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Pitfalls and Unintended Outcomes

Advice on Designing and Implementing Staff Incentive Systems

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The Practitioner Learning Program Improving Efficiency—Maximizing Human and Physical Resources, Technical Note #3

Pitfalls and Unintended Outcomes

Advice on Designing and Implementing Staff Incentive Systems

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Preface

The Practitioner Learning Program (PLP) is a SEEP Network initiative that explores key challenges facing the microenterprise field. The SEEP PLP, a competitively run grants program, engages participants in a collaborative learning process to share and document findings and lessons learned, as well as to identify effective, replicable microenterprise practices and innovations to benefit the industry as a whole. The SEEP PLP is funded by the office of Microenterprise Development of the United States Agency for International Development (USAID). For more information on this and other SEEP PLP initiatives, see The SEEP Network website: www.seepnetwork.org.

The SEEP PLP in “Improving Efficiency—Maximizing Human and Physical Resources” was conducted from 2004 through 2006 and examined strategies, tools, and technologies that microfinance institutions (MFIs) use to maximize human and physical resources. There was a particular focus on low-technology solutions to increase staff productivity, decrease personnel or administrative costs, and increase outreach and client retention.

The “Improving Efficiency” PLP has produced a series of ten Learning Products—as well as an overview outlining the PLP process and its results—to share with the microfinance and microenterprise field that are explained in more detail below. All of these publications are available on-line at <http://www.seepnetwork.org/>.

Most of the participating institutions began with a rigorous analysis of their core processes, including credit delivery, accounting, and management information systems. Process mapping proved a crucial tool in shedding light on organizational bottlenecks and inefficiencies. Three Learning Products produced from this PLP are devoted to process mapping: case studies of Pro Mujer Nicaragua and of MI BOSPO, which used the tool to make significant changes to their core operations, and a technical note that compiles interviews with MFI managers who used process mapping in their efforts to boost efficiency.

Based on their institutional assessments, most of the MFIs identified a similar set of interrelated issues they need to address in order for them to become more efficient. Decentralization emerged as an overriding theme, especially the exploration of what kinds of institutional structures and systems would support a shift in decision-making authority for credit operations to branch offices. “Decentralization of Microfinance Institutions: A Guide for Decision Making” addresses these issues in depth.

Closely related to the topic of decentralization was the need to train branch managers. Many of the participating MFIs’ branch managers had been senior loan officers and did not have many of the skills and perspectives needed to manage staff and operations. Two of our Learning Products are comprehensive training programs that address areas that were identified as key for branch management training: human resource management and financial management. The training manual on human resource management was developed by the PLP in conjunction with MEDA and is entitled “Branch Management Training for MFIs: Developing Staff Management Skills.” The financial management training manual is “Principles and Practices of Financial Management.” Based on an identified need for training materials in other topics, several of our other Learning Products have accompanying PowerPoint presentations that summarize key information in a format conducive to training.

Several other topics related to enhancing efficiency emerged during the course of this PLP. One topic was the importance of cultivating client loyalty. Loyal clients provide repeat business, contributing to both lower expenses and higher income. The second technical note, “Building Client Loyalty,” explores this issue in detail. Another recurring issue was staff incentives and the dangers of implementing a system before it is thoroughly analyzed. The third technical note, “Pitfalls and Unintended Outcomes: Advice on Designing and Implementing Staff Incentive Systems,” explores these issues. Another valuable tool that emerged from this PLP was a framework for mapping key operational tasks and areas of responsibility. This is explored in the fourth technical note, “Division of Responsibilities Framework: A Tool to Strengthen Operations Management of Microfinance Institutions.”

PLP colleagues from India faced an inverse set of challenges to those posed to most of the other participating institutions—how to capture information from an extremely decentralized network of savers and borrowers in self-help groups and centralize it in order to create accurate, timely, consolidated financial reports. The solution they developed and implemented is explained in the learning paper, “Promoting Quality Bookkeeping in Self-Help Groups: The Mahakalasm Management Information System.”

