Financial Incentives to Motivate Credit Union Managers and Staff

A Colloquium at the University of California-Berkeley

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The Filene Research Institute is a non-profit organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance and credit unions. It supports research efforts that will ultimately enhance the well-being of consumers and will assist credit unions in adapting to rapidly changing economic, legal, and social environments.

Deeply imbedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members and the general public. Credit unions, like other democratic institutions, make great progress when they welcome and carefully consider high-quality research, new perspectives, and innovative, sometimes controversial, proposals. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process. In this spirit, the Filene Research Institute grants researchers considerable latitude in their studies of high-priority consumer finance issues and encourages them to candidly communicate their findings and recommendations.

The name of the institute honors Edward A. Filene, the “father of the U.S. credit union movement.” He was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

The Center for Credit Union Research is an independent academic research center located in the School of Business at the University of Wisconsin–Madison. The Center conducts research and evaluates academic research proposals on subjects determined to be priority issues by the Research Council of the Filene Research Institute. The Center also supervises Filene Research Institute projects at other universities and institutions. The purpose of the Center’s research is to provide independent analysis of key issues faced by the credit union movement, thus assisting credit unions and public policymakers in their long-term planning.

Progress is the constant replacing of the best there is with something still better!

— Edward A. Filene
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As the American workforce becomes more sophisticated, employers need to develop rewards that will attract and retain qualified staff. At times of relatively full employment, that challenge becomes critical. The Filene Research Institute co-sponsored a colloquium at the University of California-Berkeley to explore ways credit unions can use incentive programs to make the most of their investment in human resources. The event brought together reward system experts, and senior credit union executives. The presentations and discussions are included in this volume. A second volume, based on presentations by credit unions detailing specific incentive programs, is scheduled for publication later.

**KEY FINDINGS**

**Evolving Reward Systems**

1. *Credit unions must recognize and respond to the forces bringing change in reward systems.* Electronic human resource and compensation administration tools now allow management to design reward systems that make incentive payments quickly and accurately. These systems also make it possible to individualize employee reward packages.

2. *Financial services firms now compete for human talent on a global scale.* Many organizations that use call centers and customer service centers to build relationships with consumers have moved those operations to places where talented labor is plentiful, and the cost of labor is relatively low. The scarcity of talent is particularly critical in industries that depend on knowledge workers, and the demographics suggest that this knowledge crunch will continue for some time.

3. *Credit unions need to align compensation systems with business plans in order to be successful.* Every organization has a unique mission, vision, culture and history. Pay systems must reflect the long-term circumstances the credit union expects to encounter, and emphasize the directions that the organization wants to implement. The reward system must be based upon organizational goals and objectives, using a strategy that lends itself to the credit union’s unique management style. Pay systems must align objectives and rewards.
4. Because employees differ in the things they value, reward systems need to make a connection between a desired behavior and a reward that is meaningful to the employee. We can’t assume that everybody wants the same thing from work. Research suggests that in order to be motivated by a reward, people must see a connection between outcome and behavior. A credit union employee, for example, must be able to see that cross-selling a financial product will be rewarding either in terms of self-satisfaction, or in terms of promotion, pay raises, or a pat on the back.

New Organizational Structure

1. Credit unions, like other business organizations, continue to move away from a hierarchal form to a flatter structure with fewer levels. This new structure speeds products to market and improves customer focus, cross-selling opportunities, and member service. Downsizing also reduces the number of employees per dollar of revenue. The decrease in staff flattens the organization, and makes it capable of responding to new market conditions more rapidly.

2. Reward systems can help move the credit union to a lateral model, and allow it to function effectively. That means allocating knowledge, information, power, and rewards. Empowerment of front line employees changes the role of the people who interact with members and deliver the credit union’s services. Front line employees need to understand business strategy, and overall objectives. They need to have decision-making power, and to be held accountable for their actions and decisions.

3. Paying for skills is one of several key ways to invest the credit union’s compensation dollars to generate maximum return. Skills can be perceived on a horizontal axis, a depth axis, and a vertical axis. Horizontal skills refer to those skills that span across functional or product lines. Depth skills refer to the degree of expertise an individual has in a particular skill. Vertical skills refer to higher level coordination, controlling, and management skills. Each of these skills can be priced, and individuals can be paid for the job on which they use particular skills. By learning a range of skills and becoming more flexible, employees increase their value to the organization.
4. Performance management can be an excellent way to implement an overall reward system. Individual performance management can help the credit union to motivate, define the work, and give people development goals. To be successful, however, a performance management system must have the continuous support of the organization's senior executives. The program must recognize who the appropriate appraiser should be for each position studied, design work standards properly, and set achievable goals.

**Distribution of Rewards**

1. Distribution of rewards must be based on appropriate parameters, not on arbitrary or forced distribution. Forced distribution and ranking of employees creates artificial competitiveness among people in a team or work group. We can't assume that employee competence is distributed randomly within the organization in terms of skill and performance levels. There's no reason to believe that within any group of employees, 10 percent will automatically be identifiable as poor performers, or that 10 percent will be identifiable as superior performers.

2. Considering performance and rewards at the same time may impede a discussion of career and personal development opportunities. The best organizations separate discussion about development opportunities and career opportunities from feedback about performance, and from discussion of pay increases. They also offer an appeal process so that those who feel unfairly treated can get a hearing outside their direct reporting relationship. Holding a hearing inside the credit union is much less expensive than holding it in a courtroom.

3. If the credit union emphasizes team behavior, it must also reward teams and teamwork. An effective team often deals internally with poor performers, motivating them to improve because they're holding the team back. To deal with superior performers appropriately, it may be necessary to position them higher on base pay, based on skills, knowledge, or other measures that distinguish them.
4. Effective reward systems require the CEO to have a mission to make the program work. The CEO must feel strongly about it, and be willing to sell it. The CEO must support the program unreservedly, and help others in the organization see how the results are being calculated, how it has been driven by their behaviors.

**Intrinsic vs. Extrinsic Motivation**

1. Managers need to consider whether intrinsic or extrinsic motivation is more central to an individual’s performance. They also need to address which of these motivators is more effective in making a difference within the organization. Intrinsic motivation promotes creativity, while extrinsic motivation emphasizes control. Extrinsic motivation is effective in situations involving relatively routine tasks, while intrinsic motivation works best in activities that demand problem solving, conceptual understanding, and information processing.

2. Intrinsic motivation promotes workplace well-being. Most organizations today place great emphasis on performance, and much less emphasis on the health and well-being of employees. Yet when people are more intrinsically motivated, a range of health and well-being outcomes are affected, including higher self-esteem. Anxiety and psychosomatic symptoms are reduced when workers are intrinsically motivated.

3. There is a place for both intrinsic and extrinsic motivation systems. Intrinsic motivation creates positive conditions through choice and interesting work. Extrinsic motivation sets pathways to rewards, taking care that the rewards are being offered for those kinds of performance that we want to reward.
Effects of Extrinsic Rewards on Intrinsic Motivation

1. Research indicates that adding extrinsic rewards to intrinsic motivation programs tends to have a negative effect on intrinsic motivation. In correlating 100 published studies of the phenomenon, researchers found that across a wide cross-section of reward types, the addition of extrinsic rewards resulted in a decrease in intrinsic motivation.

2. Rewards are often seen as controls on behavior. Some experts believe that control is a good thing. Others believe that employees have an innate desire to regulate themselves, to initiate their own activities, and take responsibility for their behavior rather than feel controlled by others.

3. The way in which rewards are administered makes a difference in their effectiveness. The credit union’s managers create its cultural atmosphere. The very best managers at any level are those who can keep pressure from above from having an inordinate impact on their unit. Top managers absorb the stress and still maintain a positive interpersonal climate with the members of their unit. And when managers are successful in creating a positive interpersonal climate, the negative effects of rewards and other external motivators are not nearly as great as when the organizational climate is authoritarian and controlling.

Incentive Strategies

1. Many effective incentive programs start with a business strategy, and use pay as a way to communicate direction and goals to employees. The credit union must demonstrate that it offers a total rewards package comprised of individual growth, a compelling future, total pay, and a positive workplace. That becomes the credit union’s contract with its employees. By communicating the total rewards package, the organization rises above having to compete in the marketplace solely on monetary terms.
2. *There are many ways to set performance levels.* As the incentive plan is being designed, the credit union should make sure that managers understand how performance will be measured. They should know in advance how much of the program will be based on organizational achievement, how much on team achievement, and how much on individual achievement. If the plan focuses on individual achievement, it must be designed in such a way that individuals can’t undermine team or organizational goals in order to achieve individual goals.

3. *When possible, involve employees in the development of a reward strategy.* The more involvement participants have in designing the strategy, the longer the development will take but the more they will accept the program. People like to know that they’ve had a part to play in building the program.
Edward Lawler

Edward E. Lawler III is a professor of Management and Organization at the Marshall School of Business at the University of Southern California. He also directs the school’s Center for Effective Organizations. He has been honored as a major contributor to theory, research, and practice in the fields of human resources management, compensation, and organizational development, and effectiveness. He is the author and co-author of over 300 articles and 30 books. His most recent book on reward systems is Rewarding Excellence, Jossey-Bass, 2000.

In this session, Ed Lawler shared his research findings in the field of reward and pay systems, and the implementation of effective programs to achieve organizational success through human resources.

I’ve studied organizational reward systems and pay systems for over 40 years. During that time, my interest in those systems has waxed and waned depending on the state of the environment in which they operate. At times, the stability and the static nature of reward systems give one the sense that nothing ever changes. The same issues keep coming up again and again.

But there are also periods of great change and fluidity, when organizations are undertaking new and exciting activities. New pressures demand change and, as a result, we see significant innovation in reward systems. I believe we’re in one of those periods now, which is why for the last few years I’ve been doing more research in the area of reward systems.

HOW REWARD SYSTEMS ARE CHANGING

Many forces are currently pressing change in organizational reward systems. All these forces may not affect your credit union, but they are affecting the environment in which you do business.

We’ve seen rapid technological change with the adoption of the Internet and the Intranet in organizations. Some of the most interesting information technology is in the area of electronic human resources and compensation administration tools. These tools put thousands of pages of paper onto the Internet, and allow...
almost simultaneous allocation of bonuses and pay increases. Electronic systems also create the power to individualize reward packages for employees. Now they can go online and make choices, not just about benefits but about cash trade-offs of various kinds, and create a truly flexible reward system.

We’ve also seen an incredible increase in global wage competition. Organizations with call centers and service areas are considering how to move those operations to parts of the world where wages are low. Companies are looking for comparable labor for less, and developing ways to move there.

We live in a world of continual downsizing. It’s become more visible lately, but certain kinds of downsizing continued throughout the economic boom of the nineties. Companies are intent upon reducing their number of employees per dollar of revenue. They’ve decreased the number of employees and flattened the organization.

From the point of view of reward systems, that eliminates what historically has been the most valued organizational reward, promotion. At least promotion is more difficult to achieve. Promotion simply isn’t readily available as businesses downsize and reorganize.

We’re also operating in an era of scarce talent. That’s a particular problem with respect to knowledge work. Unemployment remains low in high technology industries. And the demographics work against dramatic growth in the labor supply during the next few years. The scarcity of qualified workers in technical fields is not an issue that will go away in the foreseeable future.

**BUSINESS PLANS AND COMPENSATION SYSTEMS**

One of the major long-term problems with pay systems is that they do not reflect the unique circumstances of the organization. They have been “me too” systems that don’t emphasize particular directions of structure and approach that the organization wants to implement, partly because of the basic structure of the plans, and partly because of what they measure and how they deliver rewards.
It’s not easy to make the leap from a business plan to a compensation system. When I work with organizations, I ask them to talk about their goals and objectives, where they’re trying to go, what their strategies are. Then I get them to work through to the consequences of their reward systems, and whether the consequences of those reward systems will support corporate goals and objectives.

