PERFORMANCE BASED COMPENSATION PRACTICES AMONG COMMERCIAL BANKS IN KENYA

By

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DECLARATION

I, the undersigned, declare that this project is my original work and that it has not been presented in any other university or institution for academic credit.

14/11/2012

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DEDICATION

This work is dedicated to

My husband James Maina Mimano
My dad John Muchai Thuita
and my daughter Trayonah Muthoni

Your support, sacrifice and encouragement saw me

through.
ACKNOWLEDGEMENTS

First and foremost I want to thank the Almighty God for giving me the opportunity to advance my studies, provided finances and gave me the strength to finish this research work. Special gratitude is to my supervisor Mr. Omondi for his guidance and constructive critiques throughout this process with utmost diligence, expertise and inspiration in the process of preparing this project.

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ABSTRACT

The economic environment today is rapidly changing and organizations are faced with globalization. To compete effectively, organizations must continually improve their performance by reducing costs, innovating products, improving quality, increasing productivity of staff and efficiency in operation. Commercial banks in Kenya are faced with issues of productivity, competition for customers, efficiency in operation, trade unions and high staff turnover. Such issues must be dealt with. Commercial banks must implement motivational structures that will attract, retain and motivate employees thus the objective was to determine performance based compensation practices among large commercial banks in Kenya.

The study used a cross-sectional descriptive survey design. The study targeted all the commercial banks in Kenya. Primary data was collected using a questionnaire. The analysis involved descriptive statistics and content analysis. Content analysis was used to analyze the responses from the interviews. The study findings were that the managers disagreed that on stock ownership, employees are rewarded with company stock as an outright grant. They also agreed that the piece rate system did not pay a higher piece rate wage if employees produced more than the standard.

The study concluded that commercial banks practiced performance based compensation. It also concluded that stock ownership plans were based on the company’s performance as measured by firms’ stock prices. There were doubts as to whether employees were rewarded with company stock as an outright grant. The study recommended that organizations must align their compensation and reward systems with performance, for when they do, they will increase productivity and achieve sustainable growth.
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1.1 Background of the study

The economic environment today is rapidly changing and organizations are faced with globalization, opening up of markets thereby increasing competitive pressures, changing customer demands and an increasing product market competition (Becker, 1996). To compete effectively, organizations must continually improve their performance by reducing costs, innovating products, improving quality, increasing productivity of staff and efficiency in operation. Improvement of staff performance is a highly attractive strategy used by organizations. Performance improvement is a key objective of business organizations which strive to maintain competitive positions within the market (Gomez, 2007). Employee performance is the main answer to corporate performance (Price, 2007).

1.1.1 Concept of compensation

Employee compensation refers to all forms of pay going to employees and arising from their employment (Dessler, 2008). It has two main components, direct financial payments which include wages, salaries, incentives, commissions and bonuses and indirect financial payments which include financial benefits like employer paid vacations and insurance.

Employee compensation is a broad term that defines payments and rewards given to workers in order to persuade them to keep working for a company. Compensation is not just about regular rewards for work done but also attempts made by employers to retain employees. It goes beyond salary and transcends this boundary to include benefits and other incentives (Hall, 2008). Examples of such are salaries, wages and bonus payments. Organizations put in place schemes that ensure their employees are not lured by the competition. These schemes include insurance schemes, retirement benefits and ownership of company stocks. Employees do not come cheap and employers must be prepared to dig deeper into their pockets to finance their work force. Managers are tasked with determining the value of each employee against the price tag placed by the company. Employee benefits transform to value assigned and need not necessarily be in
cash. Some forms of compensation are actually rights and not benefits such as workman's compensation. This is a federal requirement for every employer to uphold. It is assumed that every employee has to be compensated for the work they do or services provided to an organization. Loss of income should be compensated (Becker, 1996).

Employee compensation can also be looked at as either a tangible benefit or intangible (Hill, 1997). Tangible benefits include insurance, holiday packages, maternity leaves, pension, bonuses and share of profits. Intangible compensation is in form of promotions, letters of appreciation and being provided with nice looking offices. Firms are supposed to determine what salary scales to pay for their respective positions. This will be dependent on qualifications, nature of work involved and years of experience a particular employee has. These will then be adjusted periodically based on factors such as inflation and economic changes that push up costs of living. Another factor that influences salary scales is the pressure from other players in the same sector. Employee compensation is also pegged against regulations imposed by the government. Contractual obligations in this respect must be honored lest the organization finds itself facing costly legal suits. Industrial pressure from trade unions needs to be paid attention to. These unions represent huge masses and their voice cannot be ignored (Baron, 1998). Employee compensation is the essence of human resource management. Different organizations establish different types of payment schemes to satisfy their workers. Some organizations introduce monetary benefits along with other types of fringe benefits. Compensation can therefore be defined as any form of extrinsic benefits, monetary or non-monetary, provided to employees in exchange of their contribution and service to the organization (Cole, 1998).

