MICROFINANCE BANANA SKINS 2011: What Does This Mean for People Practices?

–Peg Ross and Stephanie Denzer

The 2011 Microfinance Banana Skins report provides valuable insights into the industry's current challenges. Since the report's inception three years ago, people-related issues have always ranked among the top ten concerns. This year is no exception: seven out of the top ten concerns have a focus on people at their core.

The report specifically highlights "(a) strong concern among practitioners about internal issues, specifically corporate governance, management and staffing." It also points to a "growing awareness within MFIs [microfinance institutions] that their institutional strength needs closer attention."[1]

Let us consider the people dimension of some of these top challenges. Concerns about over-indebtedness correlate directly to both credit and reputational risk, while weak corporate governance can lead to mission drift. Organizations lacking strong, effective management are also more susceptible to competitive pressures and will experience challenges in attracting and retaining staff.

A clear, unwavering focus on social mission; developing competent, effective leaders; ethical behavior; client protection and operational excellence will do much to address these top concerns. External factors clearly affect the success of MFIs. We, however, believe that highlighting these key risks and approaches for mitigating them through thoughtful, targeted human capital management practices will strengthen MFIs' ability to deliver appropriate, sustainable financial services to the poor and poorest.

Top 10 Risks

1. **Credit risk**
2. **Reputation**
3. **Competition**
4. **Corporate governance**
5. Political interference
6. Inappropriate regulation
7. **Management quality**
8. **Staffing**
9. **Mission drift**
10. Unrealizable expectations

Source: Microfinance Banana Skins 2011

bold text highlights risks with direct connections to human capital management practices

1 Lascelles and Mendelson. 2011. Microfinance Banana Skins 2011

Risk #1 – Credit Risk

Microfinance is an extremely "high touch" business. Field officers occupy the first level of the organizational chart, yet are charged with holding the critical client relationship in their hands. The relationships these field officers build with the clients drive the entire institution, and they have been acknowledged as the "backbone of microfinance." There are few comparable industries where such a critical, trust-based client relationship is held at this level of the organization. Tasked with screening clients, they often perform cash-flow analysis on-site to determine the creditworthiness of a potential client. They are also responsible for collecting repayments and pursuing delinquencies. According to 2009 data from the Mix Market, field officers represent approximately 45 percent of an MFI's total staff.[2] While field officers do not make the final credit determination (often there is a credit review process involving an internal credit committee), they are the MFI's first line of defense against credit risk and play a critical role in maintaining portfolio quality.

Providing effective financial services and helping to protect against over-indebtedness are not mutually exclusive objectives

Organizations must clearly communicate the responsibilities and expectations of their frontline staff. Providing effective financial services and helping to protect against over-indebtedness (among other client protection concerns) are not mutually exclusive objectives. However, creating incentive structures for field staff that reward short term performance targets such as portfolio size or number of new clients without the inclusion of more qualitative customer satisfaction and service measures can lead to unintended outcomes. If, for example, a field officer is incentivized with a bonus at the end of the month for simply signing up X number of new clients, that field officer might be tempted to modify a stringent underwriting process to reach his performance target. Repeated over time, this practice can result in clients who are carrying more debt than they can handle and a loan portfolio full of non-performing loans. To mitigate this risk, an institution should consider integrating qualitative dimensions such as honesty, respect, and transparency into the incentive plan's performance targets. Each MFI should choose the behaviors that are most important to advancing their mission and strategic objectives, developing specific definitions and examples by which to assess individual actions. With a transparent and balanced incentives structure MFIs can still reward top performing field officers without creating diverging objectives.

Risk #2 – Reputation

Possibly the most precious asset an organization holds is its reputation, or external brand. This brand is created and reinforced daily through internal and external interactions by people throughout the organization, in addition to more formal marketing activities. But, from our experience, few institutions in the microfinance sector understand that in order for employees to deliver on this brand promise, they must first understand it and experience it themselves. Intentionally creating an internal brand that mirrors the external brand supports this understanding.[3] For example, focusing on transparent credit practices should be mirrored by transparent internal promotion and rewards practices. And if client education is an important part of service delivery, the organization should ensure that all employees have equal opportunity to access the learning and development they need to meet current expectations and prepare them for future roles. When field officers are able to fully articulate the organization's values, mission and long-term organizational goals, they are better able to reinforce the external brand and create trusted relationships with their clients. Understanding these key principles will also prepare them to deal with reputational challenges that may arise during the course of their every day work. Serious situations can develop quickly in

2 Average 2009 *Personnel Allocation Ratio* for all MFIs reporting to the MIX, www.mixmarket.org
3 Aligning Your Organization and Your Brand for Performance, Interbrand Insights, no. 3 (March 2001)

the field and there is not always time to consult head office for instructions or direction on how best to handle them.