Not surprisingly, the most difficult problem many organizations have is not with reward systems, but with goals and objectives (figure 1-1). That’s because they don’t have a strategy that lends itself to their organization design and management style to facilitate working through the process.

Basic to the concept of reward systems is how the behavior of individual employees and the organization as a whole can be influenced by the reward system. It’s a complicated process, and achieving a flow in alignment between objectives and rewards is not an easy task. Reward systems affecting organizational effectiveness need to consider seven issues, as shown in figure 1-2.
VALUE PERCEPTION

Motivation, attraction and retention, structure, and reward systems all influence those variables. People differ in what they value. It used to be safe to assume that everybody wanted the same thing from work. We now know that there are large individual differences relating to background and life situations, age, wealth, and other factors, that influence what's important to the individual.

What makes individual differences particularly challenging is that even if we ask people what motivates them, they may not be able to tell us what they value. Not because they’re dishonest, but because there are social desirability issues that influence what people say they like and want from work. In fact, they often don't know what really motivates them until they’ve experienced it. And only when they’ve experienced it do they know how satisfied they are.

It’s very hard for us to be self-analytic. I’ve known people who have been in therapy for ten years, and they still haven’t figured out what they want. Self-analysis is difficult, and our perceptions are constantly changing.

I support the expectancy theory, which argues that people’s expectations about rewards influence their motivation. In order to
be motivated by a reward people must see a connection between the outcome or reward and their behavior. That’s true whether the reward is an internal one, a feeling of satisfaction over having done a good job; or an external one, such as a promotion, pay increase, or pat on the back. We need a mental model of the world that assures us: “If I cross-sell a financial product, it’s going to be rewarding.”

The experience would be rewarding because it led to a promotion, or a bonus, or simply a feeling of accomplishment. But it must be rewarding, rather than trouble, for the individual. If all it means is that the employee must complete forms and deal with people in another department who she doesn’t like, chances are she’s not going to cross-sell the product.

People must also value the specific reward the organization is offering. And we differ in what we value. If the employee is going to cross-sell a financial product, she needs to anticipate a reward that she truly values. Many of the financial rewards employers offer are not large enough to change behavior.

For example, a supervisor manages pay raises for a staff of twelve individuals, and has a budget of three percent. The supervisor also has a mandate from senior management that he reward top performers, without relying on across-the-board raises.

The supervisor confides to his staff that he’s embarrassed at the three percent pool. There’s no way he can reward performance with a three percent budget. Top management doesn’t accept that approach, it merely sets the rules that others in the organization are expected to live with. To capture somebody’s attention, the rewards must be significant, and three percent does not meet that standard.

But what does meet the standard? If we want to change somebody’s behavior, it’s somewhere in the neighborhood of 10 to 15 percent. The specific number varies depending on a number of conditions.

Finally, reward satisfaction often gets confused with a measure for motivation. Rewards are not a good predictor of performance motivation. The ultimate predictor of performance motivation is whether the individual stays with the organization over the long term.
So if the employer conducts an attitude survey and finds employees dissatisfied with their pay, their chances for promotion, and their intrinsic interest in the work, chances are the turnover rate will be high. In the Silicon Valley until recently, many firms were eagerly looking at their satisfaction data to figure out whether people were planning to leave. But when the equities markets plunged, employees stopped leaving. Since then, these firms have had almost no turnover.

Does that mean employees are more satisfied with their jobs? Probably not. Much more likely, it means the opportunities to do better, the expectations about the consequences of changing to another job, have changed dramatically.

Satisfaction isn’t a perfect predictor of turnover or membership, but it is the best predictor, particularly in good economic times. To motivate employees with financial rewards, we must establish a “line of sight” – a clear connection between the person’s effort and the payout. In most cases, if we reward to motivate performance, we have to use a variable pay vehicle (figure 1-3). Merit pay doesn’t work.

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**Figure 1-3:**

*Fortune 1000 Company Reward Systems*

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<td>Profit Sharing</td>
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The research on merit pay is overwhelmingly negative. There have been more than 3,000 studies on merit pay systems, and only about 100 have found positive results. The other 2,900 have found neutral or negative results. That’s because merit pay is an inflexible, limited vehicle that is very difficult to relate to performance, and is usually based on a fatally flawed performance management system. These systems start with bad measures, and deliver inadequate rewards.

**ATTRACTION AND RETENTION**

Reward programs are a key element in the attraction and retention of qualified employees. One of the forces that’s now putting pressure on traditional pay systems is the hiring deals the dot com organizations offered. Consider the value proposition that dot com companies have offered their employees: it’s an interesting way of thinking about employees.

The dot com companies call their employees human capital. They view a brand as an employer, and talk about a value proposition to offer employees. These terms reflect a movement to a human-capital-based society in the United States. That line of thinking raises the issue of how we attract and retain employees, particularly high-value-added employees. Instead of providing time off to achieve a work-life balance, dot coms offer a “life at work, therefore you’re balanced” proposition.

It’s surprising the number of people who sign up for this kind of work environment. I like the extras that dot com companies use to create an attractive culture for employees. One of the biggest problems Amazon.com had was their pet friendly workplace policy. Anybody could bring any pet to work any day. It worked fine except when the pets didn’t get along. The human resource people were charged with creating a pet policy that would deal with conflicts between pets. The company began giving demerits to unruly pets, and after a certain number of demerits, the pet was banned from the workplace.

I mention these examples to emphasize the idea of a value proposition or employment contract that signals a unique culture, and attracts a particular kind of person.
Different kinds of value propositions attract different kinds of people. One of the things the dot coms discovered is that their value proposition (figure 1-4) attracts risk-oriented individuals. That characteristic shows up in organizational behavior, and not always in the best interest of the organization. Sometimes these individuals and companies take too many risks, and the wrong kind of risks.

Value proposition relates to compensation because it’s total compensation – the package of rewards including cash compensation, bonuses and benefits – that drives attraction and retention, while changes in compensation drive motivation. The rewards need to be significant enough to capture the employee’s attention.
A NEW ORGANIZATIONAL STRUCTURE

To be competitive in today’s environment, organizations need to be flatter, with fewer levels and more lateral processes, to speed products to market and improve customer service, cross-selling, and customer focus. That means moving away from a traditional hierarchical form to a mixed model.

The reward system is one vehicle that can help the organization move to a more lateral model, to allow it to function effectively. To do that, the credit union must correctly allocate knowledge, information, power, and rewards to reflect a flatter structure. Instead of the traditional cone shape, with large amounts of power, information, knowledge and rewards at the top and very little at the bottom, there must be more ownership of the business at the bottom.

Substantial power, information, knowledge, and rewards remain at the top of the organization, but empowerment of front-line employees, significantly changes the role of the people who interact with members and deliver credit union services. Front-line employees need to understand the overall business and its objectives. They need information about business strategies. They need the power to execute and make decisions in their jobs, and they need rewards that reflect how well they – and the organization – performs.

At the same time, moving power downward without accountability is not a good idea. Accountability needs to move downward in the organization along with knowledge, power, and information. Historically, organizational pay systems have included a base pay component that covered most employees and was based on job descriptions. The larger the job, the higher the pay. There may also be individual performance components based on merit pay. At the very senior levels, there may be bonuses.

If we move to flatter, more lateral organization and consistency among management objectives, people need to be paid for what they can do. That’s what motivates people to learn and develop. Under that kind of reward system, employees are paid for their performance as a team, as a unit or location, or as a total organization. And that payment comes in the form of variable pay.
REWARDING INDIVIDUAL PERFORMANCE

Now let’s consider what it takes to make an individual performance system work. It’s not easy, but it is very much in tune with the U.S. culture. Everybody in this country likes the idea of individual rewards for performance. Individual accountability is at the heart of our system.

We’ve collected research data from Fortune 1000 companies since 1987, most recently in 1999. Overall, corporations are moving toward more pay for performance, particularly individual pay for performance. That includes bonuses, stock options, and certain non-monetary recognition. At the same time, work team incentives have become very popular. Gainsharing, another form of collective pay for performance, has increased. Flexible benefits have become much more popular. And paying for knowledge or skills has also become popular.

Corporations are trying to invest their compensation dollars in a way that generates maximum return. Paying for skills is one way to accomplish that objective. The process starts with a simple cube (figure 1-5) we’ve used for years to describe this approach. In this approach, we perceive skills on a horizontal axis, a depth axis, and a vertical axis. Horizontal skills refer to different work stations in the organization. In the financial services industry, it may be
working with different kinds of products, developing skills across functional lines, or in other capacities. Depth skills refer to the degree of expertise an individual has in a particular skill. Vertical skills refer to higher level coordinating, controlling, and management skills.

Typically, we price a skill and pay a person for the job on which they use that skill. When they move to another area, they’re paid a wage that’s appropriate for the new position. In an assembly plant, that concept could be carried to absurdity. People may work for a couple hours at one station, then move to another station where their pay rate changes, and move again to another rate of pay, all in a single work shift.

In today’s lateral organizational environment, employers realize that employees must understand the entire work process. That requires encouraging employees to learn a range of skills so that they can be more flexible. They must also develop depth skills so that they understand the work at a higher level. And if they’re going to manage themselves, they should be encouraged to develop vertical skills as well.

Companies have adopted skill-based or knowledge-based pay systems in which people are rewarded or paid in proportion to the number and kind of skills they have mastered. If they’re being paid for these skills, they must be able to perform them on the job on a regular basis, what we call cross training. This is not just a matter of training people to learn the skills, but also rewarding them for being cross-trained. The concept has been adopted primarily in situations where people work in self-managing team environments.

Skill-based pay systems create a number of issues, however. It’s not a simple process. We need to know what skills the organization requires (figure 1-6). We need to price them. We need to test employees to determine whether they possess the required skills. We have to decide what mix of skills we want employees to have, and set up access rules. We need to do a cost benefit analysis, because a skill-based pay system does raise individual salary costs, although it may reduce total salary costs.
When employees are more flexible and the organization needs fewer of them, they need training support. There's also an issue of how to develop a training model. Employees should participate in the development process for that model.

Paying for skills and knowledge has a number of advantages. People understand the processes of the organization better. They identify with the organization. And they are more capable of self-managing, taking on work that used to be done by staff positions.

Pay for skills and knowledge is a powerful tool, but it's also a high-maintenance tool, because we must be sure we've got good skill tests and definitions. People can't get higher pay simply on the basis of seniority. When skill-based pay systems deteriorate, it's usually because discipline is lost. We can't assume that because a person has been with the credit union another year, they must have learned something, elevate them to the next skill level, and pay them more. That's fatal to the system.

**PAY FOR PERFORMANCE**

Performance management offers opportunities and risks, both factors of significant importance. Individual performance management produces better motivation, better performance, and better communication. Subordinates can be developed. Employees commit to the organization's goals. But performance management often produces turnover, false data, worsened superior/subordinate relationships, and damaged self-esteem.

These risk factors involve more than the employee getting a negative appraisal. The boss who botches the appraisal also loses self-esteem, so both parties are damaged. The result is lower...
motivation and performance, lawsuits – which are currently in vogue due to layoffs based on performance appraisals – and an enormous waste of time.

Yet in the best of all worlds, performance management makes a great deal of sense. There are good reasons to be concerned with individual performance management. It can help us to motivate, to define the work, to give people development goals. But how we put those pieces together to create an effective system is a challenge.

Figure 1-7: Performance Management Keys to Success

Figure 1-7 presents a list of issues that are predictive of whether a performance management system will work. First on that list is support from the top. I’ve studied performance appraisal in 200 to 300 companies over the past two decades, and the best predictor of whether performance management will work is how seriously the senior executive takes it.