1.1.2 Compensation Practices

Compensation is a systematic approach to providing monetary value to employees in exchange for work performed (Dessler, 2008). The most effective compensation practices employed by organizations that contribute to a positive organizational climate and higher employee engagement include five primary practices. First is to determine pay position in the market. The pay position in the market should be communicated in the compensation strategy or philosophy in an organization's handbook. As a best practice, all employees
should be paid at or above market levels. On average, employers pay two thirds of their positions at market and a third of their positions above market. On occasion, an employer could pay some positions below market if they are not strategic to the organization (Kuhn 2009). Second is to conduct a market review. Compensation structures should be reviewed every one to two years. The reason for this is that pay practices are constantly changing, especially for some jobs. In order to track these changes, an organization must review the competitive pay rates for these positions using market-based data. Third is to provide increases. Compensation increases and adjustments are provided, according to the market and differentiated based on performance. Common increases provided by employers include adjustments due to a change in market, increases to recognize exceptional performance, and cost-of-living adjustments. Fourth is to make sure managers communicate pay effectively. Pay practices need to be communicated by managers effectively. Compensation program effectiveness stems largely from the communication of pay practices by managers. Training by an organization’s compensation professionals may be necessary in order to make sure managers are aware of the information used to make pay decisions. Fifth is pay for performance. The organization should provide at least one opportunity for employees to earn more pay based on their performance, possibly in the form of bonuses, profit sharing or gain-sharing (Kessler, 2008).

1.1.3 Performance based compensation practices

Practices are generally-accepted, informally-standardized techniques, methods or processes that have proven themselves over time to accomplish given tasks. Practices are commonly used where no specific formal methodology is in place or the existing methodology does not sufficiently address the issue. The idea is that with proper processes, checks and testing, a desired outcome can be delivered more effectively with fewer problems and unforeseen complications Schatzki (2001). Performance based compensation is a method of compensation designed to reward employee performance. Performance based compensation may be based on individual and team performance (Cole, 1998). The types of individual performance based compensation practices include merit pay, bonus programs, piece rate systems and special incentive programs. Merit pay
is where the employees are given raise on the basis of their performance. The performance standards are set by the organizations in advance. Bonuses are given to employees on a pre established goal or criteria. Piece rate systems can either be straight piece rate systems in which wages are determined by multiplying the number of units produced by the piece rate for one unit or differential piece rate which pays employees one piece rate wage if they produce less than a standard output and a higher piece rate wage if they produce more than the standard (Gomez, 2007).

Team based compensation plan is defined as a system that compensates all employees in the organization based on the organizational performance. Team based compensation plan encourages teamwork and reduces conflicts between departments as it emphasizes organizational profit and productivity compared to group incentives (Lawler, 2000). The various types of team based compensation practices include profit sharing, employee stock ownership programs (ESOPs) and gain sharing. Profit sharing involves giving out the share of profits the organization earned to all the employees through issuance of dividends (Price, 2007). Gain Sharing compensation plans are given to those employees who give outstanding performances and provide for cost saving measures. Organizations believe in sharing the profits with the employees who are responsible for producing those results (Taylor, 2008).

Employee performance is determined by targets met, output per period, efficiency levels, cost saving, behavioural attributes such as punctuality, discipline and outstanding service delivery standards (Gomez, 2007). The rules for distributing rewards, the fluctuations of pay levels and structures are contingent upon the level of performances, skills, knowledge or competency exhibited by the employees and not the nature of their job structure (Amuedo-Dorantes and Mach, 2003; Appelbaum and Mackenzie, 1996 and Lee et al., 1999). The ability of management to properly implement performance based compensation practices will strongly attract, retain and motivate employees to achieve the major objectives of the organizational compensational system. These objectives include efficiency defined by improving performance, quality, customers, and labor costs; equity defined by fair compensation treatment for employees through recognition of employee
contributions and employees' needs and compliance with laws and regulations (Gomez-Mejia and Balkin, 2007; Milkovich and Newman, 2009). Proper implementation of performance based compensation practices may lead employees to sustain and increase organizational competitiveness in the global economy (Appelbaum and Mackenzie, 1996; Lawler, 2000).

1.1.4 Commercial Banks in Kenya

Commercial banks are profit making financial institutions that play a significant role in the financial system (Central Bank of Kenya, 2009). They are inclined to formulate policies that aim at diversifying their portfolio in order to achieve some minimum rate of return. To achieve this objective, the banks make decisions to invest excess cash in varying securities based on evaluation of expected cash flows and the uncertainty associated with the cash flows. Commercial banks provide financial services, including issuing money in various forms, receiving deposits of money, lending money and processing transactions and the creation of credit. Commercial banks accept deposits from customers and in turn, make loans, even in excess of the deposits; a process known as fractional-reserve banking. Commercial banks in Kenya are classified on the basis of the number of employees, the capital base and the market share.