The ten Learning Products reflect both the range of institutions and issues explored during this PLP and the consensus that emerged regarding what is needed to efficiently utilize human and physical resources while remaining responsive to client needs. The participating institutions found the PLP to be a rich learning experience and we hope the lessons learned that are distilled in this series of Learning Products prove to be of value to the field as a whole.

- Tony Sheldon, PLP facilitator and Learning Products editor

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Introduction

During the final workshop of the PLP in Improving Efficiency, participants decided that they wanted to share their experiences in designing and implementing staff incentive systems. This learning paper is structured as an interview of practitioners from seven different microfinance institutions and one technical assistance provider, offering their views on the difficulties they have encountered in implementing incentives schemes and how they have addressed them.

The participants in this discussion were:

Carmen Velasco and Neisa Vazquez, Pro Mujer Bolivia (PMP)
Naldi Delgado, Pro Mujer Peru (PMP)
Gloria Amelia Ruiz Gutierrez and Maura Arostegui, Pro Mujer Nicaragua (PMN)
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1. Have you ever been confronted with a situation where your staff rejected the incentives because they seemed unfair to them? In your opinion, how likely is this to occur? What are the classic mistakes that lead to an unfair incentive scheme and what can we do to avoid or correct them?

Claudien: Incentives are promoted as good practice, but in reality, it is difficult to develop appropriate and effective incentives. FCC has not been able to develop a good system. One of our problems was that **branch managers were not included** in the incentive scheme, while loan officers were; once the scheme went into effect, loan officers' pay ended up being twice the salary of the branch manager. FCC terminated the scheme, and the loan officers' take-home pay dropped by half.

Nejira: We had the same problem: branch managers, who weren't included in the incentive scheme, ended up earning less than some credit officers, who did receive the incentive. This was very negative. At that moment we were in the middle of a very complicated and strategic change inside our institution—the decentralization of credit operations. So we sent a message to branch managers to first get the institution through the process of decentralization, and the reward would be a revised incentive scheme that benefited them. They were satisfied with this because they anticipate that they will be rewarded.

Carmen: It's very **difficult to make everyone happy with one incentive scheme**. For those who are directly affected—loan officers, branch managers—if the scheme is not tailored well, it can raise competition and bad feelings among them. For those who are secondarily affected—administrative staff—if they don't have incentives, they become jealous of those who have them. Maybe we should develop one scheme for operational staff and another scheme for those not dealing directly with operations.

PMB has implemented three different schemes over the past years. The last incentive scheme started during the last quarter of 2005 and it was so successful in inspiring loan officers to increase loan disbursements that it almost caused a liquidity crisis.

Currently Pro Mujer Bolivia doesn't have a scheme for the administrative staff. If, as at PMB, the institution combines **non-financial services** (training and health) with financial services but offers incentives only for the latter, that undermines the institution's message that non-financial services are equally valued. The intended message is that both components are equally important, but the incentive system sends a different message, which confuses and upsets the rest of the team. In this scenario, financial services people get the attitude that the team working on non-financial services doesn't make as important a contribution to the institution.

Gloria: Another problem is the **variation in work situation between one loan officer and another**. You can't evaluate people that are confronted with different realities in the same way, but you need to have a certain degree of standard-

ization of the incentive scheme. That is part of the difficulty of designing a good scheme. In our incentive system, we learned that we need to distinguish between incentives for new loan officers and for old loan officers. When a new promoter goes into a new area, they'll fill their goals for new clients very quickly and make much more than an established promoter in an old region where opportunity for growth is less; this creates a big morale problem.

Another problem is when a promoter rotates and replaces another promoter on leave; how do you calculate incentives for this person? Which person should receive the incentive? And when a promoter rotates to a new post and inherits a low-quality portfolio, s/he is effectively penalized through the incentive system. How can a system operate in a way that avoids this kind of penalty?

Claudien: Variations in **population density** also make it difficult to design fair incentive schemes, as credit officers working in low-density areas won't be able to earn as much in incentives as those working in high-density areas.

Kim: It is important to be careful with **unequal year end bonuses**: if they are not well communicated, they can be perceived as unfair. If staff know the criteria in advance, it's all right to give unequal amounts based on performance. But if you're giving a bonus at the end of the year and crafting the criteria *post-facto*, it should be an equal amount for all staff at the same level.