We recently did a study on corporate boards, our first opportunity to look at boards of Fortune 500 companies. We found that one of the keys to board effectiveness is whether they do a performance appraisal of their CEO. It would seem that that’s an obvious thing to do, but it seems to be considerably more difficult than it might appear to be at first glance. (Conger, Lawler and Finegold, Corporate Boards, Jossey-Bass, 2001.)
About 70 percent of U.S. corporate boards do a formal appraisal of their CEO. The other 30 percent shake hands and congratulate him or her, then hand over the money. In those companies that actually do an appraisal of the CEO, the performance appraisal triggered a very predictable response. The CEO said, “If my future is on the line for results with the board, I better put some of that pressure on the organization and try to translate what I’ve agreed to with the board to assignments, responsibilities, and accountabilities for the people who report to me.”

When the CEO does that, performance management rolls down the organization. Suddenly, instead of the performance management system being something the top told the middle to do to the bottom, it becomes a way of driving the strategy of the organization from the top to at least the middle levels of the organization. It also becomes something that is on the automatic to-do list of every manager. It must be an important part of the evaluation of every manager if we expect managers to do it well.

**WHO SHOULD APPRAISE?**

With the growing use of Intranets we’ve seen a change in the model of who should do appraisals. This also applies to the appraisal of teams. Historically, the correct appraiser was assumed to be the boss and only the boss. But when people are in teams, it makes sense to get data from members, subordinates, team members, and other stakeholders. That’s resulted in the growth of 360-degree appraisal technology. At the same time, it’s critical to determine whether all the people being asked to provide input have valid data – and the motivation to give valid data when they are asked.

We can’t assume, for example, that peers will give valid data when asked what they think about a colleague’s performance. The reality is that most salary increase systems are zero sum games. If a colleague rates a peer highly, it may take away from their own increase. If an individual works with a very competent group of people, each member is likely to get a smaller increase.

Two years ago I fired an employee two weeks before I got my merit budget. It was the wrong thing to do. If I had kept that employee on for another three weeks, I could have rewarded my
good performers better. As a result of the firing, I lost the four percent increase that I could have used for others.

That’s the heart of the issue of competition among individuals with a zero sum model. The dilemma is that peers often have the best data about how someone is performing. The question is: Will they give you those data if you’re going to use them for pay purposes?

For people doing individual work station tasks, it makes sense to reward them for individual performance. If they’re part of a team and the best measures are available at the team level or the unit level, then it may not make sense to reward them as individuals. It may be better to reward them with a collective bonus system.

It also is dangerous to assume that the person being appraised and the person doing the appraisal have the skills to do it properly. These are two separate roles, each of which requires its own set of skills.

People need to be trained in the conduct of performance appraisals. It helps if the supervisor and the person being appraised are trained together, so that they understand each other’s roles and the organization’s expectations. Appraisals are best when goals are set jointly, when goals are reasonable and achievable, and when measures are behavior-based. Giving open-ended rating skills – the employee is friendly, kind, and courteous, would make a good Boy Scout or Girl Scout – does not produce valid data. What’s more, if the organization is sued, it will lose in court. Courts consistently hold that if you don’t talk about behavior in very specific terms, you’re not doing a valid appraisal.

**DISTRIBUTION OF REWARDS**

Appropriate distribution of rewards is a critical point. There is currently a fascination with forced distribution and ranking approaches to individual performance appraisal. That implies an increasing competitiveness among people in a team or work group. Even more dangerous is the underlying assumption that employees are randomly distributed within the organization in terms of skill and performance levels, which is simply not true.

Organizations today assume each unit must have 10 percent of its employees performing in a problem category. If supervisors don’t
rate their people on that standard, they’re considered to be doing an inadequate job of performance appraisal. Applying that principle to groups as small as 15 or 20 people is absurd. There’s no reason to believe that a group of 15 people automatically has 10 percent identifiable as poor performers, just as there’s no reason to believe 10 percent are outstanding performers.

In a given group, 70 percent may be outstanding performers and 30 percent may be poor performers. The world doesn’t distribute performance randomly in organizations that make conscious choices about who works where, who does the training, and who develops the employees. Yet forced distribution seems to be a very popular practice today.

One place where organizations differ substantially is whether they do performance appraisals on an employment anniversary basis or on a fiscal basis. There’s no automatic right answer, but the key is to have good data about individual performance. If the hiring anniversary is used, appraisals are distributed throughout the year. That makes comparative judgments difficult, because employees are being appraised over different time periods of time. In many cases the data hasn’t matured; that is, final operating results are not available.

To overcome this difficulty, it makes sense to appraise everybody at the same time in a focal point review. This is particularly advantageous when bonuses or rewards are tied to appraisals. Peer review helps, by providing input from several sources before performance judgment is made. Peer review may involve completing a form, or listing results achieved.

There’s significant evidence that considering performance and rewards at the same time impedes discussion of career and development. The best organizations separate discussion about development opportunities and career opportunities from feedback about performance, and from discussion of pay increases.

It’s important to have an appeal process so that those who feel unfairly treated can go outside their direct reporting relationship to get a hearing. That often prevents the employee from going to court to get a hearing. Holding an appeal hearing inside the organization is much less expensive than holding it in the courtroom.
INDIVIDUAL VS. TEAM REWARDS

We’ve been talking about measuring and rewarding individual performance with performance-based measures and bonuses. The alternative is to become more team oriented. It is possible to create a calibration of different levels to reward teams (figure 1-8). When organizations want to reward teams or teamwork, they are pressed to emphasize team behavior.

![Figure 1-8: Rewarding Team Behavior](image)

We can measure how team-oriented individuals are. The appraisal form may add a new category called “good team member.” Employees are rated on team behaviors. But that alone doesn’t produce a cohesive team. It's like voting for most valuable player, providing a group reward with an individual bonus for the most valuable player. That system keeps the emphasis on the individual, so individuals compete to be the best team member, not individuals focusing on being a member of the best team and working to make the team more effective.

To measure and reward the group with no individual differentiation, we need to wrestle with the idea of slack performers and superstars. How will we reward employees on extreme ends of the performance spectrum if we reward everybody equally?
Two things can happen with an effective team or collective reward system. First, the team may very well take care of the poor performer, and get that performer to improve because he’s holding the team back. Second, the poor performer may be removed from the team. It’s more difficult to address great performers because there’s only so much we can do to reward them. One way is to position the individual higher on their base pay rather than bonus pay, based on skills, knowledge, or other measures that distinguish them.

The truly cohesive team depends upon group measurement and rewards. Small individual rewards may also be appropriate – recognition rewards, spot bonuses, something to distinguish high-performing individuals. But for truly cohesive teams that self-manage and deal with their internal performance problems, we must reward the group as a team. Anything less produces a situation in which it is in the interest of individuals to have poor team members.

The same kind of thinking applies to the overall organization. If we want the whole organization to pull together, then we have to measure and reward the organization as a whole.

CREATING A TEAM MENTALITY

A potential problem with any of these systems is that by the time we create a collective mentality that involves hundreds, perhaps thousands of people, we also create difficulties establishing a connection between effort and payout. Timing, education, communication, and leadership become critical. There must be clear communication as to what the organization is about. Each employee needs to know how we measure performance, how the organization is doing relative to its goals, and how individuals can make a difference in reaching those goals.

Under a collective reward system – a bonus plan that involves the entire organization – the CEO must have a mission to make the program work. The CEO must feel strongly about it, and be willing to get out and sell it. The CEO must talk about it, help people see how the results are being calculated, how it has been driven by their behaviors.
Collective business unit or company-wide plans are subject to considerable problems. They may be built on bad formulas that people can’t understand, or be too complicated, or too abstract in what they measure. The net result is that people can’t relate their behavior to the reward system. Employees don’t feel involved in setting up the plan or in its operation, so they may not trust the plan. Sometimes bonuses are payable too far in the future, deferred by years. Sometimes they’re poorly maintained, and the plan provisions are not updated. And sometimes, necessary changes in managerial behavior, communication measurement, and training are not put in place.

**SUMMARY: PAY FOR PERFORMANCE**

The importance of rewards is in the eyes of the beholder. We need to know what people value. It’s critical to provide a “line of sight” – a clear connection between behavior and reward. Trust is also a key issue. The people who are in the plan need to believe that it’s well run and fairly administered. We can build trust through openness and involvement in the plan operation and design. The plan must be designed to produce more of what is rewarded and less of what is not rewarded. That’s a critical point, because if we measure just a few things, other things will be lost, and we need to be willing to sacrifice those things.

It’s easier to change the direction of behavior than it is to change effort. Rewarding certain behaviors may not move people to work harder, but move them to work on different activities.

The credit union must create a total rewards proposition that fits its strategy. Rewards must fit the kind of people the credit union wants to attract and how it wants them to behave. They must focus on the market value of individuals, their skills and knowledge, and what they’re worth in the market. The best way to reward individual market value is with base pay. The best way to reward results is with variable pay.
**DISCUSSION**

*Participant:* Professor Lawler, please talk about some of the factors that lead folks to be able to decide whether their reward management system actually works.

*Lawler:* The most important element of a successful reward program is support from the CEO or other senior managers who are passionate about the program. Then ask yourself what kind of work is important in your organization. What kind goals can you set? What are your reward system issues? What reward flexibility do you have that will make the plan successful?

I start with the work design, and support from the top. Work design leads to the issue of what you can measure. Can you set the right kind of goals and the right kind of metrics? Don’t simply reward those activities you can measure, because there are sure to be other things you want people to do that can’t be measured. If you reward only measurable behaviors, you’ll lose other behaviors you want to encourage.

*Participant:* In cross-selling activities, do you believe that bonus pay encourages all people to cross-sell? In our organization we may not always have the right people in that job, so it doesn’t matter how much we pay them because they’re motivated by other factors.

*Lawler:* I haven’t done research on cross selling, but I’ve seen it in operation. There are two issues involved. One is the issue of individual versus group rewards. And second, do your people have the skills to do it? If they don’t, creating an incentive is not productive. If employees are cross-trained, then cross selling is much easier. If they’ve worked in a number of areas, they can talk intelligently to a member about what they’re cross selling, rather than following a script.

You also need to decide what it is you want to measure. Do you measure, for example, the total number of products that you have with members, and reward the organization collectively for increases in that metric?
Or do you try to track individual cross-selling behaviors, and reward that?

You might suggest to tellers that if they refer members for an auto loan, they'll receive a monetary reward. Or you might provide rewards at the collective level based on the total number of products that members buy. Under that kind of system, you reward the staff collectively.

Those are just two alternatives. Traditionally it's difficult to give credit to one individual and not get resentment from others who may have been involved in the selling process. An employee might claim, for example: “I talked to that member last week, and now Joe is getting the credit. I played a key role and got nothing.” The same applies to other employees who may have been involved in the total process. You need to be sure you can track the process from objectives to sales success, and make that line of sight visible to your employees.

That’s where passion and leadership come in. The problem in most organizations is that people want to be rewarded as individuals when they’re a success, but they want to be rewarded collectively the rest of the time.

Participant: You pointed out the power of performance management systems, along with some of the pitfalls. What are the alternatives?

Lawler: One alternative is to do nothing at all, or to do it strictly for development purposes. If you're not creating a system for the purpose of individual or merit pay increases, it's important to connect with employees, to talk about their skills and development, and to reward development with a skill-based model. But the reward system must be made a high priority in the organization, or it won't get done.

The lever many organizations use to get results is to say if the supervisor doesn’t file the proper forms, her people won’t get a pay increase. That amounts to punishing the victim. A better lever is to tell the boss that if she doesn’t file the proper forms, she won’t get a pay increase. Or if
she doesn’t complete the forms on time, she’ll get a smaller increase.

If you’re measuring performance only for development purposes, the rationale for doing it is less obvious. It’s more subtle, and the bureaucratic pressure is a little different than when tangible rewards are part of the system.

