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# *Incentives in Microfinance: Lessons Learned on Effective Incentive System Design*

## Introduction

Well-designed and well-implemented incentive systems can help microfinance institutions boost productivity and performance, increase employee retention, and manage operational costs. An incentive system can also communicate an important message to both staff and clients about the institution's overarching strategic objectives, and can support achievement of both social and financial goals.

As powerful tools for catalyzing employee behavior, incentive systems must be approached carefully, as poor design or implementation can increase the risk of fraud, employee conditioning and employee mistrust or dissatisfaction. However, when properly designed, tested and implemented, a comprehensive incentive system can optimize staff efficiency and productivity at an MFI.

### Incentive System Design Process

1. **Fully analyze MFI's financials, operational leverage and local labor market**
2. **Identify MFI's strategic goals and metrics to measure achievements**
3. **Analyze MFI's organizational structure to identify distinct employee groups**
4. **Determine the proportion of fixed vs. variable compensation and set the desired pay-out curve**
5. **Set parameters, weights and conditions to calculate variable payments for each employee group**
6. **Run a pilot to test the system**
7. **Evaluate the incentive system, making changes as necessary**

This document draws upon key lessons learned from Training and Capacity Building Spotlight webinars on Incentive System Design and Implementation, facilitated by Human Resources and Organizational Development Consultant Solymar Torres. The presentations provided one expert perspective on key considerations in incentive system design and the process for MFIs to develop a new incentive system or adjust an existing system. The presentations highlighted how carefully-designed incentive systems can contribute to MFIs' strategic objectives, using practical examples from Akiba Commercial Bank in Tanzania and Financiera FAMA in Nicaragua. As appropriate, the insights and ideas in this document may be applied across Accion's partner institutions.

### Key Considerations in Incentive System Design

Before making the decision to develop an incentive system, MFIs should conduct a thorough institutional analysis to ensure the proposed system aligns with the MFI's strategic goals and overall business model. Additional pre-design considerations include the following:

- **Timing:** An incentive system should be introduced when an MFI is institutionally ready to support it. Design, testing and implementation will require not only human and financial resources, but also core infrastructure requirements (such as an MIS to measure and track performance). New MFIs may want to start with a small-scale incentive system that can be expanded in the future as they grow and mature.

- **Leadership buy-in:** An MFI's Board and Senior Management team should fully support the introduction of an incentive system. Once designed, the key components of the system should be shared with the Board for approval.
- **Labor market analysis:** Assessing the use of variable compensation and incentives in the local microfinance industry is important to ensure an MFI's compensation structure remains competitive, and that the system attracts, not discourages, potential employees.

**Box 1: Labor Market Analysis at Akiba Commercial Bank**

*In some regions, incentives are not widely used in the workplace and employees may be wary of variable compensation systems. Before introducing its own incentive system, Akiba Commercial Bank in Tanzania ensured that their stand-alone fixed salaries were competitive in the local labor market. This established the new incentive system as a source of additional income for staff, setting the institution apart and creating a competitive advantage with which it can attract high-quality employees.*

## Step 1 Conduct a Complete Financial Analysis

Once the decision has been made to develop an incentive system, the next step is to conduct a financial analysis of the MFI to assess the impact of introducing a variable compensation system.

- **Operational leverage**: Analyze operational leverage to determine the right proportion of fixed to variable costs in the budget. Higher variable cost components often imply higher risk, as variable salaries create fluctuations in personnel expenses (often an MFI's highest expenses). The recommended percentage of fixed to variable costs is between 50-50 and 70-30.
- **Budget:** For new MFIs, consider including the incentive system in the staff compensation structure from the onset. For existing MFIs, evaluate the budget to determine the financial resources available to provide additional compensation to staff. Conduct a cost-benefit analysis, comparing the costs of extra compensation to the benefits of an expected increase in productivity as a result of implementing the incentive system.

## Step 2 Identify and Define Goals and Metrics

- **Strategic objectives:** Determine the key business priorities that are related to the strategic goals of the MFI.
- **Performance indicators:** Identify quantifiable benchmarks of success and achievement that can be reliably measured and tracked. For examples, see Figure 1 below and the MicroBanking Bulletin Tables A-D.
- **Metrics:** Select a unit to concretely and objectively evaluate the performance indicators.

**Figure 1: Sample Objectives and Corresponding Performance Indicators**

| STRATEGIC OBJECTIVE | PERFORMANCE INDICATOR | METRICS |
|---|---|---|
| Profit | Net Profit | $ |
| Increased outreach | Net increase of active clients | # clients |
| Effective implementation and use of IT platforms and systems | Implementation of IT innovations (CORE Banking System) | % project completion |
| Value growth | Net increase in deposits value | $ |
| | Net increase in loan portfolio value | $ |

## Step 3 Analyze the Organizational Structure

- **Identify groups:** Incentives may be applied firm-wide or only to certain positions, depending on the level of system complexity the MFI is willing and able to support. If appropriate, a comprehensive incentive system that covers the majority of positions at the institution is recommended for maximum equality and motivation. Analyzing the organizational structure of an MFI allows management to determine the most effective and relevant type of incentive system for each employee position. Employees may be grouped according to different criteria, such as function, level or seniority, and incentives should be based on the unique roles and responsibilities of each employee group.