Nejira: A very common risk of improperly designed incentives is the **risk of "free riders"** in systems that reward the team and not the individual. That is why so often best practices recommend individual incentives. Nevertheless, we introduced incentives on an individual basis for our new individual loan product; because we wanted everyone to feel a sense of ownership over the portfolio. We introduced a branch-based incentive, only for loan officers, and it was equally divided among them.

In theory, this created an opportunity for lazy staff to become free riders on the work of more diligent loan officers; but when we calculated data to determine end-of-year individual bonuses, we found that there weren't actually any poor performers—the fear of free riders was unfounded. This was good news; it meant that our organizational culture was not undermined by the incentive. Actually, there was one free rider in one of the offices, but the branch manager was able to work with her to make her a team player.

2. What is optimal proportion of incentive to salary?

Kim: The industry standard is 30 to 50%, but it's tied very closely to local conditions. In most cases, incentive should be a bonus; the salary should be sufficient so that a person can live on it alone.

3. Do you think that an incentive scheme can eventually lead to poor customer service? If so, how can we avoid or mitigate that effect?

Nejira: If there are targets for each month, loan officers **may delay disbursements** until the next month if they have already reached the current month's target. This is inconvenient for the client. Another problem was that loan officers would receive more incentives for making new loans than for making repeat loans, which led to poor customer service for established clients.

Arije: To mitigate that risk, you weigh each component of the incentive system appropriately, so that the additional incentive earned for new clients is not so great that established clients are neglected. MFW makes the incentive for new loans 150% of the incentive for repeat loans to established clients, and finds that that additional incentive is offset by the extra time it takes to make a new loan. With this incentive in place, 75% of the loans MFW makes are repeat loans to established clients and 25% are loans to new clients.

Joséphine: In our system, the **targets for client retention were so low** (at 75%) that at the end of the month, credit officers qualified for an incentive even if they had fewer clients than the month before. The incentive system's targets gave staff the impression that they were doing a good job at client retention even when they weren't.

We mitigated this through changing the target. PMM has a plan to redesign the entire system and will formally change the target at that time, but in the interim we've made it clear to loan officers that they will no longer receive bonuses for 75% client retention. We could have avoided this problem if we had done some projections on the impact of a 75% client retention rate.

4. What unanticipated consequences have resulted from the systems you've designed for your institutions?

Carmen: When our staff began earning incentives, some credit officers were doubling the money they had been receiving previously. But then the staff got used to the money they were earning through incentives and began to break rules to make sure they made the same amount of money one month after another, because they had come to depend on it.

So the incentive system **needs to have very rigid rules**, and a maximum cap on the amount of portfolio growth that qualifies for incentives (i.e., if you grow beyond a certain point, you don't get any additional incentive). This can guard against poor portfolio quality and liquidity crises arising from overzealous pursuit of incentives based on disbursements. Moreover, the incentives should be reviewed periodically and the targets and weights adjusted in order to maintain the MFI's sustainability. Staff should always anticipate that incentives can be adjusted. If your incentives are too successful and if there is no upper limit to them, then you can suffer a liquidity crisis. like we did during the first months when we implemented the new scheme. or a drop in your sustainability if the amount you are paying for the staff is proportionally higher than the extra income they are generating

Dina: At MI-BOSPO we used to have a satisfactory incentive system. Then we implemented a decentralization of credit operations that has made it easy for employees to qualify for very large bonuses. The incentive system needs to be realigned with the new realities resulting from decentralization, so we are about to implement a new system. But we risk a morale problem when we implement the new system. To avoid this, **institutions should realign their incentive systems each time they plan to change their operational structure**. The challenge then is that it adds another layer of change, which frustrates staff; also, it **may increase the difficulty of projecting accurately the financial impact** on the institution.

Another way to mitigate this risk might be to hold off on adjusting the incentive system until the effects of the change are clear. However it is better to tell the staff that they can expect some adjustment in the incentive system in the near future, so they don't become used to big increases in bonus and then feel disappointed when the system is adjusted and those big increases drop.