Participant: Could you talk a little more about a situation in which the overall bonus pool is small – in the three percent area, as you suggested earlier? What can be done to overcome that kind of limitation? How can the group be motivated?

Lawler: First, you need to be direct and honest about what’s going on. Explain the constraints to the group. Also, tell employees when they’re first hired what to expect by way of monetary rewards. If yours is not a pay for performance organization, let them know about it up front. Tell them how you will help with their development, how you’ll support them if they’re good performers. Tell them what you’ll do to help them learn skills and other parts of the operation.

Participant: In an environment where team rewards are emphasized, you suggested that the way to reward peak performers is through base pay. Although they helped the group move ahead, you can’t reward them because the team is rewarded equally.

Lawler: I encourage the organizations I work with to have a budget for equity increases when there’s clear market data indicating the need to adjust base pay to keep the employee in line with the external market. I’m a believer in paying according to external market data. External equity – people doing the same job – can be measured.

You need a budget that reflects the movement in the external market. Not just the overall external market, but also the employee’s growth in the external market. If an employee is adding skills and knowledge, her market value is going up, and you need to reflect that in your reward system, or you’re going to lose your best people, and end up with a staff of poor performers.
SESSION 2: When Are Financial Incentives Counter-productive?

Edward L. Deci

Edward Deci is a professor of psychology and director of the Human Motivation program at the University of Rochester. He holds a Ph.D. in psychology from Carnegie-Mellon University, and studied at the University of Pennsylvania, the University of London, and Hamilton College. He was an interdisciplinary postdoctoral fellow at Stanford University. Deci’s 30 years of research on human motivation is summarized in nine books on the subject. His writings have been translated into seven languages. In this session he explores how decisions are made within organizations, and the effects those decisions have upon the motivation of individuals working within those organizations. He describes the differences between extrinsic and intrinsic motivation, and the implications of each upon the behavior of employees. And he supports his conclusions with research findings over a period of several decades.

Motivation is a subject that is applicable in a wide spectrum of settings, from sports to academia to business. Every managerial function has direct, immediate and important implications for the motivation of people working in an organization.

The vitality of organizations depends to a significant degree on how decisions are made, and the implications of those decisions. I’m interested in that decision-making process, along with goal setting for individuals, small teams, and larger units in the organization. And I’m interested in performance evaluation. Performance evaluation is done in very different ways in organizations, and the way in which it’s done has important implications for the motivation of people in that organization.
MOTIVATIONAL THEORY

Today we’re discussing rewards or incentives. Let’s start with motivation, and lead into rewards. In management literature over the last hundred years, every managerial approach, every theory of management and every managerial technique makes implicit assumptions about the nature of human motivation. Across all these managerial systems and practices, there are two quite different underlying motivational assumptions. The first assumption that many managerial theories make is that people will perform effectively to the extent that their rewards and other desired outcomes – including promotions and other incentives – are made contingent upon effective performance. Motivation is viewed instrumentally, as something that is intended to get you an intrinsic reward.

That’s a reasonable motivational assumption. There is a great deal of research in psychology that supports that assumption. The research falls into two categories. Behaviorism, or behavior modification, examines reinforcement theory, and fits nicely with this assumption.

Another area of psychology deals with cognitive approaches to motivation – the expectancy-valence theories. This approach says that motivation is all about goals or future outcomes, and when we value future outcomes we do what is necessary to achieve them. Cognitive approaches to motivation suggest that if we think our behavior will get us to the desired reward, then we will be motivated to perform. The notion is that our behavior is instrumental in achieving a desired outcome or what is sometimes called a separable consequence.

That’s one way to think about motivation. In management literature, as shown in figure 2-1, we find systems that are based wholly on that notion, with the emphasis on rewards. Scientific management goes back to the beginning of the twentieth century, when piece rate payments were first implemented. The idea is that pay is a direct function of the number of “widgets” produced.
The same system is used in selling cars and receiving commissions for each car sold. This motivational system is implicit in scientific management. Back in the 1950s, Douglas Macgregor came up with the phrase “Theory X” to describe this kind of management. Theory X management depends upon a hierarchy, an authority relationship as a central part of the management structure, and management uses rewards as a technique of control.

A contrasting view of motivation involves a different assumption about motivation, one that emphasizes the notion of self-motivation. This theory assumes that given the right kind of circumstances, people will motivate themselves.

This second approach relies on managers create work conditions within which people will motivate themselves. The assumption is that people are inherently motivated to do a good job because it’s personally satisfying to do well. The feeling of accomplishment is a strong reward and motivator. This approach, as represented in “Theory Y” management, or participative management, specifies the conditions that support intrinsic or self-motivation.

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**Figure 2-1: Motivational Assumptions**

1. People are motivated *instrumentally*. They perform effectively to the extent that desired rewards are made contingent upon effective performance.
   - Theory X management
   - Scientific management
   - Traditional management

2. People are motivated *intrinsically*. They will perform effectively to the extent that the job is interesting and challenging, they are provided choice about how to do it, and they are allowed a sense of belonging with respect to other members of the team.
   - Theory Y management
   - High involvement management
   - Participative management
People like to have a say about what they do. We don’t like to be told what to do, when to do it, and how to do it, with other people imposing answers on us. We like to have freedom, flexibility, opportunity to make choices and decisions about how we do our work. When managers give people the opportunity to be part of a team and let them feel that they are working together rather than competing with their fellow team members, then jobs become more inherently interesting.

The traditional approach is to break jobs into the simplest elements, then assign each person to do one simple element in the overall process. The participative approach involves bringing processes together and designing jobs in more interesting ways to give people conditions through which they will be self-motivated.

The self-motivation approach changes the nature of the relationship between a manager and a subordinate. When managers support the intrinsic motivation of subordinates, decision-making, goal-setting, and performance evaluations have very different implications in the workplace.

Intrinsic motivation suggests that people and groups need to be involved in setting their own goals. Overall objectives must be clear, so that at the end of the evaluation period employees can essentially do their own performance evaluations. They’ve been actively involved in the process of setting goals, agreeing on what needs to be done, and what schedules must be maintained. This changes the way we think about motivation, away from traditional authority-based approaches and toward self-motivation approaches, and it leads to a rather radical approach to performance evaluation. It suggests that if managers create the right work environment, subordinates can do their own performance evaluations.
INTRINSIC VS. EXTRINSIC MOTIVATION

In psychology we talk about intrinsic and extrinsic motivation as ways to approach the divergent motivational assumptions I’ve mentioned. With that distinction, the first consideration is the differences intrinsic and extrinsic motivation make in people’s behavior and performance on the job. The traditional view is that motivation is a unitary concept. It suggests that we can have more or less motivation and asks how to foster more motivation. However, I maintain that the amount of motivation is not the most important and relevant question. The real question is not how much people are motivated, but how they are motivated – that is, whether they are intrinsically or extrinsically motivated.

The importance of that question is that the quality of individuals’ performance is different as a function of whether they are primarily intrinsically motivated or primarily extrinsically motivated. We’ve done research on those differences, on ways of measuring intrinsic and extrinsic motivation and on the results you can expect to see in the performance of someone who’s intrinsically vs. extrinsically motivated on the job.

We found that intrinsic motivation promotes creativity. In all activities in which creativity is involved, the more intrinsically motivated employees are, the more creative they will be. We also found that intrinsically motivated employees are more flexible in the way they think about issues and solve problems. There’s a tendency in extrinsically motivated people to become rigid and

<table>
<thead>
<tr>
<th>Figure 2-2: Basic Features of Intrinsic and Extrinsic Motivation</th>
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<tbody>
<tr>
<td><strong>Intrinsic Motivation</strong></td>
</tr>
<tr>
<td>• Flexible information processing</td>
</tr>
<tr>
<td>• Superior problem solving</td>
</tr>
<tr>
<td>• Improved conceptual understanding</td>
</tr>
<tr>
<td>• Better health and well-being</td>
</tr>
<tr>
<td>• Enhanced creativity</td>
</tr>
<tr>
<td><strong>Extrinsic Motivation</strong></td>
</tr>
<tr>
<td>• High productivity on routine tasks</td>
</tr>
<tr>
<td>• High energy for goal attainment</td>
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create mental sets that are hard to break. In current jargon, they find it difficult to think outside of the box. Extrinsic motivation makes people become set in the ways they approach problems. They lose mental flexibility and the ability to think in new ways about problems and issues.

In education research, we find that the more intrinsically motivated students are – whether kindergarten pupils, medical students, or people in advanced adult education – the fuller their conceptual understanding of what they’re learning.

Extrinsic motivation emphasizes control over people. That approach gets them to memorize facts. The emphasis is on tests. It’s what’s currently happening in our educational system – more tests, more tests, more tests. We find that students memorize the things they need to know in order to pass the tests, without much long-term comprehension. They retain the material until they’ve gotten through the test and then forget it, because the test was the only reason they needed it.

Intrinsically motivated learners, on the other hand, engage the material in such a way that they understand relationships among facts, rather than just memorizing the facts. As a result, the material stays with them. They can go back to it a week, a month, or a year later. Particular facts may be gone, but they have gained a conceptual understanding of the issues that stays with them over the long term.

Intrinsic motivation promotes a different kind of learning, a different kind of performance, and it makes a big difference in the way the individual is able to contribute to the goals of the organization. It’s important to understand these different kinds of motivation, because they have an impact upon the way employees approach their jobs.
WORKPLACE WELL-BEING

In most work settings today, we place extraordinary emphasis on performance. At the same time, we pay very little attention to the health and well-being of our employees. Occasionally it is mentioned in passing, but one of the strongest sets of results that we’ve had in doing research through the years is that when people are more intrinsically motivated, a whole range of health and well-being outcomes is affected, including higher self-esteem.

For example, anxiety and psychosomatic symptoms are reduced when workers are intrinsically motivated. When people are genuinely engaged and involved in their activities, we find them to be healthier and better adjusted. That’s an important issue. It’s always been a mystery why we don’t think about well-being as an important element in dealing with work and learning issues.

ADVANTAGES OF EXTRINSIC MOTIVATION

There are advantages to extrinsic motivation, but they’re different kinds of advantages. Extrinsic motivation is effective in situations involving relatively routine tasks. There are some places where incentive systems and extrinsic motivation, linking task behavior to outcomes such as rewards, works effectively. Extrinsic motivation promotes work outcomes that are comparable to rote memorization as a learning outcome.

I worked on a machine one summer, and was paid according to how much I produced. I was pleased about that, because I was able to earn more money by working harder, and I also had a sense of being in control. But I was there for two months, not 20 years. I don’t know how long the challenge would have lasted, but it illustrates the kind of job where extrinsic reward systems seem to work. There’s high energy and excitement around goal attainment in extrinsic motivation systems.

There is a place for both intrinsic and extrinsic motivation systems. Intrinsic motivation creates positive conditions through choice and interesting work. Extrinsic motivation sets pathways to rewards, taking care that we’re rewarding the performances we want to be rewarding.
However, research also demonstrates that when we set up reward systems in an instrumental way, people are very quick to figure out the shortest route to the reward. And if we’re not careful about how the reward system is structured, we’re going to have people finding the simplest way to outsmart the system. You need to be very careful about what activities we will reward, and very clear in communicating it.

**INTRINSIC MOTIVATION AND EXTERNAL REWARDS**

Research has been conducted into the hypothesis that the best way to motivate people in organizations is to design interesting jobs to facilitate intrinsic motivation and then install the best kinds of instrumental systems to combine intrinsic and extrinsic motivation and create maximum total motivation. Implicit in that theory is the notion that extrinsic and intrinsic motivation are additive. Intrinsic plus extrinsic motivation add up to total motivation.

