achievements they insert.

BancoSol also utilizes short term incentive schemes for other branch staff, including bad debt recovery officers, loan supervisors, branch managers, branch operation managers, sales representatives, and data typists. All these schemes are designed around staff productivity. Senior management receives an annual bonus, and all staff receive a Christmas bonus and one additional basic salary at the end of the year (the "Prima", as required by law). In addition, the bank employs a host of non-monetary incentives such as annual recreation activities, nice office buildings and fair promotion opportunities.

4.2.3 Effects of SIS on the balance between social and financial goals

BancoSol has designed a fairly complex incentive scheme for its loan officers which carefully balances institutional objectives and, at the same time, is fair to all loan officers. The incentive scheme is an important part of the bank's organizational culture. Staff work very hard in order to achieve their bonuses which are usually large enough to make a significant difference in their income – many loan officers double their basic salaries with their bonuses. There is no doubt that the scheme clearly focuses on staff productivity and, thus, on contributing to the achievement of financial objectives. Indirectly, the scheme also helps to meet social goals since BancoSol redistributes portions of its profits to social activities and funds, and because institutional sustainability is the key to subsidize the smaller loans for poor customers.

While the structure of the scheme is the same for all types of loan officers, BancoSol calibrated it differently for the various types of loan officers to ensure that everyone has the same likelihood of earning a certain bonus. Most loan officers manage smaller initial loan sizes: Around 60% of the credit officers need to seek new customers who apply for loans up to US$ 3,000. 25% acquire customers who take loans between US$ 3,000 and US$ 6,000, and the remaining 15% disburse loans above US$ 6,000. Hence, the balance between the smaller loan sizes and the larger ones is predetermined by BancoSol's categorization of loan officers. While 40% of the loan officers manage the wealthier third of the bank's customers (whose expenditures exceed US$ 2 a day per person), 60% disburse initial loans to those who have an expenditure of less than US$ 2 a day per person[12].

The bonus scheme adequately reflects the balance between targeting richer and poorer customers. For microcredit officers who manage small initial loan sizes, the weights are higher for the "numbers" (the number of loans disbursed, the number of outstanding loans, the number of loans in arrears) in relation to the weights for the "volumes". The incentives for the volumes gradually increase as the credit officers take care of larger initial loan sizes. Hence, BancoSol's incentive scheme also attempts:

1. to increase breadth of outreach, especially among the poorer customers,
2. to increase depth of outreach,
3. to increase profitability by disbursing larger loans (the bank also donates portions of its profit to social activities).

While the exact balance between these goals is widely determined by operational policies, the staff incentive scheme also contributes to balancing social and financial goals:

1. Within the loan sizes which the credit officers manage, they have some discretion as to whether they seek wealthier or poorer customers. While most credit officers indicated that they take any available customer, those who manage the smaller loans also reported that they preferred to seek poorer clients as smaller loans are easier and quicker to disburse, and because the loan volumes have a fairly low weight in the bonus formula[13].

2. Although customer retention is only directly rewarded for those microcredit officers who manage the smallest initial loan sizes, the scheme indirectly rewards low dropout rates, since loan officers know that disbursing loans to repeat customers is simpler than appraising new customers. Hence, they attempt to retain as many of their good customers as possible in order to achieve high rewards – this is not only beneficial to themselves but also benefits both BancoSol's profitability and the clients (due to good customer service).

3. The loan portfolio quality is weighted heavily in the incentive scheme. Hence, loan officers are careful in their analysis and in the credit committee and spend a significant portion of their time recovering loans in arrears. This is not only vital for institutional sustainability, but also avoids that customers become over-indebted due to "relaxed" repayment capacity assessments. Credit officers need to find the right balance between disbursements and portfolio quality.

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[12] Rough estimations based on BancoSol's poverty scorecard and the number of loan officers by type.

[13] However, loan officers of some branches reported that they rather seek wealthier customers to meet their monthly disbursement targets.

The non-performance based incentives enhance staff loyalty and commitment, which is vital for institutions to achieve their goals since staff who are not only motivated by money are more likely to work towards achieving the organization's mission.