1.2 Statement of the Problem

Performance based compensation is a method of compensation developed to reward employee performance. It may be based on individual, group performance, plant wide performance and corporate performance (Gomez, 2007). Linking pay to performance is something employers increasingly seek to achieve. This was once seen as an objective which could only be met in the private sector. That is no longer true. The days when government officials marched in step up incremental pay scales are gone. Linking pay to performance also potentially introduces equity and consistency in the pay structure and enables the firm to attract more able workers (Lazear, 2000). Performance based Practices ensure that employees' base pay, salary increases, bonuses, incentives and other are in alignment with an organization's mission, goals, and objectives. The performance
Based pay practices include market-based pay ranges, competitive starting pay, merit increases, promotion pay, reward and recognition, differential pay, incentives and strategic compensation alignment (Price, 2007).

Commercial banks in Kenya are faced with issues of productivity, competition for customers, efficiency in operation, trade unions and high staff turnover. Such issues must be dealt with (Robbins, 2001). Achieving success in core business is the concern of every organization. This requires considerable skill, expertise, experience and judgment on the part of its staff. Commercial banks must implement motivational structures that will attract, retain and motivate employees to major objectives of the organizational pay system which include efficiency, equity and compliance with laws and regulations (Gomez and Balkin, 2007).

Studies that have been done on employee performance based pay include Kiarie (2004), a survey of performance based compensation schemes in companies listed at the NSE and Ooko (2003), employee perception of the link between performance and incentive pay: The case of selected employees in Mobile Phone Industry. Kiarie (2004) concluded that performance is not a major factor while setting compensation schemes for most quoted companies in Kenya. A majority of companies use salaries to compensate their employees with only a small number combining both salaries and bonuses. These salaries are based on grading systems that companies set based on either the education level or the experience of the employees. Ooko (2003) concluded that employees in the mobile phone industry perceive a link between performance and incentive pay both among the sales persons and technicians. Work, salary and incentives are important to most employees in the mobile phone industry positively influence satisfaction among employees and the timing of incentives is satisfactory to majority of employees. To the best of my knowledge, no study has dealt with performance based pay practices among commercial banks in Kenya. This study addresses this knowledge gap.
1.3 Objective of the study

To determine performance based compensation practices among commercial banks in Kenya.

1.4 Value of the study

The study was important to the Commercial Banks in Kenya as they devise more ways on how to motivate employees through implementing competitive performance based pay schemes and hence performance improvement and increase. The Management of the Banks was able to identify ways or compensatory tactics to improve productivity, know how to motivate employees and identify that they cannot operate in isolation of employees. It also made significant contribution to all other banking and financial institutions such as SACCOS in enabling them to emphasize on the need for performance based pay schemes.

The government was able to understand the criteria used by Organizations to compensate their employees and formulate policies that are aimed at increasing productivity and safeguarding their interests. This enhanced their productivity and competitiveness and eventually improved the livelihood of the target area. The development partners who are usually interested at helping the Financial Institutions to prosper had an understanding of a wide variety of factors that hinder the Financial Institutions hence sustainability and the extent to which the identified factors affect Financial Institutions.

The scholars and researchers who wished to debate or carry out more studies on challenges faced by the Financial Institutions found this study useful as a basis of carrying out more studies in Kenya. The study formed a basis upon which further research on the same was to be based. The findings enabled the researchers to understand the necessary resources which may be required in future related studies.
CHAPTER TWO: LITERATURE REVIEW

2.1 Compensation

Compensation is referred to as money and other benefits received by an employee for providing services to his employer. Compensation includes direct cash payment, indirect payments in the form of employee's benefits and incentives to motivate employees to strive for higher level of productivity (Williams, 2001). Compensation includes wages and salary. Wage is referred to as remuneration to workers particularly hourly rated payment. Salary refers to as remuneration paid to white-collar employees including managerial personnel. Incentives are the additional payment to employees besides the payment of wages and salaries. Incentives are linked with productivity, either in terms of higher production or cost saving or both. Fringe benefits include such benefits which are provided to the employees either having long term impact or short term impact. They include; Retirement benefits which are those benefits which are received after an employee's retirement from the organization; Provident fund. Under the provisions of Employees provident fund and miscellaneous Provisions Act, 1952 the employer has to contribute 8.33% of wages or salaries of employees every month and this accumulated amount will be paid to the employee when he retires.

Total compensation is the package of quantifiable rewards an employee receives from his or her labour. Total compensation includes three components namely base compensation, pay incentives and indirect compensation or benefits (Balkin, 2007). Base compensation is the fixed pay an employee receives on a regular basis, either in the form of salary or as an hourly wage. Pay incentive programs are designed to reward employees for good performance such as bonuses and profit sharing. Benefits encompass a wide variety of programmes such as health insurance, vacations and unemployment compensations. A firm should design a compensation system that will enable it achieve its strategic objectives and one which is molded in the firm's unique characteristics and environment (Cardy, 2007).