But the research asked whether, if you take intrinsic motivation and add external rewards, these elements will add up to the best possible outcome? Imagine yourself doing something in which you have a basic interest. Then you begin getting paid for doing it. The issue is whether the pay will affect your intrinsic motivation, your interest in the activity?

Some people argue that it will enhance your interest. Or maybe it’ll do nothing to your interest, the two elements won’t influence each other. A third possibility is that intrinsic motivation and external rewards will interact in a negative way, so that the addition of extrinsic rewards will actually undermine intrinsic motivation. That’s what I wondered about when I began researching the subject.

I went into the laboratory and gave people interesting tasks, providing some of them with extrinsic rewards and others with no extrinsic rewards. The purpose of the research was to discover what happens when we add extrinsic rewards to intrinsic motivation.

I found in several studies that when we introduce monetary incentives into a situation for doing an activity that people find interesting and are willing to do without monetary incentives, the
monetary incentives lead them to find the activity less interesting. They are less willing to perform the activity without rewards once they have had the experience of getting paid for it. In other words, their motivation for the activity shifts from intrinsic to extrinsic, leaving them less intrinsically motivated.

To assess intrinsic motivation, we asked participants how interesting they found the activity. How much fun it was, and how engaging it was. That’s one way we measured intrinsic motivation. We call this self-reporting. Another assessment method is to look at behavior and infer what the motivation must be. To do that, we set up a subsequent situation in which participants were free to do various things, including the experiment’s target activity. If they went back to the activity they initially found interesting, then they had maintained their intrinsic motivation for it. But if they went to some other activity once they were paid, it suggests that we’ve changed the orientation toward the activity and no longer find it interesting and intrinsically rewarding.

In this experiment, we found that people’s focus shifted away from the interest value and satisfaction of the activity to the reward. Subsequently, we would have to offer participants more rewards in order to have them continue to do the activity. But their sense of relating to the activity as something that’s meaningful in its own right suddenly seemed to be lost.

At the outset, I had no clear idea of what we would find. There had been no prior research on the subject. Any of the several possibilities that I laid out at the beginning might have been verified. In fact, the evidence was clear that the addition of extrinsic rewards into a situation tended to undermine intrinsic motivation.
A META ANALYSIS

Thirty years later my research findings about extrinsic rewards undermining intrinsic motivation remains a controversial notion. I still read reports on my work that can only be described as diatribes. It’s amazing how unwilling people are to even consider the possibility that extrinsic rewards undermine intrinsic motivation. A couple of years ago some colleagues went back to the literature and found nearly one hundred published articles reporting experiments of the type that I described.

We took all the research – the hundred published studies – and examined them. We used a statistical research technique called meta-analysis, which allows us to take the results of many different experiments and standardize them so we can combine results across many studies. And we found a high degree of consistency in these studies concerning the addition of extrinsic motivators decreasing intrinsic motivation.

<table>
<thead>
<tr>
<th>Reward Type</th>
<th>Effect</th>
<th>No. of Studies</th>
</tr>
</thead>
<tbody>
<tr>
<td>All tangible rewards</td>
<td>-0.34*</td>
<td>92</td>
</tr>
<tr>
<td>Unexpected rewards</td>
<td>0.01</td>
<td>9#</td>
</tr>
<tr>
<td>Expected rewards</td>
<td>-0.36*</td>
<td>92</td>
</tr>
<tr>
<td>Task non-contingent rewards</td>
<td>-0.14</td>
<td>7#</td>
</tr>
<tr>
<td>Engagement contingent</td>
<td>-0.40*</td>
<td>55#</td>
</tr>
<tr>
<td>Completion contingent</td>
<td>-0.44*</td>
<td>19#</td>
</tr>
<tr>
<td>Performance contingent</td>
<td>-0.28*</td>
<td>32</td>
</tr>
<tr>
<td>Maximum reward</td>
<td>-0.17*</td>
<td>8#</td>
</tr>
<tr>
<td>Non maximum reward</td>
<td>-0.88*</td>
<td>7#</td>
</tr>
</tbody>
</table>

* Significant at p < .05 or greater
# Effect sizes are homogenous
In figure 2-3, a negative sign indicates that tangible rewards led to lower levels of intrinsic motivation. In other words, it means that extrinsic rewards undermined intrinsic motivation and interest value in the activity. That’s an important point. The larger the number is in the Effect column, the more intrinsic motivation was undermined.

An asterisk after the number in the Effect column indicates statistical significance, it indicates that we have confidence that the effect is reliable. The numbers in the right column indicate the number of experiments included in the category. A single experiment might involve 200 participants. So if we find that 55 experiments of a particular type were conducted, it means that as many as 11,000 people may have been involved in the effect.

Next, we need to look at the labels in the Reward Type column. This is a particularly important consideration in the business world. By considering what is it that people are being rewarded for in the experiments we can draw inferences about the effects of incentives in the workplace. Incentives may be contingent upon merely showing up for work, or on sitting at one’s desk, looking busy and involved in the work. Many reward systems in business amount to not much more than that.

Rewards can also be made contingent upon how many tasks are completed, or upon the quality of people’s performance. Experiments used these various kinds of contingencies, and that allows us to determine which kinds of reward contingencies are undermining, and which are not.

In our meta-analysis, we find conclusive evidence that tangible rewards tend to undermine intrinsic motivation. In a total of 92 studies, there is a significant negative effect of rewards on intrinsic motivation. Thus, in general, the use of tangible rewards to motivate performance does have an undermining effect on intrinsic motivation.

We divided these studies into two categories. In some cases, participants were asked to work on a task, and after they had finished, they were given a reward that they had not been expecting. These unexpected rewards did not have a negative effect on intrinsic motivation. Sometimes there was even a positive effect with unexpected rewards. Unexpected rewards are simply a
way of saying, “you did a great job. Here’s a token of our appreciation for having done it well.”

This is a spot bonus, rather than a bonus system. A bonus system becomes an expected reward after the first bonus is distributed and participants expect that future payouts will be forthcoming. In that case, a bonus is no different than any other pay system in terms of expectations.

When bonuses are unexpected, performance may peak over the short term. The unexpected reward is new and novel. Employees weren’t working to get the incentive, nor were they expecting it. During the initial period the incentive creates excitement. Expected rewards, on the other hand, are likely to produce negative effects.

**CONTINGENT REWARDS**

In figure 2-3, we have a group of categories that refer to various types of contingencies. These categories relate to the behavior that’s being focused on when rewards are offered. The first kind of reward is called task non-contingent, because the reward is not contingent on any specific task. Salaries are an example. The employee gets paid for holding a particular job. Pay is contingent not on what the individual does on the job, but on the position being filled.

Research indicates that task non-contingent rewards do not affect intrinsic motivation. There’s no asterisk after this category, meaning that it’s not a reliable undermining effect. It appears that task non-contingent rewards have only minor effects on intrinsic motivation.

The second of the contingency categories involves giving rewards for being engaged in the task. It doesn’t matter how well the employee does the task. The reward is given for spending time working on the activity. We call that engagement contingent activity, because the reward is contingent on being engaged in the activity.

Here we find clear and reliable undermining effects. When people are rewarded for engaging in a task – and this is a consistent finding across studies – it leads them to be less intrinsically
motivated after receiving the reward than they were before receiving it, and less intrinsically motivated than those doing it without rewards.

The next possibility is to provide rewards that are contingent on completing a task over and over. The reward is given for the volume of tasks completed successfully. This is what piece rate payment is about, but the reward system can also be translated to more sophisticated tasks than turning out nuts and bolts. And when extrinsic rewards are completion contingent, the research shows that intrinsic motivation is clearly undermined.

We can also give people rewards based on an indicator of their specific performance. For example, the reward can be contingent upon doing better than 80 percent of the other people who are doing it. Rewards are given to top team members, for example. Rewards might also be based on the individual reaching an absolute standard, as a function of the specific performance criteria.

All of the studies in this performance contingent category set up a criterion beforehand. If people met the criterion, they got the reward. In most instances, the study was designed in such a way that everybody who did the task got the reward. What was really being studied was the giving of rewards for having done well.

Across all these studies, we found a negative effect, a reliable undermining of intrinsic motivation, even when people were given a reward for meeting performance criteria.

**REWARD LEVELS**

We went one step further and examined studies set up so that participants’ level of rewards was a function of how well they performed, with those who performed better getting more rewards. We believe this is a more relevant reward contingency for the actual workplace than one in which everybody gets the maximum reward.

We found that for people who get the maximum reward show there was a modest undermining of intrinsic motivation, but the negative effects were most apparent among those who do not receive maximum rewards. The undermining with this contingency
was greater by far than the undermining for any other contingency. This is a very important finding because it indicates that the incentive system that is most typically used – namely, one where people’s rewards depend directly on their performance – has the most negative effect on intrinsic motivation. Comparing this approach to one in which everyone gets the maximum reward shows that rewards can be detrimental for the intrinsic motivation of people who get them as signifiers of doing very well, but they are much more detrimental for those who were not the very best performers and thus did not get maximum rewards.

Under this kind of system, you can be one of several excellent performers, better than 95 percent of the other people in your organization, and still come out a loser. But if you are not one of the very best, you will be an even bigger loser because the non-maximum reward is likely to prompt feelings of incompetence and kill your interest in your job.

UNDERLYING FACTORS

What is it about rewards that creates problems for intrinsic motivation? What happens psychologically to participants in these programs? People tend to regard rewards as controls on their behavior. Some psychologists think that’s a good thing, that we ought to be doing controlling behavior. Reward systems can work to control behavior. But if we believe that people have an innate desire to regulate themselves, to initiate their own activities and take responsibility for their behavior rather, then this idea of control runs counter to intrinsic motivation.

I’m not implying that all rewards are a form of coercion, but there is a certain control implicit in all tangible rewards which might be labeled seductive rather than coercive. There’s some commonality between seduction and coercion. An external element is now responsible for maintaining the individual’s motivation and initiation. Self-direction is surrendered to the seductive force of the reward system.

It’s an issue of control. And if that’s the case, then we ought to see the undermining of intrinsic motivation by other factors that we think of as controlling. Some of the other external motivating factors that seem to control people’s behavior include threats of punishment, pressure to win, deadlines, surveillance, and
managers with a controlling orientation (figure 2-4). We looked at those factors to see what happens to intrinsic motivation when we threaten people with punishment for not doing the task well. That’s the opposite of rewards, and most everybody who emphasizes extrinsic motivation says rewards are better than threats of punishment, threats of punishment are not an effective way of changing behavior. Still, we wanted to consider their effects on intrinsic motivation, and we found no question that motivating people through threats of punishment is detrimental to intrinsic motivation.

Pressure to win is also detrimental, the idea that each member of the team must compete with all other members to rise to the top. Completion involves placing people in a situation where there is undue emphasis on winning rather than on getting better, rather than on doing a better job than they did last quarter or last year.

We set up our research in such a way that everybody won the competitions. We found that even among all the winners, the very fact that the emphasis was on competition and the individual had to beat the other team members resulted in decreased intrinsic motivation among the participants. People usually think about competition in a very positive way, but competition produces pressure, anxiety, and tension. The individual feels an overwhelming need to win above all else, which undermines of intrinsic motivation.

When we pressure people with deadlines we get the same kind of result. As a matter of fact, the deadline experiments were done in such a way that people had much more time than they would actually need to do the activity, and the results showed that even when participants were given plenty of time to meet the deadline, the presence of a deadline led to decreased intrinsic motivation.
We found the same undermining effect when we closely surveilled people as they performed their work. Intrinsic motivation is decreased when surveillance techniques are used as external motivators.

These are all familiar techniques used to motivate people. In fact, the very word motivate is really a euphemism for control. Rewards, incentives, punishment, threats, and deadlines are all too often used as ways to control people’s behavior. As a result, these methods have achieved a psychological significance of control for people, so their very presence runs the risk of diminishing people’s intrinsic motivation.