4.3 BRAC, Bangladesh

4.3.1 Institutional Overview

Established as a relief organization in 1972, just after Bangladesh's independence war, BRAC follows an integrated village development approach which includes an economic development program as well as health, education, social development, human rights and legal services programs. BRAC founded a number of related institutions such as a university, BRAC Bank and Aarong, and has recently expanded to Afghanistan and Sri Lanka.

Serving almost 5 million customers throughout Bangladesh, BRAC's microfinance program is among the largest in the world.

Table 4.3.1: BRAC at a glance (as at April 2006)

Number of outlets	1,807
Number of total staff[14]	91,143
Number of lending staff (2005)	13,000
Number of active borrowers	4,279,294
Outstanding loan portfolio volume (in US$)	297,740,000
Portfolio at risk (PAR) > 1 day	4.3%
Avg. loan size (in US$)	152
Case load per lending staff (2005)	330
Number of depositors (members)	4,863,651
Savings balance (in US$)	146,000,000
Avg. savings balance (in US$)	30
Return on performing assets 2005	24.6%

Source: BRAC

With its microfinance program, BRAC targets "moderate poor" and "vulnerable non-poor" households. The "extreme poor" are served through two non-profitable economic development programs, namely the "Challenging the Frontiers of Poverty Reduction – Targeting the Ultra Poor" (CFPR-TUP) and the "Income Generation for Vulnerable Group Development" (IGVGD) programs. While CFPR-TUP provides asset transfers and subsistence allowances, the IGVGD program offers small loans (starting from as little as US$ 20) so that customers may graduate to the regular microfinance program. Both of these programs include social and economic training opportunities.

BRAC offers 2 microfinance products, *Dabi* and *Unnati*, to the moderate poor. Both programs use a group lending technology and require compulsory savings. The obligatory membership for borrowers includes life insurance as well as a voluntary savings product. Vulnerable non-poor can access larger loan sizes through BRAC's individual loan product called "*Progoti*".

Virtually all borrowers are women. *Dabi* is BRAC's most important microfinance program as it comprises 91% of BRAC's borrowers and 68% of the outstanding loan portfolio volume.

4.3.2 Overview of Staff Incentive Schemes

BRAC implemented a monthly monetary performance-based staff incentive scheme for its loan officers ("Programme Organizers", "POs") from scratch in March 2006. Three months before

[14] Including 56,458 part time employees such as teachers.

implementation, in January 2006, the scheme was explained to all staff. BRAC took great care in presenting the scheme to ensure that all staff received the same message and understand the scheme well. For example, the Microfinance Manager as well as the Deputy Executive Director traveled around the whole country to explain the scheme to all managers.

Based on their performance in key areas, POs can earn a bonus of up to around 60% of their basic salary. The scheme is designed to be very simple, and essentially uses only 2 performance measurement parameters, namely the number of outstanding loans and the current[15] outstanding loan portfolio volume.

While the structure of the scheme is the same for all POs, the benchmarks are set differently for *Dabi*, *Unnati* and *Progoti* POs as well as for different categories of branches. BRAC has defined 3 categories of branches to reflect local operational circumstances. Categories were set according to the branch's previous performance in the number and the volume of outstanding loans per PO as well as the branch's loan portfolio quality ("APO"[16]). New branches and those that operate under extremely difficult circumstances were not clustered. In these branches, the incentive scheme's benchmarks are set by a committee which is comprised of the regional manager, the branch manager and the respective PO.

The incentive scheme includes 2 parts: a "microfinance allowance", and a bonus. The microfinance allowance is paid to all POs who manage a certain number of customers. As all benchmarks in BRAC's incentive scheme, this target is set according to the type of loan officer (*Dabi*, *Unnati*, *Progoti*) and the category of the branch. The size of the allowance is set as a function of the employee's salary scale and amounts to around 10% of the PO's basic pay.

POs are also eligible for a bonus if they exceeded the target of the microfinance allowance by more than 50 outstanding clients: *Dabi* and *Unnati* officers receive 1% of their basic salary as incentive for each additional 10 outstanding clients, and *Progoti* officers receive 1% for each 5 additional customers. This bonus is capped at 25% of the base salary.