The nine criteria for developing a compensation plan include: Internal versus external equity; will the compensation plan be perceived as fair with the company or will it be
perceived as fair relative to what other employers are paying for the same type of labour. Fixed versus variable pay; will compensation emphasize performance and tie pay to individual or group contributions or will it emphasize membership in the organization. Performance versus membership; will compensation emphasize performance and tie pay to individual or group contributions or will it emphasize membership in the organization. Job versus individual pay; will compensation be based on how the company values a particular job or will it be based on how much skill and knowledge an employee brings to that job. Egalitarianism versus elitism; will the compensation plan place most employees under the same compensation system, egalitarianism, or will it establish different plans by organizational level or employee group, elitism.

Below-market versus above-market compensation; will employees be compensated at below-market levels, at market levels or at above market levels. Monetary versus non monetary awards; will compensation plan emphasize motivating employees through monetary rewards like pay and stock options or will it stress on monetary rewards such as interesting work or job security. Open versus secret pay; will employees have access to information about other worker’s compensation levels and how compensation decisions are made, open pay, or will this knowledge be withheld from employees, secret pay. Centralization versus decentralization of pay decisions; will compensation decisions be made in a tightly controlled central location or will they be delegated to managers in the firm’s units (Paarberg, 2006).

The employer’s objectives on compensation include: attraction of staff; the compensation package must be sufficiently attractive to ensure that it is able to secure the services of the staff it needs quickly: staff retention; an attractive compensation package prevents employees from becoming dissatisfied and looking elsewhere for career development opportunities: staff motivation; the compensation package should positively motivate employees in such a way as to create the conditions in which they are prepared to work hard to help achieve their employer’s objectives and to demonstrate discretionary effort. Such employees will be positively engaged with their work, they will participate in continuous improvement programmes and will work beyond contract when required: corporate reputation; employers will implement a competitive compensation scheme so
as to establish a positive corporate reputation (Brown, 2000). Some employers aim to gain prestige by producing high quality, high value added or innovative goods and services. Other employers aim to maintain an ethical reputation in order to attract and maintain a strong customer base (Steers et al. 1996).

The employee objectives on compensation include: purchasing power; a compensation package determines the standard of living for an employee and will therefore be the most important consideration for most employees. Enhanced satisfaction only occurs when a pay rise is given which surpasses expectations (Karsley et al. 2005): fairness; every employee has a strong feeling about the level of payment that is fair for the job. The employee who feels underpaid is likely to determine the conventional symptoms of withdrawal from the job such as looking for another job, carelessness, disgruntlement, lateness and absence. The worst manifestation of this is when employees feel trapped in a situation they resent: recognition; employees feel their personal contribution should be recognized. This is seeking reassurance and is a way in which employees can mold their behaviour and their career thinking to produce progress and satisfaction.

The legal considerations in compensation include: the 1938 Fair Labor Standards Act which was originally passed in 1938 contains minimum wage, overtime pay, equal pay, record keeping and child labor provisions (Batt, 1994). On overtime pay employers at a rate of at least one and a half time normal pay for any hours worked over 40 in a week. Minimum wage sets a floor for employees covered by the act: Exempt/ non Exempt; specific categories of employees are exempt from the act or certain provisions of the act and particularly from the act’s overtime provisions. A person’s exemption depends on his or her duties and salary Sheppard, 1992). Bona fide executive, administrative such as office managers and professional employees like architects are exempt from the minimum wage and overtime requirements of the act: 1963 Equal Act Pay; the act states that employees of one sex may not be paid wages at a rate lower than that paid to employees of the opposite sex for doing roughly equivalent work specifically if the work requires equal skills, effort and responsibility and involves similar working conditions, employees of both sexes must receives equal pay, unless the differences in pay stem from a seniority system, a merit system, quantity or quality of production or any other factors
other than sex.: 1974 Employee Retirement Income Security Act (ERISA); sets regulations regarding vesting rights, equity or ownership the employees build up in their pension plans should their employment be terminated before retirement. ERISA also regulates portability rights, the transfer of an employee’s vested rights from one organization to another, and contains fiduciary standards to prevent dishonesty in pension plan funding (Philpott, 1992).

2.2 Performance based compensation

Performance based compensation is a method of compensation designed to reward employee performance. Performance based compensation may be based on individual and team performance (Gomez, 2007). Gomez-Mejia and Balkin (2007) specify favorable conditions under which performance related compensation is deemed to be favorable and they include; where individual performance can be objectively and meaningfully measured, where individuals are in a position to control the outcomes of their work, where close team working or cooperation with others is not central to successful job performance and where there is individualistic organizational culture. In addition, Brown and Armstrong (2000) rightly point to the importance of careful implementation and lengthy preparation prior to the installation of a performance based pay compensation scheme.