The targets and weights in any incentive scheme should be flexible, and it should be clear to staff that these will be reviewed periodically depending on circumstances.

Joséphine: To mitigate the risk of unexpected results it is crucial to **pilot test your incentive system before implementing it on a full scale**.

Neisa: It may be necessary to pilot the system across all branches simultaneously, because otherwise a problem can arise, wherein staff at one branch gets upset when staff at another branch is included in a pilot. One way around this is to pilot it in one branch but then award the incentive retroactively to staff at other branches if the pilot succeeds.

Kim: Another way to pilot is to implement a system over the course of six months, with staff participation optional for those first six months and mandatory thereafter (assuming the pilot succeeds). Staff will self-select, with the less risk-averse joining first and others following as they see how the early entrants to the scheme fare.

Carmen: Another way to balance the risk of unexpected and unwanted effects is to review periodically your incentive system in order to track and adjust for unanticipated results. You need to review your incentive system periodically. However, it is important to consider the impact on staff and on the institution of stopping, changing, or restarting an incentive system. You **need to find a balance between necessary periodic adjustment (to ensure institutional sustainability, effect of incentives, etc.) and too-frequent adjustments, which can affect morale and hence sustainability and productivity**.

5. Have you been confronted with any legal constraints in the implementation your incentive scheme?

Carmen: In Bolivia, we have a legal constraint: if a staff member gets a bonus two or three times, that bonus becomes the person's new salary in the eyes of the law, which removes the motivational effect of the incentive, since the staff member now knows they are entitled to receive that amount regardless of performance.

To mitigate this, we decided that incentives would be distributed only once a year, although this reduces the moti-

vational effect of the whole incentive approach. Another alternative may be to give gifts instead of cash, or an allowance such as a car allowance. The challenge with this approach is that the administrative burden is much greater than with pure cash incentive schemes. Or, incentives could take the form of shares in the institution.

Naldi: Peru has the same legal constraint. Pro Mujer Peru designed an incentive scheme, then examined the risk in relation to this constraint, and ended up not implementing the scheme. Instead, we increased base salaries. We also investigated how regulated MFIs in Peru pay incentives. They tend to hire employees for six to seven months, paying them incentives, and then fire them because the incentive becomes too high a cost for the institution. Staff of regulated MFIs jump from one institution to another as a consequence.

6. What is your opinion on non-monetary incentives for staff?

Carmen: Our incentive system included monetary and non-monetary incentives. The system enabled some credit officers to double the money they had been receiving previously—this was enormously important and far overshadowed the certificates of recognition that were also part of the system.

7. What happens when incentives are not aligned with the messages the MFI is trying to send to staff?

Arije: Incentives send a message about what aspect of performance is valued. At MFW, there were two parts to the incentive scheme: portfolio quality and productivity in terms of number of loans disbursed. But the scheme disproportionately emphasized portfolio quality, which sent the wrong message to staff, who then focused more on ensuring the quality of the loans than on making more loans. As a result, growth slowed.

In the new system, more weight is given to disbursements; in the scheme loan disbursement is counted as both new and repeat loans. This reflects the objective of the institution, which is to make more loans as well as ensure portfolio quality. Also, quality is defined more precisely in the new scheme, with loan delinquency divided into 1-30 days and more than 30 days, with more weight given to loans over 30 days late in determining incentives. Finally, the scheme is scheduled for periodic review: if changes need to be made, they will be made on a quarterly basis.

The lesson we have learned is to **shape incentives based on the institution's goals**, because loan officers are smart and will respond to incentives often much more strongly than an MFI can anticipate. They will definitely deliver what the incentive scheme appears to be asking for, so incentives need to be geared toward exactly what the institution wants.

Carmen: An increase in the amount of disbursements but not in number of clients has resulted from PMB's scheme. PMB is developing tools to reach down-market, but this increase in amount disbursed reflects a reward for having more clients who are not from the poorest/smallest loans category. We are sending mixed messages to the loan officers: focus on our target market, the poorest, and at the same time make bigger loans.