- **Structure Incentive Schemes per Employee Group:** Incentives may be based on individual or group performance. Individual incentives schemes are best suited for positions where employees have a certain degree of autonomy, individual performance is easily measured and there is little need for close collaboration among staff. Inversely, group based incentives are more appropriate for positions where it is hard to measure individual outputs and the organizational structure lends itself to the measurement of group outputs (such as branch performance). Group based performance systems can help to foster staff collaboration and encourage high-performance teams.
  - **Senior Management** (I): *Based on successes in specific area/department and success of the MFI as a whole.* Rewards should align with a corporate system that focuses on long-term projects and goals. In some cases, executives may participate in an annual profit sharing scheme, in which they receive a percentage of net earnings beyond a certain minimum threshold.
  - **Managers** (IV): *Based on team results and the performance of those they manage.* Incentives should focus on longer-term results, as well as key performance indicators that managers influence.
  - **Operational staff** (II, III): *Based on team success.* For back-office and administrative roles (at head office and all branches), where it is more difficult to track and quantify individual performance, incentives should be based on team success, like branch performance, instead of individual achievements.
  - **Front-line staff (Including loan and recovery officers)** (V, VI)**:** *Based on individual results.* Front-line staff are typically responsible for building and maintaining their own clients and portfolio. For positions with defined learning curves, compensation should vary by experience level. LOs in training may be initially excluded from the system to encourage new client growth and foster learning. If included, variable compensation should be small or subject to certain conditions.

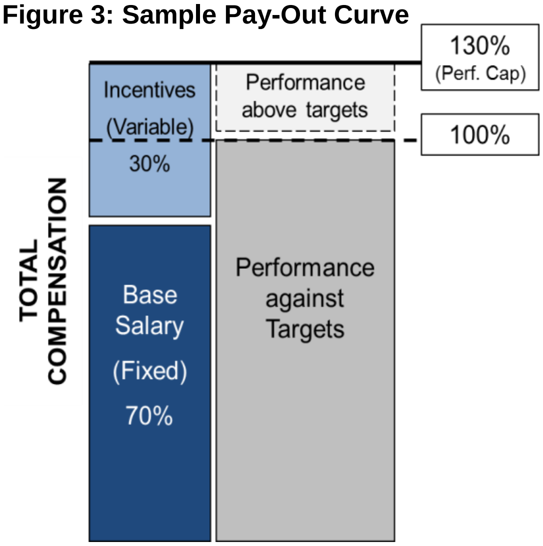
**Figure 2: Sample Performance Evaluation per Employee Group**

| EMPLOYEE GROUP | | PERFORMANCE EVALUATION | | |
|---|---|---|---|---|
| | | Individual Level | Group/Branch Level | Institutional Level |
| I. | Senior Management | | | ★ |
| II. | Operational staff / Head Office | | | ★ |
| III. | Operational staff / Branches | | ★ | |
| IV. | Branch Managers / Supervisors | | ★ | |
| V. | Loan Officers | ★ | | |
| VI. | Recovery Officers | ★ | | |

## Step 4 Determine the Proportion of Fixed vs. Variable Compensation

- **Proportion rules:**
  - Fixed salaries should always cover basic living expenses and be competitive in the local labor market.
  - Incentives are most effective between 30% and 50% of total remuneration (less than 20% are not motivating, and more than 70% can encourage high-risk actions).
  - Stable financials and mature markets can support a higher variable percentage.
- **Pay-out curve**: The pay-out curve sets the percentage of compensation awarded at each performance level within a pre-determined range. Employees become eligible to receive an incentive when they achieve a minimum level of performance (such as 85% achievement of a target). Ideally pay-out curve targets should be higher than those approved in the annual plan by the Board, to encourage high achievement and leave room to compensate employees for outstanding performance.

**Figure 3: Sample Pay-Out Curve**



However, eligibility requirements and targets should also ensure the majority of staff participates in the scheme. Once defined, the standard pay-out curve should be clearly communicated to employees.

- **Cap:** Compensation caps or ceilings can help control and predict costs of the incentive system. However, some MFIs may prefer not to set a cap in order to incentivize (and not limit) highest performers as their performance proportionately contributes to the profit of the institution. If setting a cap, ensure that it is high enough to keep staff motivated yet maintains financial control of the incentive system. At Akiba, the cap was set at 130% of the target performance.

## Step 5 Set Parameters for the Incentive System

MFIs should keep parameters for an incentive system relatively simple by having a few, clear indicators. Incentive calculations should be simple and transparent for each employee group, so employees understand how their rewards are calculated and can calculate their own incentives. Parameters should also be based on factors such as employee experience, branch maturity and the local market environment, and therefore may vary by region.