Performance based compensation often combine a fixed base salary with a variable pay component such as bonuses or stock options that vary with the individual’s performance (Mackenzie, 1996). The performance based compensation offered by an organization can be individual, group or organizational incentives. Mathis et.al (2000) identifies individual compensation as those given to individual employees relative to their effort to pay and can be suitable to use when individual performance can be identified and isolated by the nature of job performed, where a substantial amount of work is done independently allowing individual contributions to be identified, where there is competition among employees and where the organization culture emphasizes individual’s achievement and reward.
Recent years have witnessed extensive innovations in compensation systems and, in particular, a variety of attempts to link compensation to a measure of performance. Such innovations have often been related to broader initiatives to improve the performance of organizations and especially efforts to increase employee involvement in decision-making (Appelbaum et al. 1998). Two main variables proxying the use of performance based compensation schemes are used. The first is based on whether employees at the establishment receive payments from any type of performance based compensation schemes. The second is based on whether the establishment has individual or group performance compensation schemes. Performance based compensation schemes are part of a continuum of compensation systems aimed at encouraging greater inputs by workers into the production process (Kleiner et al. 2001). Performance based compensation ties pay directly to an individual’s performance in meeting specific business goals or objectives. Managers and employees design performance targets to which the employee will be held accountable. The targets have accompanying metrics that enable employees and managers to track performance. The metrics can be financial indicators or they can be indirect indicators such as customer satisfaction or speed of development (Cole, 1998).

2.3 Performance based compensation practices

Performance based compensation practices refer to how the performance based compensation is implemented (Schuler, 2008). Organizations must align their compensation and reward systems with performance, for when they do, they will increase productivity and achieve sustainable growth. Performance based compensation practices help organizations develop effective strategies that reflect an employee's performance and contributions, improve employee and customer engagement, increase productivity, focus employees on clear, objective, and measurable outcomes, link to the organization's strategic direction and business goals and reward employees who achieve results (Torrington, 2008). Gomez-Mejia and Balkin (2007) specify favorable conditions under which performance related compensation practices are deemed to be favorable and they include; where individual performance can be objectively and meaningfully measured, where individuals are in a position to control the outcomes of their work, where close
team working or cooperation with others is not central to successful job performance and where there is individualistic organizational culture. In addition, Brown and Armstrong (2000) rightly point to the importance of careful implementation and lengthy preparation prior to the installation of a performance based pay compensation practices.

The development of performance based compensation practices has generally been viewed as a response by employers to the principal-agent problem inherent in the employment relationship. Many workers have a wide range of discretion in how they undertake their work. They can vary their effort, their cooperation with colleagues and management, and their contribution to improving the effectiveness their inputs (Drago, 1998). The principal-agent problem can be most directly addressed by the close monitoring of workers' performance and the disciplining of workers deemed to be shirking. This can however prove costly, not only because of the need to pay supervisors, but also because the demonstration by employers of a lack of trust in their workers can encourage behaviour based on narrow opportunistic motives (Perlman, 1999). An alternative is to design compensation practices to reward individual or group output. Such performance compensation practices have the advantage to the firm in that they not only induce greater effort from the employees but they may also encourage the commitment of employees and reinforce existing cultures and values where these foster high levels of performance, innovation and team-work. Linking compensation to performance also potentially introduces equity and consistency in the compensation structure and enables the firm to attract more able employees (Lazear et al. 2000). Performance based compensation practices in most organizations include:

2.3.1 Bonus schemes

Bonus Schemes are based on the Balance Score Card which is a strategic planning and management system that is used extensively in business and industry, government, and non-profit organizations worldwide to align business activities to the vision and strategy of the organization, improve internal and external communications, and monitor organization performance against strategic goals (Gomez, 2007). Bonuses which tend to be larger than merit pay increases involve lower risk to the employer since the employer
does not make a permanent financial commitment. The organizations set policies regarding the bonuses. Usually bonuses are provided at the end of a designated period (Armstrong, 2001). Some of the criteria for the success of such bonus payments are group over individual performance, the existence of objective criteria for distribution, and the fact that such criteria are capable of measurement to ensure that what is paid is related to it (Allan, 2007).

A bonus is a gratuitous payment by the employer that is not directly earned by the employee. The employee has no entitlement to the payment as a result of a contract of employment and cannot be assured of receiving it in return for a specific performance. The point is that the level of the benefit cannot be directly linked to the performance of the individual rather to the performance of the business (Hall, 2008).