To mitigate this, one should design the incentives to reflect an institution's target clientele. If your mission is to reach down-market, reflect that in the incentive scheme by rewarding performance based on a proxy indicator of depth of outreach. For example, your proxy can be loans less than \$100, and you can reward staff for making a certain number of loans of this amount. Establishing the proxy can be tricky and needs to be monitored and adjusted if it's not appropriate; otherwise, you risk introducing a new bias when you try to address an existing one.

8. What happens when incentives are not aligned with the MFI's corporate culture?

Naldi: We were getting pressure to pay incentives, but how? First we analyzed the state of the art in incentive systems; We realized that our **MIS yielded insufficiently detailed information** to calculate incentives; this would make it difficult for us to craft a good system.

We did a staff survey to find out whether they wanted an incentive scheme or another type of benefit; we realized the team has a strong culture of working as a team; individual incentives, they feared, would undermine teamwork; this was another reason not to have incentives.

Nonetheless we developed an incentive scheme—with prizes for productivity and portfolio quality, and also as a way to involve administrative staff by having branches give a percentage of income to non-field personnel, that would be paid only once a year and linked with the annual performance evaluation.

In the end, we couldn't apply this model because the results of the performance evaluations were low—a lot of training was needed to improve performance. When we told the team we wouldn't give incentives, I thought everyone was going to kill me, but the team was happy, which showed me that **putting an incentive system in place would have undermined our institutional culture.**

We do not currently give incentives. We pay a fixed salary; we use one credit methodology (group lending), which doesn't lead to huge differences in performance among credit officers. We don't differentiate—we have one performance standard; rewards come in the form of promotions and positive evaluations. The incentive system that we're now developing is non-monetary, not financial. The incentive scheme needs to reflect your corporate culture.

Kim: Don't continue with an incentive system that contradicts your corporate culture. If you find you have a scheme that does this, you should stop it immediately.

Communication with staff is critical to having an effective incentive system. **Trust is also critical:** if staff don't think management is being transparent, it's very difficult to put in place an effective incentive system. Ideally, issues of communication and trust need to be addressed before putting an incentive system in place. This includes knowing/defining your corporate culture, and also surveying staff to get a clear sense of whether they understand that culture and what will motivate them.

9. Finally, the 8 “Don’t’s” and 8 “Do’s” from our participants to “get it right the first time.”

Don't:

1. **Promise what you can't deliver.**
2. **Introduce incentive schemes during a period of change.**
3. **Introduce an incentive system for one product and not another.** Different products can have different systems, but all products should have incentives if any do.
4. **Send mixed messages to your staff.**
5. **Standardize targets from the head office for different branches.** Incentive schemes need to be geared toward branch realities.
6. **Wait too long to get new staff on the incentive scheme.**
7. **Forget that your institution is unique.** What is considered “best practice” may not work for you, and what may work for you may not be considered “best practice.”
8. **Forget to include non-financial incentives in your system**—keeping in mind that often staff value monetary incentives most highly.

Do:

1. **Keep it simple!** Make the system simple and easy for all staff to understand quickly.
2. **Read the literature!** You can avoid a lot of problems by understanding what's already been learned and written on the subject.
3. **Study the financial impacts in terms of profitability and liquidity.** A good incentive scheme should more than pay for itself.
4. **Take your institutional culture into account.** Have a very clear idea of what you want to incentivize and to what degree.
5. **Take all staff into consideration and respect earning levels.** A subordinate should not earn more than her supervisor.
6. **Review your system periodically.** In order to track and adjust for unanticipated results you need to review your incentive system periodically, and staff should be informed of this upfront.
7. **Consider year-end bonuses, based on institutional profitability, for administrative staff.**
8. **Pilot the system before establishing it throughout the institution.**

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ABOUT SEEP:

SEEP is an international network of institutional and individual members committed to reducing poverty through the power of enterprise. Its over 70 institutional members are active in 139 countries and reach over 25 million microentrepreneurs and their families. SEEP promotes professional standards of practice in microfinance and enterprise development, conducts capacity building activities for its members and other practitioners, creates and disseminates publications for application in the field, and serves as a center for collaboration on a broad range of sector-related issues.

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