- **Variables:** The key indicators that combine to evaluate an employee's performance against pre-defined targets. Examples include disbursement volume, portfolio value, number of new clients, and PAR, among others. MFIs should choose 3-5 for each employee group.
- **Weights:** The proportion or weight of each variable should be adjusted depending on the employee group and current goals of the MFI. Adjustments may be based on experience and position level. Management may also emphasize the importance of certain variables within employee groups and drive specific results by weighing these more heavily. For example, if managing portfolio quality is an important goal for the MFI, greater weight may be placed on the PAR variable. Generally, weights lower than 10% per variable are not motivating. The combined weights of all variables for each employee group should total to 100%.
- **Conditions:** Conditions are certain minimum levels of performance that staff are required to meet to be eligible for their incentives. For example, a loan officer's incentives may be conditional upon increasing his net client base by a minimum number each period. Initially, conditions should not be too strict or they can be discouraging to employees. Over time, conditions should become stricter to motivate constant improvement. At all stages, MFIs should aim to set conditions such that at least 70% of employees are eligible for incentives.

**Figure 4: Sample Variables and Weights for Branch Performance**

| **Branch Type** | **VARIABLES** | | |
|---|---|---|---|
| | **Net Increase Number of Clients** | **Value of Portfolio** | **PAR> 15 days** |
| New Branch | 50% | 25% | 25% |
| Mature Branch | 35% | 15% | 50% |

## Step 6 Test and Implement the Incentive System

- **Run financial scenarios:** Forecast optimistic, realistic and pessimistic scenarios for the results of the incentive system to ensure affordability at various institutional performance levels.
- **Establish policies and procedures:** Define roles and responsibilities for the operation of the incentive system. While the system may be managed by HR, often team members from multiple departments are implicated in system implementation. Therefore, it is important that all staff involved are well trained in and held accountable for their contributions. Responsibilities include training and onboarding staff, obtaining performance data, calculating and double checking incentives for each employee group, and entering and approving payments in the payroll system. The system should be standardized to maintain objectivity yet flexible enough that MFIs may review the system annually and adjust conditions once certain goals are met. All policies should be fair, transparent and non-discretionary to ensure that MFIs keep their promises to their staff, building staff trust and confidence in the system and management.
- **Run a pilot:** Design the pilot to cover multiple pay-out cycles so that data can be analyzed over time. The purpose of the pilot should be clearly communicated to staff before its introduction.

## Step 7 Monitor and Evaluate the Incentive System

- **Implement adjustments:** Make adjustments according to the results of the pilot. If less than 70% of qualifying employees are receiving the incentives, qualifying conditions may be too strict and should be relaxed accordingly.
- **Training and communication:** Prepare an organization-wide training before implementing the new incentive system. Complement training with brief staff guides explaining the scheme policies and sample calculations. Ideally, each staff member should have a guide to navigate the applicable compensation system.
- **Monitor and evaluate:** Once implemented, the incentive system should be reviewed annually to ensure it is having the desired effect and to adjust conditions and targets as necessary. Include incentives in the Employee Satisfaction Survey to gather regular feedback from staff.

**Box 2: Design and Implementation Timeline at Akiba Commercial Bank**

*Developing an incentive system takes time, typically between one to two years. The initial development phase may take up to one year, and a pilot program should be implemented after this period of development. At Akiba, it took almost three years to design and implement its firm-wide incentive system.*

## Mini Case Study: Revising an Existing Incentive System at Financiera FAMA

FAMA was experiencing problems with an existing incentives system plagued by high turn-over rates and employee dissatisfaction.

- **Challenges**: Less than 40% of loan officers had qualified for incentives in the previous year, due to strict conditions and high minimum benchmarks. To receive the incentive, employees had to reach the high 90% performance target (made up of a combination of variables). Within this target, employees were eligible for the incentive only if they reached 100% of the performance target for the PAR>30 variable (which was set at 3%).
- **Solutions:** Relaxing the qualifying conditions from 90% to 85% of the target enabled a higher percentage of loan officers to receive incentives (projected at 60%). Setting the benchmark for incentive qualification slightly lower than the performance target ensured that employees received compensation for their hard work even if they did not reach the target. This solution was implemented in combination with other commercial strategies to make sure institutional results were achieved.
- **Results:** Approximately 55% of Loan Officers received the incentive, an increase of almost 15%. The percentage of variable salary was also reduced, which allowed FAMA to manage fixed and variable costs more efficiently.

## Mini Case Study: No Incentive System

**Prodem (Bolivia) & ProCredit Bank (Kosovo):**

- **Challenges:** The incentive systems started to encourage unethical practices and fraud, and they were causing staff an unhealthy balance between work and home life.
- **Solutions:**
  - Both MFIs removed individual incentives from their compensation systems and instead implemented a team-based incentive system, in which all employees are rewarded annually based on the performance of the institution as a whole. The MFIs also shifted their focus to non-financial incentives by introducing alternatives for rewarding staff, such as an improved benefits package, better internal communication, and staff recognition and awards. In their new approach, the MFIs focused on using their core mission and values to motivate staff towards high performance.

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