2.3.2 Commissions

Commission schemes typically treat the salesperson as a self-standing profit unit. The commission plan is structured to share the gross margin of sales between the organization and the salesperson. If the organization provides selling tools such as a car, mobile phone or portable computer, these costs may be explicitly taken into account (Mach, 2003). The main risk inherent in commission schemes is that the sales person will be motivated only by personal gain. The interest of the organization or the customer may not predominate. This can be reduced by paying only for outcomes which are acceptable to the organization or by paying true salary, which is related to wider issues than financial performance (Appelbaum, 1996). A further issue which normally rises is that of career progression. A commission pay scheme might not give any recognition to levels of competence or performance except through the level of earnings. In these circumstances salespeople often ask for a career structure. This can be provided by defining the number of levels of sales role. Progression through these is governed by a set of criteria which could include performance levels and competence standards (Taylor, 2008). Commission is a variable component of compensation package. It is given on the basis of business generated by the employee. Commission is a pre fixed component say 5% of the total
sales done by the employee. It is practiced in the retail and other sectors in the marketing and sales segment.

2.3.3 Piece rate systems

Piece rate systems can either be the straight piece rate systems in which wages are determined by multiplying the number of units produced by the piece rate for one unit or a differential piece rate which pays employees one piece rate wage if they produce less than a standard output and a higher piece rate wage if they produce more than the standard (Price, 2007). This system was developed by Fredrick Taylor in 1871 when he did a study on scientific management studies which he designed to stimulate employees to achieve or exceed established standards (Cole, 1998). Piece Rate compensation plan is given to the employees based on the number of units produced. This plan is practiced in the sectors dealing with manufacturing of products such as engineering – automobile, telecommunication, and Fast Moving Consumer Goods (FMCG)

2.3.4 Incentives

Incentive pay is generally given for specific performance results rather than simply for time worked. Incentives include profit sharing, gain sharing and employee stock ownership plans.

Gain Sharing involves sharing with employees greater than expected gains in profits and for productivity (Lazear, 2000). The gains can be measured financially, by productivity and quality measure and can be paid monthly, quarterly, semiannually or annually. Gain sharing compensation schemes include Scanlon Plan where organization department committees are set to evaluate cost banking suggestions and the savings resulting from the suggestions are placed in a bonus fund and incentive rewards are given to employees from this fund. The fund is split between employees and the organization. Employees receive the incentives compensation for reducing labour costs regardless of whether the organization makes a profit; Runcker plan program uses worker-management committees to solicit and screen ideas. The cost saving calculation in this plan tends to be more complex because the formula encompasses not only labor costs but other expenses
involved in the production process; Improshare or improved productivity through cost sharing plan. In this plan, a standard is developed based on research by an industrial engineering group or some set of base period experience data that identifies the expected number of hours required to produce an acceptable level of output. Any savings arising from production in this agreed on output in fewer than expected hours are shared between the firm and the workers (Gomez and Balkin, 2007).

Gain sharing is a form of pay for performance. In gain sharing employees receive a portion of the profit achieved from their efforts. How much they receive is determined by their performance against the plan (Brown, 2000). Gain sharing works as follows; the organization must measure the historical or baseline performance. Then if employees help improve the organization’s performance on those measures, they share in the financial rewards achieved. The effectiveness of a gain sharing plan depends on employees seeing a relationship between what they do and how well the organization performs. The larger the size of the organization, the harder it is for employees to see the effect of their work. Gain sharing plans are therefore more effective in companies with fewer than 1,000 people. Gain sharing success also requires the company to have good performance metrics in place so that employees can track their process. The gain sharing plan can only be successful if employees believe and see that if they perform better, they will be paid more. The pay should be given as soon as possible after the performance so that the tie between the two is established (Kleiner et al. 2001).

Profit Sharing entitles employees to a share of an organization’s financial success commonly referred to as “financial participation” (Poutsma 2006). Such are less immediately related to the performance of individual employees and work groups. The objectives, according to Bryson and Freeman (2007) include; promoting organizational culture, employee retention and engagement of employees with business objectives (Sengupta 2008). Profit sharing programs do not attempt to reward workers for productivity improvement. They make use of a formula that allocates a portion of declared profits to employees, normally on a quarterly or annual basis, and do not attempt to elicit worker participation (Perry, Mesch and Paarberg, 2006). Linking pay to profits
increases the commitment to his or her company by deepening the level of mutual interest. As a result, it is argued that such schemes act as an incentive encouraging employees to work harder with greater flexibility in pursuit of higher levels of take home pay. The other advantages for employers are better cost flexibility, changed attitudes in the part of employees and the discouragement of union membership (Pendleton, 2000).

Employee stock ownership plans (ESOPs) are based on the entire corporation’s performance as measured by the firm’s stock price. ESOPs reward employees with company stock either as an outright grant or at a favorable price that may be below market value. Employers often use ESOPs as a low cost retirement benefit for employees because stock contributions made by the company are nontaxable until the employee redeems the stock (Hahn, 2006).