**ORGANIZATIONAL CULTURES**

The way in which rewards are administered in a particular organization also makes a difference. Just walking through an organization, we sometimes get a sense of the particular culture of the place. We feel it just by being there. In one organization we might feel ourselves shutting down, getting tighter, feeling closed in. In another organization we might find ourselves feeling open and free, interested, as though the ambience is nurturing and supportive.

To a large extent, this cultural climate is created by managers. Managers have to deal with their superiors in the organization, and the very best managers at any level are ones who can take the heat from above and keep it from having too much impact within their unit. There are managers who absorb the pressure and stress from above and still maintain a positive interpersonal climate with the members of their unit.

When managers have been successful in creating a positive interpersonal climate, the negative effects of rewards and other external motivators are not nearly as great as when the organizational climate is authoritarian, controlling, and traditional. It is important to understand that incentive systems have a lot to do with the overall interpersonal climate or social context of the organization or the organizational unit.
CONCLUSION

There is a strong tendency for extrinsic rewards to undermining intrinsic motivation. You should not ignore that effect, because the consequences are likely to show up in workplace performance in a number of ways.

The problem of rewards is a problem of control and how people experience rewards as controls. You need to be attuned to how people experience rewards, and create a supportive and affirming climate within the organization so they won’t experience the rewards as controls. In supportive organizations, external rewards are much less detrimental to intrinsic motivation. When you use rewards simply to acknowledge a job well done they are less likely to be detrimental because they are less likely to prompt the perception that the rewards are tools of control. Rewards should be used in a way that is relatively nonsalient and that conveys information about effectiveness and competence.

People must also feel that they work in an organization that’s equitable and fair, all things considered. When employees start to feel that their rewards are inequitable, a likely result is decreased intrinsic motivation.

It’s a paradoxical notion that the more that you use rewards to motivate people, the more negative the motivational effect will be. That’s because using external rewards to motivate easily lapses into a perception that rewards are merely a technique to control people.
SESSION 3: Pay People Right! Breakthrough Strategies to Create Great Credit Unions

Patricia K. Zingheim, Ph.D.

Patricia Zingheim founded Schuster-Zingheim and Associates, Inc. with Jay Schuster in 1985. She advises a wide range of companies on total pay and other rewards. A recognized expert on the role of pay in accelerating company growth and bottom-line performance, Pat is also author of two books on linking pay with organizational effectiveness. In this session, Pat Zingheim examined the components involved in a total rewards program, and the role that incentives play in such programs. She also shared her perception of what is required to create reward changes that work to the benefit of both the individual and the organization.

I regard pay and other rewards as a powerful communications vehicle. Pay allows us to give a stronger communications message than some other available tools. Organizations try many different things to send a message about their values and directions, and pay is one way to accomplish that objective. Many companies adopt incentive plans because employees want to share in the results of improved performance and quality, to share in the success of the organization.

Your credit union sets the goals and creates the conditions under which employees can work to help achieve these goals. The organization tells its people to be as creative as possible in figuring out how to accomplish those goals. That’s how people become engaged in the enterprise. Employees want to be engaged, and to work for a successful organization, a winning team.

COMPONENTS OF TOTAL REWARDS

Employees want to know what the organization wants to accomplish, so they can help it to be successful. They want to buy into the values and goals of the organization. But in order to do so those values and goals must be clearly spelled out. That’s the idea underlying our concept of Total Rewards (figure 3-1), a concept that there’s more to rewards than just pay. Pay is one component, but it’s not the only reason people work for a particular organization.
### Figure 3-1:
Total Rewards Components

<table>
<thead>
<tr>
<th>Individual Growth</th>
<th>Score</th>
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<tbody>
<tr>
<td></td>
<td>+</td>
</tr>
<tr>
<td>Investment in people</td>
<td></td>
</tr>
<tr>
<td>Development and training</td>
<td></td>
</tr>
<tr>
<td>Performance management</td>
<td></td>
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<tr>
<td>Career enhancement</td>
<td></td>
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<tr>
<td></td>
<td>−</td>
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<td></td>
<td>±</td>
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<table>
<thead>
<tr>
<th>Compelling Future</th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>+</td>
</tr>
<tr>
<td>Vision and values</td>
<td></td>
</tr>
<tr>
<td>Organization growth and success</td>
<td></td>
</tr>
<tr>
<td>Organization image, reputation</td>
<td></td>
</tr>
<tr>
<td>Stakeholdership</td>
<td></td>
</tr>
<tr>
<td>Win-win over time</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Total Pay</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Base pay</td>
<td></td>
</tr>
<tr>
<td>Variable pay (cash incentives and equity)</td>
<td></td>
</tr>
<tr>
<td>Benefits or indirect pay</td>
<td></td>
</tr>
<tr>
<td>Recognition and celebration</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Positive Workplace</th>
<th></th>
</tr>
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<tbody>
<tr>
<td>People focus</td>
<td></td>
</tr>
<tr>
<td>Leadership</td>
<td></td>
</tr>
<tr>
<td>Colleagues</td>
<td></td>
</tr>
<tr>
<td>Work itself</td>
<td></td>
</tr>
<tr>
<td>Involvement</td>
<td></td>
</tr>
<tr>
<td>Trust and commitment</td>
<td></td>
</tr>
<tr>
<td>Open communication</td>
<td></td>
</tr>
</tbody>
</table>

+ Strength  = Neutral  − Weakness

The organization must determine where it stands with respect to each of the components that comprise Total Rewards. You might want to do an inventory for your own organization on figure 3-1. Place plus, equal, or minus signs at each of the elements to determine where you’re strong and where you’re weak. Start in the upper right-hand corner, Compelling Future, and ask yourself if you offer your employees programs that engage them and capture their imagination.

Amazon.com, for example, used the theme line: “We’re creating the future of E-retail.” They were able to build a compelling future based on that concept. A pharmaceutical company might adopt a theme: “We’re creating wellness,” to engage its people. These themes tap into the organization’s image and reputation. They present what it is that would make people want to work for the organization.

Wise leaders realize that they’ve got to prove to employees that they made the right choice in coming to work with this organization, that there’s a compelling reason to work here. In the Individual Growth area, elements such as coaching, development, and career opportunities are important in broadening the skills and experience of employees. A Positive Workplace reflects the leadership abilities of the organization’s senior managers. Are they individuals that other people want to follow? Is the work itself challenging and interesting? Do the organization and leaders inspire involvement, trust and commitment on the part of employees? Does the organization engage its employees in open communication?

Some organizations are committed to doing well in all four of these Total Rewards components. That includes companies like General Mills, for example. They want to be strong in all four areas. Franklin Covey Company, which teaches *The Seven Habits of Highly Effective People*, also adopted this model of Total Rewards.

There’s been a great deal of talk about work/life benefits over the last couple years, but at some point we’ve got to focus on results and performance. Results are what business is all about, and we have to add value to the products and services we offer in the marketplace.
Ask yourself where your credit union’s differential advantage lies. You’ve got to have that kind of advantage in a tight labor market for top talent. Ask yourself where you can get a differential advantage. The answers to those questions will allow you to create a Total Rewards package with a differential advantage in the employment marketplace. Consider learning and development on the one hand, and at results on the other, then find a balance between the two.

Within Total Rewards, organizational results for business-aligned goals should impact primarily on variable pay. Skill and competency growth and development should impact primarily on base pay and individual growth components of Total Rewards.

Growth in skills and competency should be rewarded through base pay, while operational results are rewarded through variable pay. The objective of Total Rewards is to incorporate both these elements for maximum total return to both the organization and its employees.

Credit unions need to develop employee skills in order to maximize their performance, but we can’t become a learning organization for the sake of learning. We’ve got to focus on organizational results as well. We’ve got to have the right balance. Both development and organizational results are important to long-term success.
SUCCESSFUL INCENTIVES

If you don’t have a compelling message to communicate, do not undertake an incentive program. It’s too much work. Successful incentives require a business focus and a willingness to communicate (figure 3-2).

**Figure 3-2:**
Elements of a Successful Incentive Program

**Business Focus**
- Support business directions and performance initiatives
- Design measures and goals to fit changing business needs

**Communicate, Communicate, Communicate**
- Educate people on measures
- Engage people in developing ways to improve performance
- Smarter, not harder
- Communicate progress on goals

**Ensure Win-Win**
- Organization gets added value from pay cost
- People believe reasonable win for performance and effort
- Goals neither too easy nor too tough
- Provide upside opportunity to reward outstanding results

**Agility and Flexibility**
- Changing goals as the business changes renews interest

**Championing By All Leadership**

**Celebrate Success**

The first two criteria tell employees that management knows what the business needs to accomplish, and that employees can help do that. Management engages them in helping to accomplish organizational goals, and when they do they will share in the success.

Incentive plans can’t be installed and then ignored. Some organizations have had job evaluation systems in place for the last 20 years. They may not be working well anymore, but they’re still in place. Incentives, by contrast, must be constantly changing because goals change, directions change, how the credit union is organized changes. Incentives are an ongoing process. If you’re thinking of doing something simple, incentives are not the thing to do. Put in a training program instead. There’s less emotion involved in training programs.

Pay is a hot change item. Some people say: “Do anything to me, but don’t touch my kids or my pay.” That shows how emotional a topic pay is. We must tread gingerly when we work with pay systems. That doesn’t mean avoiding pay altogether. It does mean we need to consider pay changes in a thoughtful, involved way. It’s also important to involve participants in the process. That can be done in the design process or in having them help set goals to get their understanding, acceptance and commitment.

Consider the financial affordability of the program, too. The credit union must get added value from an incentive program at the same time that employees receive a return for their results and effort. It’s a balancing act. If the organization makes the goals too easy, everybody earns the maximum award every time and the program becomes an entitlement. If the goals are too hard, people lose interest because they can’t reasonably achieve the goals. Finding a balance is difficult, but it’s also an enjoyable challenge.

For the super-performing team or individual there’s an opportunity to share in the success they create. Incentives are different from merit pay in that they’re not as budget-sensitive. In fact, the objective is to pay more than budget because that means results are better than budget or plan. If goals are set properly, the program will pay out based on business value added. A properly designed incentive plan pays out dollars because the organization is achieving or exceeding its goals so the awards are affordable. It’s a win-win partnership—for both the organization and employees.
The program needs to be agile and flexible. It can’t be cast in concrete. And it requires championing by leadership to be successful. Success depends on the support of organizational leadership.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Result of Implementing Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>200% return on amount paid to participants, if the organization placed a dollar value on performance improvement</td>
</tr>
<tr>
<td>2</td>
<td>Improved communications</td>
</tr>
<tr>
<td>3</td>
<td>Improved business performance</td>
</tr>
<tr>
<td>4</td>
<td>Improved morale</td>
</tr>
<tr>
<td>5</td>
<td>Improved teamwork</td>
</tr>
<tr>
<td>6</td>
<td>Improved performance-reward linkage</td>
</tr>
</tbody>
</table>


Figure 3-3 shows the results an organization can expect to achieve through incentives. These results were compiled by the American Compensation Association (now called WorldatWork) from a study on variable pay. Particularly important is the measurable results in return on the amount paid to workers, where workers shared a percentage of the cost savings. The study found a 200 percent return on the dollars paid in incentives. It also found other positive results of incentive programs.

The study asked whether organizations used variable pay or incentives to lead organizational change, or to support organizational change. Surprisingly, the majority of participating companies said they used incentives to lead organizational change, because it’s such a potent communications vehicle.
Figure 3-4 summarizes different types of short-term incentive plans. The first five items are group incentives based on business unit or organization-wide results. The most common group incentive is a goalsharing plan. If the organization achieves specific stated goals, participants receive awards.