Similarly, PO's whose current loan portfolio exceeds a certain benchmark receive a bonus of 1% of their basic salary for each additional Tk. 50,000 (*Dabi* officers), Tk. 100,000 (*Unnati* officers), and Tk. 300,000 (*Progoti* officers). For *Dabi* and *Unnati* officers, this bonus is capped at 25% of their basic salaries, and *Progoti* officers can receive a maximum of 35% of their basic salary.

To become eligible for these bonuses, POs need to meet a number of further requirements, including:

- Savings withdrawals do not exceed the "voluntary" deposits within the month[17].
- Less than 2% (0.25% for *Progoti* officers) of the outstanding loan portfolio is transferred to the "late portfolio"[18];

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[15] Principal amounts at risk are not considered.

[16] APO means "Aged Portfolio Outstanding" and is calculated by 1-PAR>1day.

[17] Since a vast number of POs have not met this requirement, BRAC will lower this requirement. Under the planned scheme, POs will be eligible for bonuses if the withdrawals do not exceed the voluntary deposits by more than 10%. The deposited amount is reduced by the withdrawn compulsory savings.

[18] One year after disbursement, loans in arrears are automatically transferred to the "late portfolio". One year later, respective loans are transferred to the "non interest bearing loan portfolio" (NIBL).

- Less than 50% (10% for *Progoti* officers) of the late portfolio is transferred to the "non interest bearing loan portfolio";
- The current loan portfolio ("0 past due") needs to remain stable or increase during the month;
- Staff have achieved a tenure of 6 months (for the microfinance allowance) and a tenure of 12 months (for the incentive), respectively.

While bonuses are paid at the 10th of each month, staff receive their basic salaries at the end of the month.

4.3.3 Effects of BRAC's SIS on the balance between social and financial goals

BRAC's *economic development program* includes 5 sub-programs, namely CFPR-TUP, IGVGD, *Dabi*, *Unnati* and *Progoti*. Each program has its own staff, and while there is no incentive scheme for employees in the CFPR-TUP and IGVGD programs, the incentive schemes for *Dabi*, *Unnati* and *Progoti* POs have the same structure, but are calibrated differently.

Dabi, *Unnati* and *Progoti* POs are specialized by the products they manage. The design of these products already excludes the extreme poor (which are targeted by the CFPR-TUP and IGVGD programs) and the wealthier segments of society (which are reached by commercial banks, such as BRAC Bank). Likewise, the *Dabi*, *Unnati* and *Progoti* programs target different clients. Hence, the depth of outreach (targeting the poor) is already widely determined by the type of product which the POs manage – and is therefore partly beyond the POs' discretion.

Dabi and *Unnati* POs are not heavily engaged in marketing activities. They attempt to deliver a high customer service quality to retain customers and to strengthen BRAC's reputation for admitting new customers in the community which largely depends on word of mouth promotion and acceptance by existing group members.

As discussed earlier in this report, staff incentives should be fair and transparent. For BRAC, these 2 requirements include two important implications regarding to the role in balancing social and financial goals:

1. Since POs work in different operational circumstances, BRAC had to cluster the branches and calibrate the incentive scheme differently according to operational circumstances. Hence, the same achievements are rewarded differently in different clusters of branches as achievements are only partly under the control of POs. This implies that POs who work in more difficult operational circumstances (e.g. with higher competition, weaker economic circumstances or in areas which are more frequently affected by natural disasters) receive higher rewards for delivering certain results than POs who work in a good area.

2. *Dabi* and *Unnati* POs usually enjoy the same status within BRAC. While *Dabi* POs naturally have a lower profitability (due to lower average loan sizes) and a higher impact on poverty outreach than *Unnati* POs, their bonus schemes are calibrated differently to ensure that they have the same likelihood to earn a certain bonus (in percent of their basic salary). For instance, the baselines for which no bonuses are earned are set at 350 customers and an outstanding loan portfolio volume of Taka 1.5 million for *Dabi* POs,

and 300 clients and Taka 2.5 million outstanding for *Unnati* POs, respectively[19]. *Progoti* POs need to manage fewer borrowers but a higher loan portfolio volume than *Unnati* POs in order to receive the same incentive amount. Obviously, BRAC is willing to pay the same bonuses for different levels and types of achievements.