Incentive systems based on individual performance are problematic for a number of reasons. First, it may be difficult to disentangle each individual’s contribution to production. This is seen to be particularly important for jobs involving specific human capital (Fitzroy et al. 1997). Secondly, the output of a work team might exceed the sum of individual contributions. Thirdly, such schemes are seen to discourage political interaction among workers, which often positively influences the level of output (Lazear, 1999).

2.3.5 Merit pay

Merit pay consists of an increase in base pay and is normally given once a year, supervisors’ ratings of employees’ performance such as below expectations, achieved expectations, and exceeded expectations are typically used to determine the amount of merit pay granted. Once a merit pay increase is given to an employee, it remains a part of that employee’s base salary for the rest of his or her tenure with the firm except under extreme conditions such as a general wage cut or a demotion (Hall et al. 2008). The workability and effectiveness of merit pay depends on the existence of a suitable performance appraisal system. Merit pay is integrated into salary and is not lost due to poor performance later (Dessler 2008). Stronge (2006) argues that merit pay or other performance pay programs provide added motivation for employees in keeping novice
employees from leaving the profession after a few years and especially in retaining experienced employees. Performance based merit pay is designed to provide a tool to move employees from the midpoint to the maximum of their salary ranges (Sheppard, 1992).

Merit based systems involve the immediate supervisor undertaking an appraisal of each subordiate’s work performance during the previous year. This will typically be done following a formal appraisal interview and often requires the completion of standard documentation drawn by a human resource department. A proposition of future remuneration is then linked to a score derived from the supervisor’s assessment. Some systems require supervisors to award a percentage mark against different criteria while others oblige them to assess individual performance as excellent, good, satisfactory or inadequate (Taylor, 208).
CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Research design

This was a cross-sectional descriptive survey design. This design was applicable since the study involved investigations of variables in units at the same time.

3.2 Population

The study targeted all the commercial banks in Kenya. There are forty three commercial banks licensed to operate in Kenya, Bank Supervision Annual Report (2010). The study was thus to be a census.

3.3 Data collection

This study used primary and secondary data. Primary data was collected by use of questionnaires. The respondents were the head of Human Resource function for each of the banks. The questionnaire was divided into section A, respondent’s profile and section B, performance compensation systems. Secondary data included pay roll data such as variable pay components and how these are worked out and current collective bargaining agreements.

3.4 Data analysis

The analysis involved descriptive statistics and content analysis. Content analysis was used to analyze the responses from the interviews. Descriptive statistics such as means, frequencies, modes and standard deviations was used to classify the responses on performance based pay practices from the banks.
4.1 Demographic data

This section shows the demographic characteristics of the respondents including gender, age bracket and length of continuous service. A total of 43 questionnaires were administered to the heads of human resource functions for each bank of which 34 responded. This represents 80% of the total.

4.1.1 Gender of respondents

This section shows the gender of the respondents. The sample was fairly dominated by the male (65%) and female (35%). This is a clear indication that majority of the workers in the organization were male.

4.1.2 Age of respondents

The cumulative age profile showed that most of the managers ranged between 31 and 40 years (50%) while those between 41 and 50 years were 20%. This indicates that majority of the respondents who were managers aged between 31 and 40 years were those who could use their strength to maximize the output of the organization.

Figure 4.1 Age of respondents
4.1.3 Length of continuous service

Fifty (50%) of the managers had worked in their organization for two to five years while twenty five (25%) had worked in the organization for a period of between six years and fifteen years. Fifteen (15%) and ten (10%) of the managers had worked in the company for less than two years and over fifteen years respectively. Figure 4.2 shows the results of the findings.

Figure 4.2 Length of continuous service

4.2 Performance compensation practices

The study showed that 75% of firms practiced performance based compensation while 25% disagreed that the firms practiced performance based compensation. The findings of the study also showed that 85.7% of the managers stated that there were bonuses in the organization while 82.8% stated that there were piece rate incentives. The findings also showed that 80% of the managers stated that there was gain sharing, 71.4% stated there were commission schemes, 74.2% stated there was merit pay while 57.1% stated that profit sharing was practiced.
4.2.1 Commissions
The finding of the study showed that majority of the managers (80%) stated that commission was calculated as a percentage of the gross margin of sales. This concurs with Taylor, (2008) findings that commission is a variable component of compensation package. It is given on the basis of business generated by the employee. Commission is a pre fixed component say 5% of the total sales done by the employee. It is practiced in the retail and other sectors in the marketing and sales segment.