<table>
<thead>
<tr>
<th>Incentive Plan</th>
<th>Basic Design</th>
<th>Indicators</th>
<th>Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goalsharing or business goal plan</td>
<td>Award achievement of predetermined goals</td>
<td>Several goals, including cost, are important. After gainsharing has squeezed out most cost, introduce new directions</td>
<td>Must have value added from goal achievement to fund plan</td>
</tr>
<tr>
<td>Winsharing</td>
<td>Funding based on income performance and distributed for meeting predetermined goals</td>
<td>Key strategy is financial (self-funded) plus additional measures are important and provide focus.</td>
<td>Must create understanding of financial measure and how people affect it</td>
</tr>
<tr>
<td>Gainsharing</td>
<td>Share gain from cost savings or productivity improvements</td>
<td>Key strategy is cost reduction (self-funded from cost savings)</td>
<td>Must have broad enough cost measure not to suboptimize overall cost performance</td>
</tr>
<tr>
<td>Combination plan</td>
<td>Combination of designs</td>
<td>Customize to align with business needs</td>
<td>Must clearly communicate priorities</td>
</tr>
<tr>
<td>Cash profit sharing</td>
<td>Funding based on income performance</td>
<td>Goal is financial; self-funded</td>
<td>Must create understanding of financial measure, of how people affect it, and of importance of other measures</td>
</tr>
<tr>
<td>Team incentive</td>
<td>Team plays a key role; funding based on organization or team performance; award distribution based on team or individual performance</td>
<td>Organization is team-based</td>
<td>Must optimize performance at all organizational levels</td>
</tr>
<tr>
<td>Individual incentive</td>
<td>Award achievement of predetermined individual goals</td>
<td>Individuals work autonomously</td>
<td>Must link individual goals to team, group, business unit, or company goals</td>
</tr>
</tbody>
</table>

Next, winsharing is funding based on income performance. Payment is made based on achieving income as well as other goals such as customer service or successful product introduction goals.

Team incentives can be organized around units within the credit union. If you’ve organized around teams and don’t have some kind of team incentive, it’s difficult to focus team activity on group goals. You may have teamwork or focus on process as opposed to a real team with an emphasis on results on team goals. It’s often a painful process to change the focus from individual performance to team performance. But once the initial shock is over, employees are often very happy with the team incentive system. If you’ve organized around teams, your rewards should be organized around teams as well.

MANAGEMENT INCENTIVES

A credit union management incentive may include some measure of member satisfaction (e.g., survey results) or volume from the launch of a new product or service. Incentives should encourage managers to spend their time and energy on new products or services that have a likelihood of success. One of the key elements that research and development organizations examine is under what circumstances it becomes necessary to abandon a project when it becomes apparent that the project is not working. They don’t keep on working on a project that no longer appears to have a likelihood of success.

Financial performance is another way to provide incentives to managers. This might involve a combination of both asset growth and an expense ratio reduction. The driver is not only cost-effectiveness, but also good member service. You want to optimize performance on a number of levels, not solely on financial measures. There are a number of activities that managers need to be measured on, including member satisfaction, cost-effectiveness, and business growth.

Overall organizational goals often cascade down to business units where the objective might be to grow loan volume, adjusted by any problem loans, charge-offs, or delinquencies. It’s important to include quality measures along with loan volume measures, to make sure that the focus is on the entire process.
A FAMIL Y OF MEASURES

A successful incentive plan includes a family of measures, not just one measure. This results in a fairly complex plan, but credit unions are in a fairly complex business. It's not as easy as if you were traded on the stock market and could focus exclusively on earnings growth.

Suppose you’re working on an incentive plan for loan officers. You’re actively recruiting loan officers, and need quality people. You’re looking for multi-skilled people who can not only sell loans, but also follow up with servicing and managing those loans to maintain the quality of the portfolio. You’d also like these people to be accountable for delinquencies and charge-offs, and to measure their attention to member service and satisfaction. The incentive plan, therefore, can’t be geared exclusively to increasing loan volume.

Now let’s look at an incentive program for a call center operation. We did a survey of investment funds companies and found that their call center people are as critical to the organization’s success as their investment portfolio managers are. Call center people aren’t paid like investment portfolio managers, but they’re considered critical to the company’s success. It’s important for them to provide good customer service, in order to retain customers. The job is basically an individual task, because it’s the relationship that these people build with the customer that nurtures retention and penetration of the business.

When our client looked at their incentive plan measures, they considered customer satisfaction. They perform quality audits with their call center staff, in which customers are asked to answer five questions on customer service. Our client also measures productivity, which involves handle time per call within a range. Representatives are not expected to hang up on a customer before they solved the problem; but they are expected to handle the call in an expeditious manner. There’s an acceptable range.

The client also wanted a team incentive measure for customers who were relationship rather than efficiency focused. Investment companies divide their customers into two groups, depending on the volume of business they can expect from the customer. In calls with relationship customers, the call center employee is judged on customer service measures. That’s difficult to attribute volume on
an individual basis, because one representative might talk to a customer about putting money into a particular fund one day, and the customer acts on the suggestion two days later while they’re talking to somebody else.

People in this kind of job love daily, weekly, and monthly recognition. That means daily, weekly, and monthly. Every kind of recognition is valuable, because it’s very stressful working the phones. Call center employees are monitored constantly. Recognition helps to make the job interesting.

**LONG-TERM INCENTIVES**

Long-term incentives may be either individual or team, but they’re usually team oriented. They can apply to executives only, to all employees, or to some employees. An example is a computer conversion that takes more than a year to complete. The incentive plan is designed to keep people focused, and to retain their services. If the conversion is successful, participants get more money than if it’s less successful.

An event-related plan applies to activities such as planning for and opening new facilities. A long-term incentive with overlapping performance periods provides executives with the incentive to focus on long-term goals or sustained performance. It also places a focus on retention so that people leave something on the table if they leave the organization because there are typically three overlapping plans operating concurrently.

A performance unit plan is an alternative to stock options in a for-profit company. For a credit union, you can create incentives that mimic the provisions of a stock option. Organizations that have to compete with companies that have stock options have tried to do this. The plan creates performance units at a certain value, one dollar, for example. If the organization is more successful in attracting assets, the value of the performance unit goes up. If the unit value increases to two dollars, participants get the difference between one and two dollars, times the number of units they hold. These plans are worth thinking about if you’re trying to compete with banks that can offer stock option plans to executives.
INCENTIVE STRATEGIES

Start with your credit union’s business strategy. Regard pay as a communications vehicle that’s communicating direction and goals to employees. It is then their job to figure out how to accomplish those goals. The organization empowers them to do that, and they share in the success of those results.

Organizations often start by looking at pay rather than at goals. That becomes confusing, because it’s merely a competitive analysis at that point. You’re concerned only with how the organization compares in the marketplace. If it’s low on the pay comparison, it simply puts more dollars into the fund. But the market should not be the driver of a pay program, because a differential advantage can’t be achieved through high pay. All the organization is doing is positioning itself relative to everybody else, but not making a statement about its uniqueness.

When the only advantage is pay competitiveness, the organization does not present a strong Total Rewards picture to employees. The new concept of e-pay recognizes that employees can go on the Web and access different surveys to determine how much they’re worth in the marketplace. They can then go to their HR department and say: “The survey data says you’re underpaying me.”

The Internet has democratized pay. HR used to be able to tell employees: “We did these surveys, and found that your job is worth this much. And employees typically accepted that judgment. If they wanted higher pay, they were free to look elsewhere.

Now employees have access to a broad range of data. It’s information overload. Employers can make a case by arguing on the basis of their own competitive survey data. You might point out that the sample is different, or there’s geographic adjustment, or the job is different, or a particular employee has limited experience. But the employee may not accept those arguments in the face of competing survey information.
The goal is to demonstrate that the credit union offers a Total Rewards package with all four basic components: Individual Growth, Compelling Future, Total Pay, and Positive Workplace. That’s the credit union’s “contract” with its employee. If you can do that, you’re not competing on the basis of a single component. You can’t win if you compete on the basis of a single reward component.

At the business strategy level, are you dealing with a burning platform to change rewards? Is a simple course correction in order? Or are you seeking out opportunities for a better future? Design of an incentive program depends on these business strategies, and involves more than financial rewards. The reason is that business strategy links with development and performance goals, and subsequently with rewards. Once again, you need to look at a family of measures, and optimize performance on the basis of the entire family of measures.

**GOALS AND ROLES**

We often find miscommunication about employee roles, and about how they fit into the organization. Think about how clear you are in setting employee goals. Figure 3-5 is a checklist that management and participants can use to determine the quality of the goals set for incentives. This cascading goal approach is a popular way to approach goals today.
In designing incentives, participants in the plan sometimes insist that they must have complete control of a particular measure or they don’t want to be measured on it. My response is that they can

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**Figure 3-5: Goal Setting Checklist**

<table>
<thead>
<tr>
<th>Questions</th>
<th>Check If Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Have you determined how you impact the goals of the organization and your business unit?</td>
<td>✗</td>
</tr>
<tr>
<td>2. Have you documented your highest priority business goals that add the most value to the organization and your business unit?</td>
<td>✗</td>
</tr>
<tr>
<td>3. Have you made sure that the business results will be better if you accomplish the goal – or have you chosen another goal?</td>
<td>✗</td>
</tr>
<tr>
<td>4. Have you developed goals that: • Have measurable business outcomes, and meaningful quantitative measures of results?</td>
<td>✗</td>
</tr>
<tr>
<td></td>
<td>• Have a reasonable stretch?</td>
</tr>
<tr>
<td></td>
<td>• Reflect the balanced scorecard or business plan?</td>
</tr>
<tr>
<td>5. Have you thought beyond the activity or project and pushed for the outcome or the result – asked why?</td>
<td>✗</td>
</tr>
<tr>
<td>6. Are you or your area able to meaningfully influence and impact achieving goals (although it’s unlikely to have nearly complete control over all variables impacting goals)?</td>
<td>✗</td>
</tr>
<tr>
<td>7. Goals may create natural conflicts – have you optimized performance outcomes on all goals?</td>
<td>✗</td>
</tr>
<tr>
<td>8. Have you developed a set of goals that maximizes performance overall?</td>
<td>✗</td>
</tr>
<tr>
<td>9. Have you included shared goals, not just individual goals?</td>
<td>✗</td>
</tr>
</tbody>
</table>

influence outcomes even if they don’t have total control over them. Try to make the line of sight as short as possible, but also encourage them to extend their line of sight.

The same idea applies to performance levels (figure 3-6). There are many ways to set performance levels. As you design an incentive plan, make sure managers understand how performance will be measured, how tough is tough or how easy is easy. Decide how much of the incentive plan will be based on organizational achievement, how much on team achievement, and how much on individual achievement. Organization-wide plans require lots of communication. Alternatively, if you focus on individual achievement, you’ve got to make sure people aren’t undermining team or organizational goals in order to achieve their individual goals.

<table>
<thead>
<tr>
<th>Figure 3-6: Setting Performance Levels for Goals</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Set at business plan</td>
</tr>
<tr>
<td>• Use participative goal-setting, with both leaders and employees involved in the process</td>
</tr>
<tr>
<td>• Focus on continuous improvement</td>
</tr>
<tr>
<td>• Maintain at least current performance</td>
</tr>
<tr>
<td>• Compare to past performance (historical baseline, rolling baseline, ratcheting baseline)</td>
</tr>
<tr>
<td>• Compare to industry standards</td>
</tr>
<tr>
<td>• Benchmark against best practices</td>
</tr>
</tbody>
</table>


What is the purpose of the incentive plan? Is it to change behaviors? To communicate results? Programs that feature stock options or alternatives to stock options, for example, are really communicating results, rather than driving performance. Pepsi gave stock options to all of their people because they were tired of seeing Coke cans in their delivery truck windshields. Stock options sent a message. It may not motivate the delivery person to do more work every day, but it communicates the importance of company results. In general, the longer the line of sight, the more it’s a communication vehicle. The closer the line of sight, the more you’re going to drive behavior.
CHANGING BASE PAY TO INCENTIVES

Think also about how much your credit union can afford to pay in an incentive program. Business results will drive how much you can afford to spend. Another factor that determines the size of the incentive is how competitive you are on base pay. Do you want to place base pay at risk? You may be creating sales incentives and reducing base pay and providing guarantees during a transition period as you train participants to be successful sales people (figure 3-7).