The organization's internal brand should also influence its recruitment practices. From the initial recruitment steps throughout the selection process, the organization's mission and values should be clearly communicated. The specific expectations and responsibilities for the open position should also be reviewed to ensure clear expectations are set from the outset. Field employees are often highly motivated by their organizations' social mission and consistently cite their ability to help their clients move out of poverty as one of the most rewarding parts of their work. When an MFI is experiencing significant growth and needs to increase headcount quickly, recruitment targets should not outweigh the need to fit the right person with the right role. With passionate staff motivated by a social mission, the organization is much better positioned to face reputational challenges (and will likely decrease reputational risk from the outset).

Risk #3 – Competition

In the increasingly competitive microfinance industry, MFIs are searching for any and all opportunities to improve their competitive advantage. On average, personnel costs represent 55 percent[4] of an MFI's total operating expenses, so improved human capital management practices can have a direct impact on an MFI's operating expense ratio and by extension, its profitability.[5]

The private sector has shown that even incremental increases in comprehensive human capital management practices can result in reduced turnover, increased sales/employee as well as increases in market value and profits.[6] And significant cost savings can be realized with reductions in turnover.[7] Perhaps the most compelling example of how human capital management practices contribute to positive financial results is the significant business turnaround at Sears, Roebuck and Company in the early 1990s in the US. Through rigorously measuring what contributed to financial results, Sears found that every five point increase in employee attitudes drove a 1.3 point improvement in customer satisfaction, resulting in a 0.5 percent improvement in revenue growth.[8] We believe the microfinance sector can achieve similar outcomes.

We are beginning to see comparable results in the microfinance sector. While the particular sample size is small, a 2010 study by the MIX Market confirms that "the more progressive the human resource policies implemented by MFIs, the higher the productivity of their staff."[9] There was also a strong positive correlation between staff productivity and training on social performance. It will be interesting to see how this trends across broader dimensions of training and strategic HCM practices.

Risk #4 – Corporate Governance

Respondents in this year's Banana Skins report highlighted a connection between poor corporate governance and management problems, as well as conflicts of interest and challenges with accountability. The Microfinance India: State of the Sector Report 2010 also echoes this challenge: "Governance workshops for directors on the board and senior management seem an urgent necessity. The influence of the promoter [founder] over boards has been perceived to be excessive in some MFIs and must be scaled back."[10]

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4 Defining a global average for personnel costs as a percentage of operational costs is difficult as the cost of personnel varies greatly from region to region. Data from the MIX Market shows that averaged by region, these costs can range from roughly 50% to over 70% (with MENA having the highest average percentage of operating costs encompassed in personnel expenses)
5 Trend Lines 2006 – 2008 MFI Benchmark Tables. 2010. *Microbanking Bulletin*
6 Huselid. 1995. The Impact of Human Resource Management Practices on Turnover, Productivity, and Corporate Financial Performance
7 Nalbantian and Szostak. 2004. Best Practice: How Fleet Bank fought employee flight
8 Rucci, Kirn, and Quinn. 1998. Employee-Customer-Profit Chain at Sears
9 Gonzalez, A. 2010. Microfinance Synergies and Trade-offs: Social versus Financial Performance Outcomes in 2008
10 Srinivasan, N. 2010. Microfinance India: State of the Sector Report 2010

With increasing pressures for financial sustainability from investors, along with the highlighted importance of reputation as a key area of risk for the sector, it is increasingly important for an institution's board to be clearly aligned on the organization's mission, values and goals. A strong board can be a CEO's strategic ally, providing business guidance and supporting the external image of the institution. However, when there is a weak board or if the board does not fully understand the nuances of the microfinance industry, it may push for changes that are not fully aligned with the organization's strategic plan and mission. To be effective, the strengths and capabilities of board members must complement those of the organization's senior team, and the board must be prepared to challenge the thinking of the organization's chief executive when necessary. A strong and effective board can lead an organization's growth and should have the influence and contacts to help it maximize its impact.

Risk #7 – Management Quality

The report also identified growth as one of the key reasons management quality continues to rank among the top ten industry risks. MFIs are simply unable to develop or attract enough experienced, capable leaders to fill the ever expanding needs within their institutions.

Through extensive field research and experience (specifically in India) we have identified mid-level management as especially underdeveloped, creating a constraint for expansion and a drag on effectiveness within the MFI system. Though rapid growth has created an almost constant need for aggressive recruitment, the current selection practices for hiring and cultivating competent middle managers in the field are often inadequate. At times, newly promoted branch managers or even recent university graduates without management experience may be asked to lead scores of field officers. While MFIs, faced with the pressure to expand quickly to meet market demand, may feel there are no other options, these new leaders must be set up for success from day one.