In conclusion, the operational circumstances and the specialization of the POs in certain products already imply a certain calibration of the incentive scheme for motivational reasons. In some cases, the incentive scheme focuses on poverty outreach (e.g. for *Dabi* POs who work in poor areas), and in other cases the profit generated by the POs is rewarded (e.g. *Progoti* POs in wealthier areas). This is clearly in line with BRAC's policy of subsidizing non-profitable branches over the medium- and even long-term in order to achieve its social mission. Furthermore, this operational framework defines the limits of the incentive scheme in balancing social and financial goals – POs manage a certain product in a certain environment which largely determines the impact on poverty alleviation and profitability: The PO's and, hence, the incentive scheme's ability to balance social and financial goals is limited.

A closer look at the incentive scheme's design reveals that BRAC offers the same maximum rewards for breadth of outreach and the outstanding loan portfolio volume (which is a good indicator for achieving financial goals). *Progoti* POs can earn higher incentives for managing a large loan portfolio volume (up to 35% of their basic pay) than for outreach (capped at 25% of their basic salary). Hence, the incentive scheme allocates the same weights to social and financial goals for *Dabi* and *Unnati* POs, and slightly focuses on financial goals in the *Progoti* program.

The fact that the scheme basically does not consider portfolio quality emphasizes BRAC's social goals. The institution has been operating branches which are not very likely to generate any net income in the near future due to their often extremely-weak repayment rates. Nevertheless, to ensure that the poor in these regions have *any* access to working capital such branches continue lending although it is extremely difficult to recover most of the borrowed amounts.

Since the incentive scheme is rather new, only a few effects on the balance between social and financial goals have been observed so far. The two most important are:

1. Staff have increased their productivity and efficiency, which contributes to both BRAC's financial and social goals.

2. Staff report that POs encourage customers to apply for the largest possible loan size in order to achieve higher rewards. Hence, if we assume that clients know best what loan size they need at a particular point of time, the incentive scheme may encourage staff to boost financial outcomes as the expense of client well-being or other social goals. In the future, this may be exacerbated by the fact that the loan portfolio quality is virtually not considered in the incentive scheme. To earn high incentives, POs may disburse large amounts which would lead to over-indebted customers – such a practice would ultimately have detrimental impacts on both financial and social goals.

[19] These figures represent the benchmarks for the highest graded cluster of branches.

4.4 Equity Bank, Kenya

4.4.1 Institutional Overview

Equity Bank (EBL) has experienced strong growth in its network and operations in the last years. Since the year 2000, EBL has increased its number of savers more than tenfold from 60,000 to 650,000; And whereas EBL managed 20,000 outstanding loans six years ago, its loan portfolio now includes around 110,000 loans. During the same period, the staff has multiplied by 10 times to nearly 1,150 individuals, with further growth likely given the rapid pace of network expansion. At present, EBL serves its customers through 31 branches, and the bank plans to open 12 more branches before the end of this year. Meanwhile, 22% of Kenya's bank accounts are managed by Equity Bank. In December 2004, the institution transformed from a building society into a bank, and as the first formal MFI, Equity Bank has recently listed in the stock market.

Table 4.4.1: Equity Bank at a glance (Dec. 05)

Number of branches	31
Number of total staff	1,000
Number of outstanding loans	110,000
Outstanding loan portfolio volume	78,919,429
Number of depositors	650,000
Savings balance	129,253,786
RoA Dec. 2005	3%
RoE Dec. 2005	21.6%

Source: EBL, exchange rate 70 KShs./USD

Equity's mission is to "mobilize resources and offer credit to maximize value and economically empower the micro-finance clients and other stakeholders by offering customer-focused quality financial services". The bank's wide range of savings products is accessible, affordable and attractive for all Kenyans. Loan products are designed for microenterpreneurs, poorer employees, SMEs and larger corporations. However, the bank targets poorer employees and, more recently, also microenterpreneurs. Equity operates throughout the country. It reaches remote areas through its "mobile branches", consisting of small rented offices where a "mobile unit" (staff with laptop computers and a pick up with V-Sat internet connection) attends to clients on certain days of the week. Branches are also located in areas where they can easily be reached by poorer clients. Equity regularly sponsors social events and programs as part of its powerful marketing strategy as well as to further the bank's social goals.