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Add-On Incentive</th>
<th>Potential Pay At Risk</th>
<th>Base Pay at Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>Methodology</td>
<td>Incentive is in addition to regular base pay adjustments</td>
<td>Use some or all of anticipated future base pay increase budget to help fund incentives</td>
<td>Reduce base pay to help fund variable pay</td>
</tr>
<tr>
<td>Business case</td>
<td>Ability to fund; reasonable base pay compared to labor market; wanting easy implementation with workforce acceptance and focus on business-aligned goals</td>
<td>Low margins and labor cost is large portion of total cost; some financial concerns; high base pay relative to labor market; creating stakeholdership desired; ensuring awards of meaningful size</td>
<td>Severe financial problems; redesigning sales compensation; making other major total cash mix changes</td>
</tr>
<tr>
<td>Target and upside variable pay opportunities</td>
<td>Least</td>
<td>Middle</td>
<td>Most</td>
</tr>
<tr>
<td>Lines of sight of measures</td>
<td>Longest</td>
<td>Middle</td>
<td>Shortest</td>
</tr>
<tr>
<td>Goal difficulty</td>
<td>Most</td>
<td>Middle</td>
<td>Least</td>
</tr>
<tr>
<td>Threshold</td>
<td>No</td>
<td>Maybe</td>
<td>Yes</td>
</tr>
<tr>
<td>Workforce readiness</td>
<td>Least</td>
<td>Middle</td>
<td>Most</td>
</tr>
<tr>
<td>People's current level of trust and confidence in company</td>
<td>Least</td>
<td>Middle</td>
<td>Most</td>
</tr>
<tr>
<td>Easing transition</td>
<td>Least</td>
<td>Middle</td>
<td>Most</td>
</tr>
</tbody>
</table>

The characteristics show the conditions under which these approaches can be used rather than representing actual prevalent practice or how approaches must be used.

Base pay potential at risk means changing the overall salary increase budget from four percent to perhaps three percent or two-and-one-half percent. The difference is moved to variable pay and additional upside incentive opportunity is added to make up for the additional risk. The more base pay is at risk, the more you need larger incentive opportunity. With longer line of sight measures, the incentive opportunity must be greater as well, all other things being equal.

An add-on incentive system is a lot easier to implement than changing total cash mix to more incentive pay using potential base pay at risk or base pay at risk. If you want to implement an incentive system in an easy way, do an add-on incentive for additional dollars over base pay. It's a little tougher to have base pay potential at risk and a smaller merit budget, and use that to help fund incentives. If you do a base pay reduction, incentive opportunity must be significant.

A few years ago, some experts said the design of an incentive didn't matter; it was how the program was communicated that mattered. I believe that design and communication are equally important. It's both how well you design the program, and how well you roll it out.

Start with a strategy. Get credit union leaders involved. Determine what you really want to measure. Make sure measures are ones the participants can get interested or excited about, and can help you achieve. Then develop the reward strategy. Decide how much involvement participants will have. The more involvement they have, the longer the development will take but the more acceptance you'll get for the program. People like to know that they've had a part to play in helping to build the program. Decide how much help you want them to give you on measures and funding. Use either focus groups or a design team or both. Let all levels in the organization and all functions participate in the development.

Once you've implemented the incentive plan, the work has only begun. Look at the plan every year, improve it, and make sure the results are communicated to all participants. In fact, the longer the performance period, the more communication is necessary. If it's an annual plan, you'll have to communicate a whole lot more than if it's a quarterly plan.
Figure 3-8 is a checklist to determine what is necessary to make changes in a reward structure work. Top management support and workforce trust are the most critical elements. You’ve got to have those two components for the plan to work. Be sure you’re communicating clearly about the plan. Make sure it’s simple enough for everybody to understand, and you’ll be successful with incentives.

---

**Figure 3-8:**
**Making Changes in Rewards Work**

<table>
<thead>
<tr>
<th>Successful Reward Change</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Top management support and championing</td>
<td></td>
</tr>
<tr>
<td>2. Workforce trust</td>
<td></td>
</tr>
<tr>
<td>3. Consistency with total reward strategy, business case, and work design</td>
<td></td>
</tr>
<tr>
<td>4. Challenges that people can help address</td>
<td></td>
</tr>
<tr>
<td>5. Belief that workforce can enhance organizational performance</td>
<td></td>
</tr>
<tr>
<td>6. Adequate communications with people</td>
<td></td>
</tr>
<tr>
<td>7. Willingness to share information with people</td>
<td></td>
</tr>
<tr>
<td>8. Current measurement of results on key initiatives</td>
<td></td>
</tr>
<tr>
<td>9. Accounting and information system to support reward solution</td>
<td></td>
</tr>
</tbody>
</table>

+ Strength  = Neutral  – Weakness

DISCUSSION

Participant: What does the term “line of sight” mean?

Zingheim: Line of sight means that employees feel that they can directly impact the results for a particular goal. Profit or income may be a fairly long line of sight measure for most employees. What an employee does in a given day may influence it, but not directly. By contrast, if the measure is how many phone calls did the employee take, and what was the customer satisfaction score, an individual employee can have a direct impact on that measurement. That’s a very close line of sight.

Participant: Pat, can you share with us your experience with sustaining an incentive plan? You come in to a company and construct a superb plan. It works very well for the first year. Suppose that goals and market conditions haven’t changed in the second and third year of the plan. Will the plan continue to function, or do people tend to view it differently over time?

Zingheim: If you give people the impression that none of their measures are ever going to change, then you’re likely to have tough going. If the plan becomes an entitlement and you pay an award even when performance goals are not met, the program loses its punch. If you don’t communicate results, it loses its punch. If you don’t engage people in how the organization achieves its goals, it loses its punch.

Participant: And if you do all those things right, will the plan continue to work year after year?

Zingheim: It ought to be a living, breathing thing. You can’t set goals at the beginning of the year and not talk about them until the end of the year. If you do that, you’re likely to get to yearend and realize none of your original goals are relevant anymore. If the program is not a living, breathing thing, it won’t work. If it continues to work, it’s because you make the effort to be sure it does.
Levine: Many organizations set measures of performance very narrowly. When that happens, employees figure out more and more ways to game the system so that they look good on specific metrics. You’ve got to monitor how the program affects behavior, and that’s going to change over time as people learn to game the system. When you install a plan, be clear in communicating that it will evolve.

Zingheim: I know of few companies that haven’t changed incentive measures or goals each year. Especially if you have a goal-based plan, your goals are frequently changing. Even if you achieve world class status on a particular performance measurement, other measures are likely to come up that are appropriate to the organization’s current goals.

In considering Total Rewards, remember that recognition is part of total pay. If you’re not ready to create a formal incentive plan, consider a recognition program. Set the standards at a level so that everybody can win. The more winners you have, the more participants will have a positive opinion of the program.

Participant: Is there any rule of thumb or percentage of what incentives should be? Is it in the neighborhood of two to five percent? And how much should be variable pay as opposed to base pay? We’re pretty conservative, so we rely heavily on base pay without a lot of variable pay.

Zingheim: Our studies show that incentives run about five or six percent for nonexempt employees. At that level, the program drives behavior, too. For exempt employees, programs are in the nine to 10 percent range. For middle management, the number is 15 to 20 percent, depending on the type of organization, what’s affordable, and how much you want to drive behavior versus communication.

Participant: Are there any statistics about the success of the individual incentives versus team incentives?

Zingheim: It’s a matter of choosing the right vehicle to suit the job. If we were on a team to develop a product, I’d want a team incentive. If it were a call center, I’d
recommend individual incentives, perhaps with a team component. Look at the job and how it’s organized rather than adopting a plan where one size fits all. Look at how the job is designed, and then figure out what type of incentive plan is the right for that job.

In general, companies move to team incentives in order to get people engaged. About 80 percent of the Fortune 1000 have team or group incentives. Most manufacturing companies are trying to discard piece rates, and going to a plant-based team or group incentive.

Participant: Regarding the need for change, one of the problems is changing the threshold to get the incentive. That’s very disruptive. Do you have any experience that would be helpful in changing the core threshold before participants can earn the incentive?

Zingheim: It goes back to how you set your goals. If you tell everybody the goal will never change, it’s going to be tough. If you say the process will evolve and we’re going to be looking at process improvements to set the target higher, then people understand that the threshold may go up. In management incentives, the bar is likely to be raised every year. S&P 500 companies need a certain percentage of earnings growth each year, so their thresholds always go up.

Communicate to help participants understand that the environment is always evolving. Conditions change, and the plan must change with them. The organization must continue to make improvements. Many companies need to improve five percent each year to cover their base pay wages. They’ve got to cover their increased costs if they don’t want to lay off people. Process improvements can make that happen.

Participant: I prefer team incentives to individual incentives, but I wonder if team members put undue pressure on participants who are not performing up to standard?
Zingheim: In mature teams, they do. In the early stages they may not, but once they mature they become very concerned about poor performers. Some companies even have trouble with team members putting too much pressure on colleagues, and they’ve had to intervene. You have to be careful that you establish norms and rules governing appropriate pressure.
About the Presenters

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Edward E. Lawler III is a professor of Management and Organization at the Marshall School of Business at the University of Southern California. He also directs the school's Center for Effective Organizations. Ed Lawler received his Ph.D. from the University of California Berkeley in 1964 and joined the faculty of Yale University as assistant professor of Industrial Administration and Psychology. He moved to the University of Michigan in 1972 as a professor of psychology and became a program director in the Survey Research Center at the Institute for Social Research. He held a Fulbright Fellowship at the London Graduate School of Business, and in 1978 became a professor in the Marshall School of Business. In 1979, he founded and became Director of the University’s Center for Effective Organizations. Ed Lawler has been honored as a major contributor to theory, research, and practice in the fields of human resources management, compensation, and organizational development, and effectiveness. He is the author and co-author of over 300 articles and 30 books.

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Edward Deci is a professor of psychology and director of the human motivation program at the University of Rochester. He holds a Ph.D. in psychology from Carnegie-Mellon University, studied at the University of Pennsylvania, the University of London, and Hamilton College, and was an interdisciplinary post-doctoral fellow at Stanford University. Deci's 30 years of research on human motivation is summarized in nine books on the subject. His writings have been translated into seven languages. His research has been supported by grants from the National Institute of Mental Health, the National Science Foundation, and the National Institute of Child Health and Human Development. He is a fellow of the American Psychological Association and the American Psychological Society, and is a member of many other professional associations. Deci has lectured and consulted for corporations, public school systems, mental health agencies, universities, and government agencies throughout the United States and in many international areas.
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Patricia Zingheim founded Schuster-Zingheim and Associates, Inc. with Jay Schuster in 1985. She advises a wide range of companies on total pay and other rewards. She is a recognized expert on the role of pay in accelerating company growth and bottom-line performance. Her books Pay People Right! Breakthrough Strategies to Create Great Companies, and The New Pay: Linking Employee and Organizational Performance are acknowledged to be keystone works in linking pay with organizational effectiveness. Pat has published numerous articles and chapters for business and professional journals and magazines. She is quoted in management literature and speaks throughout the world on how companies can best align rewards with their business goals. She earned her M.S. and Ph.D. from Ohio State University and A.B. from the University of Michigan.
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