MFIs around the globe must develop both the management and leadership capabilities of these mid-level managers so that they can be more effective in their current positions and be positioned to move into more senior leadership positions as opportunities arise. Improving the leadership ability of middle managers will have a profound impact on the sector's ability to grow and reach ever larger numbers of the poor and poorest.

Risk #8 – Staffing

As MFIs grow, they need to attract even larger numbers of new employees as well as retain experienced staff. This can be challenging, especially in markets experiencing significant competitive pressures. The decision to stay with an organization can be a complex one, with a number of contributing factors. These may include clearly understanding expectations, having the right tools and materials to perform, the opportunity to leverage individual strengths, having a supervisor who cares about them, feeling proud about the organization's mission, being recognized for doing a good job, and being able to express one's opinion, among others.[12]

Experience from the private sector has demonstrated that increased employee commitment is key to creating a successful organization — and is a critical factor in retaining employees. Higher levels of employee commitment enhance job performance and lead to increases in "extra-role behavior"— the act of going above and beyond established expectations to apply discretionary effort that results in additional gains for the organization.[13] Organizations with committed and motivated employees who bring both their minds *and* their hearts to their work, experience much lower employee turnover, a key challenge highlighted in this year's Banana Skins report.

One of the most critical drivers of employee engagement and commitment is understanding how individual efforts support organizational goals. Creating this line-of-sight starts with developing a robust performance planning process where broad organizational goals and objectives cascade down to the various business units and functional teams, and ultimately translate into individual performance objectives. These individual

12 The 12 Elements of Great Managing, Gallup Inc. 2010
13 Gardner, Moynihan and Wright. 2003. The Impact of HR Practices on the Performance of Business Units

objectives can form the basis for a proactive performance planning process, which should be supported with structured, regular check-ins to confirm progress and identify any course corrections or additional support that may be required.

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A second, critical practice that results in higher levels of employee commitment and motivation is ensuring that decisions are made as close to the source of information as possible, delegating the authority to act along with accountability for results. Keeping decision making at the top of an organization means these decisions are made far away from the people who have the most current information on clients and local conditions. Providing targeted learning and development opportunities to frontline staff that focus on enhancing their ability to drive both financial and social results will increase capability and result in more effective organizations.

Risk #9 – Mission Drift

Creating and maintaining a culture that focuses on social as well as financial returns and embraces client protection principles requires intention and appropriate guiding actions. Large, rapidly growing organizations may be tempted to cut corners on the selection, orientation and training of new hires, with the result that the organization's social mission, core values and long-term vision are not effectively communicated to the new hire. Ensuring the organization's core values and social mission are understood and embraced by everyone in the organization should be one of the primary roles of the chief executive, supported by the board of directors. Every internal and external presentation or communication piece is an opportunity to reinforce this message, and all senior staff should be held accountable for modeling these behaviors. In fact, adherence to these core values should be part of each employee's individual performance expectations.

The importance of proactively guiding organizational culture takes on renewed importance as organizations undergo transformation to more regulated entities able to mobilize ever larger amounts of capital and in many cases mobilize savings. During the process of transformation, organizations often seek to recruit new employees who have experience in regulated institutions. While these new hires may have the financial and operational expertise necessary to support the new reporting requirements, they also have a much more commercial orientation that could be at odds with the organization's original social objectives. In these situations, it is common for two divergent organizational cultures to emerge — one based on the original organizational values and the other more driven by financial and profitability objectives. The capabilities and expertise of both the "old guard" and the "new guard" can be combined to yield a stronger, more effective organization if guided by an intentional change management process. Through a structured onboarding process and ongoing guidance, these new employees will better understand the organization's social mission and core values. And those employees who began their careers under the NGO can learn much from their new colleagues. Success is achieved through intentional, continual communication and through leveraging the talents of both groups in service of the new objective.

It's Really All About The People

Microfinance is a powerful part of the solution in alleviating global poverty. *Strengthening the people side of the equation will go a long way to ensure that microfinance institutions have the human capital they need to do their part.*

However, ad hoc measures for addressing the individual human capital risks highlighted in the 2011 Microfinance Banana Skins Report will not solve the problem. Human capital management needs to be addressed as a system that is tied to each strategic decision the organization makes. Maintaining and revising this system as needed to achieve strategic objectives will deliver an organization far better positioned to provide appropriate financial and other services to the most vulnerable among us. The ability to leverage individual strengths to achieve these important social goals should be seen as one of the MFI's most strategic assets, essential to delivering a more competitive, sustainable and scalable institution that is poised to dramatically expand its social impact and support the movement out of poverty.

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