At present, the bank is focusing on coping with its strong growth as well as increasing its savings balance and loan portfolio volume.

4.4.2 Objectives and design of planned staff incentive schemes

Until recently, EBL provided its staff with an annual bonus and competitive basic salaries. However, the bank's strong growth necessitates an upgrade in the staff incentive scheme, and Equity plans to implement a performance-based incentive scheme for all staff to focus on portfolio quality, productivity, profitability and service quality. In particular, the scheme aims to:

- Align the interests of the staff members with those of the organization (management);
- Maintain EBL's strong focus on savings mobilization while incorporating an additional emphasis on portfolio quality in lending operations;
- Be simple and not overly complex.
- Be adaptable to future (and perhaps more complex) needs;
- Support the existing spirit of teamwork where this is necessary or beneficial.

EBL has decided to implement three different types of incentive scheme for its employees, including a branch-based quarterly bonus scheme for branch staff, an annual profit-sharing scheme for head-office staff as well as an Employee Stock Ownership Plan ("ESOP") for all staff. Together, these incentive schemes should meet their objectives. The quarterly bonus scheme is designed to foster team work and productivity in relevant areas. The annual profit sharing scheme supports and enhances the team spirit and overall long-term commitment and motivation of head office staff. Table 4.4.2.1 provides on overview of these 3 planned incentive schemes including their objectives and the estimated costs.

Table 4.4.2.1: Overview of the three incentive schemes

SIS	Section	Participating staff members	Main objectives	Budget in % of EBL's profit	Estimated variable pay/total pay
Branch-based SIS	4	Branch staff	- Increase savings balance - Increase loan portfolio quality - Foster productivity	4%	18%
Profit sharing	6	Head office staff	- Enhance overall staff motivation and loyalty - Foster staff retention	2%	12%
ESOP	7	All staff	- Enhance overall staff motivation - Enhance staff loyalty/retention	4%	11%

The quarterly branch-based bonus scheme is flexible enough to cope with EBL's rapid growth. The branch team's total bonus pool is calculated as a function of the branch's achievements in 5 to 6 areas which are selected branch-wise from a list of 10 indicators, including:

1. *Net increase in the number of active savings accounts:* The net increase in the number of active accounts is calculated by the number of active accounts at the end of the quarter minus the number of active accounts at the beginning of the quarter. This performance measurement parameter should not only encourage staff to open new accounts but also to maintain them in the long run. Different weights can be allocated to the different types of savings accounts to reflect management's preferences.
2. *Outstanding volume of deposits:* By factoring in the outstanding volume of deposits, there is a clear incentive not just to attract new clients but also to keep existing clients happy (which will be reflected in stable or growing deposit volumes). Together with the loan portfolio quality (see below), this performance measurement indicator is perhaps the most important one for EBL at present.
3. *Loan disbursement:* The disbursement of loans can be captured by the number of disbursed loans and/or by the principal amount of disbursed loans. Different weights are allocated to the two types of loans to account for the difference in workload related to their disbursement (one type requires field visits and the other does not).
4. *Outstanding loan portfolio:* The outstanding loan portfolio volume reflects the income from interest, and the number of outstanding loans reflects the breadth of outreach.
5. *Portfolio at risk:* At present, recovering loans in arrears is among the most important challenges that EBL faces. Thus, this factor is heavily weighted in the performance measurement of the branches.

6. *Compliance with processes and procedures and customer service quality* are areas in which staff performance is difficult and costly to measure. Since these are nevertheless important for the bank, EBL rewards performance in these 2 areas semi-annually.
   a. *Compliance with processes and procedures:* In a recent internal review, EBL recognised the importance of compliance with processes and procedures. The internal audit department developed and implemented a comprehensive tool to monitor branch compliance with processes and procedures on a regular basis. Branches receive "compliance scores" (in percent) according to the degree to which they meet relevant standards.
   b. *Quality of customer service:* Customer service quality is one of the key factors for EBL's success. Hence, increasing staff productivity should not come at the expense of high quality customer service. At present, EBL conducts regular mystery shopping exercises, customer feedback surveys, and supervisors appraise the customer service quality in their branches. According to the results of these evaluation tools, branches receive "customer service scores" which range from 1 ("poor performance") to 5 ("outstanding performance").
7. *Profit* to reward branch staff for keeping costs low, as well as to put an additional emphasis on the bank's financial goals.
8. *Number of cash transactions:* At present, transaction speed is the most important factor for good customer service at EBL. Since the transaction speed depends on the teller's ability to process transactions, and also on the efficiency of back office staff, EBL is thinking about including this factor into the set of branch performance measurement indicators.

In order to determine the branch bonus pool, management sets quarterly branch targets for each of these performance measurement parameters and allocates different weights to each of these. A total maximum bonus is calculated as a function of the number of staff in the branch. To compute the maximum bonus for each performance measurement indicator, the total maximum bonus is multiplied by the weights of the performance measurement parameters. If targets are not achieved fully but achievements are still high, staff receive a certain portion of the maximum bonuses. Targets are set considering external operational circumstances for which staff are not accountable, the maturity of the branch, and the number of staff in the branch.

80% of the bonus pool achieved by the branch is then distributed equally among all staff members. The remaining 20% is distributed among the best performing loan officers and tellers who are identified through tournaments. This distribution technique was chosen to avoid free rider behaviour, but it also somewhat reduces the impact of the incentive scheme on loan officer and teller performance.

As far as the balance between social and financial goals is concerned, this bonus scheme is extremely flexible as EBL's management can adjust the weights quarterly and for each branch in a different way. The set of performance measurement indicators allows a strong focus on the achievement of financial goals as well as a focus on breadth and depth of outreach.

The annual profit-sharing scheme for head-office staff is straightforward: 2% of EBL's profit before taxes is allocated to head-office staff. This bonus pool is distributed as a function of the employees' basic salaries. EBL is thinking about utilizing a more complex distribution technique at a later stage which would consider an individual's or department's performance. Obviously,

this scheme focuses on the achievement of financial goals: the higher EBL's profit, the higher the bonuses paid out to staff. However, the incentive scheme's impact on performance is rather low due to the extremely indirect link between performance and reward. Rather, employees will be indirectly motivated to achieve the organization's goals which also include social goals.

Under the planned ESOP, all staff will receive 4% of EBL's profit in "units" that can be converted into shares. EBL envisages that staff will be able to convert a certain percentage of their accumulated units as a function of their tenure. For instance, staff who have worked with EBL for only 5 years will not be able to encash all their accumulated units. Hence, the scheme not only provides incentives for staff commitment, but also fosters staff retention. From an employee's point of view, the ESOP also serves as a "delayed benefit" because there is a strong incentive to accumulate the units or shares over the long term.

In conclusion, EBL has designed a very flexible incentive scheme that can be easily adjusted to balance between social and financial goals. The different weights of the scheme provide direct incentives for high staff performance through the branch-based incentive scheme, which can be changed as needed for each particular branch. And although the annual profit-sharing scheme and ESOP will provide higher rewards as EBL's profits increase, these schemes focus on staff loyalty and commitment to the organization's mission and vision. Hence, the effects of these schemes are rather indirect and will probably not disturb the desired balance between social and financial goals. Management and board believe that the bank's products and branch locations ensure that Equity is more attractive to poorer customers and, hence, staff incentives are not considered as an essential tool targeted at balancing social and financial goals.

5 Conclusion

Well-designed staff incentive schemes help improve the productivity and efficiency of microfinance institutions. They can indirectly support the overall organizational (i.e. usually social) mission. While we generally find that factors such as product mix and branch network policy are more important tools for ensuring goal attainment in terms of social impact, some of the examples presented in this paper clearly demonstrate that SIS can play a supporting role.

We also want to stress that it may well be feasible to include the attainment of certain social goals (which are usually longer-term trends) into incentives that are designed for senior management. This may well be achieved by utilizing the balanced scorecard approach.

Finally, one should not underestimate the "power of measurement". As outlined in the 2007 edition of the World Bank's "Doing Business Report", "what gets measured, gets done". In other words, to the extent that MFIs can agree on a small number of social impact indicators that can get measured at reasonable cost and with a reasonable time lag, their inclusion into the overall "corporate performance scorecard" (notwithstanding the question at which organizational level) will have an impact all by itself.

Further Readings

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