Figure 4.3 Commissions as a percentage of the gross margin of sales

4.2.2 Employee stock ownership plans
The findings of the study showed that 85.7% of the managers stated that stock ownership plans were based on the company’s performance as measured by the firm’s stock price. This concurs with the literature review that employee stock ownership plans (ESOPs) are based on the entire corporation’s performance as measured by the firm’s stock price. The findings of the study also showed that 15% of the managers stated that employees are not rewarded with company stock as an outright grant. This is a small percentage which differs with the Hahn, (2006) findings that ESOPs reward employees with company stock either as an outright grant or at a favorable price that may be below market value.
4.2.3 Profit sharing

The findings in Figure 4.4 findings show that majority (78%) of the managers stated that profit sharing was allocated as a percentage of annual profit while a few (22%) stated that profit sharing was not allocated as a percentage of annual profit. This concurs with Poutsma (2006) that Profit sharing entitles employees to a share of an organization's financial success commonly referred to as "financial participation".

![Figure 4.4 Allocation of profit](image)

4.2.4. Measurement of gain sharing

The findings of the study in figure 4.5 show that majority of the managers (65%) stated that gain sharing was measured by productivity while 35% of the managers stated that gain sharing was measured by quality. This was in agreement with Lazear, (2000) gain sharing involves sharing with employees greater than expected gains in profits and can be measured financially, by productivity and by quality.
4.2.5 Payment of gain sharing

Figure 4.6 shows that 40% of employees were paid on a semi-annually basis once their performance was measured, 30% were paid on an annually basis while 20% were paid on a quarterly basis. The study also showed that only 10% were paid on a monthly basis. This is in agreement with Lazear, (2000) that gain sharing can be paid monthly, quarterly, semiannually or annually depending on the organization choice.

Figure 4.6 Payment of gain sharing
4.2.6 Gain sharing schemes

The study noted that majority of the respondents (82.9%) used Scanlon plan programme as a gain sharing scheme while 77.1% stated that they used improshare plan programme gain sharing scheme. The runcker plan programme was not well known to the managers as a gain sharing scheme. Scanlon plan is where an organization’s department committees are set to evaluate cost banking suggestions and the savings resulting from the suggestions are placed in a bonus fund and incentive rewards are given to employees from this fund. The fund is split between employees and the organization. Employees receive the incentives compensation for reducing labour costs regardless of whether the organization makes a profit.

4.2.7 Piece rate system

This section of the study shows the type of piece rate systems used and how each is administered. Figure 4.7 shows that 56% of the managers stated that they used straight line piece rate system in their organizations while 44% used differential piece rate system. The 56% of managers stated that straight line piece rate system was calculated by multiplying the number of units produced by the piece rate for one unit. The 44% of managers stated that differential piece rate system paid employees one piece rate wage if they produce less than a standard. This concurs findings by Price (2007), that piece rate systems can either be the straight piece rate systems in which wages are determined by multiplying the number of units produced by the piece rate for one unit or a differential piece rate which pays employees one piece rate wage if they produce less than a standard output.
4.2.8 Bonuses

The findings of the study showed that 95% of the managers stated that bonuses were paid annually while 5% stated that bonuses were not paid annually. This statement concurs with Armstrong (2001), bonuses are usually provided at the end of a designated period.

Figure 4.7 Types of piece rate systems

Figure 4.8 Payment of bonuses
4.2.7 Merit pay

The findings of the study as shown in figure 4.9 show that majority of the managers (85%) stated that merit pay is paid annually while 15% stated that merit pay was not paid annually. This is in line with the literature review that merit pay consists of an increase in base pay and is normally given once a year (Hall et al. 2008).

Figure 4.9 Merit Pay

4.3 Rating of employee performance

Figure 5.0 shows the rating of employee performance. According to the findings majority of the managers (58%) rated employee performance as satisfactory while 48% rated it as good. 12% of the managers rated employee performance as excellent and a marginal 8% of the managers rated employee performance as inadequate. This is in line with the literature review that some systems require supervisors to award a percentage mark against different criteria while others oblige them to assess individual performance as excellent, good, satisfactory or inadequate (Taylor, 208).
4.4 Enhancement of performance
The presence of bonuses helps us to identify and estimate discount factors. Theoretically, one can perform counterfactuals of any type of compensation plan if we can estimate structural parameters (other than discount factors) for a sales person with a less rich compensation plan, an analyst or manager should have greater faith in the counterfactuals, based on parameters that were estimated from observed responses to different elements of the compensation plan.

The advantage associated with utilizing a straight commission arrangement is that it gives sales people a major incentive to work hard on behalf of the company. Workers can earn more based on the rate of performance they adopt. These plans often provide greater incentive for higher levels of productivity.

Merit pay is seen as being "marginally successful" in influencing employee attitudes and behaviors. It includes a financial measurement and feedback system to monitor company
performance and distribute gains in the form of bonuses when appropriate, and a focused involvement system to eliminate barriers to improved company performance.

4.5 Employee entitlement to performance based compensation

The findings of the study as shown in figure 5.1 section shows that majority of the managers (75.3%) stated that all employees were entitled to performance based compensation while 24.7% stated that performance based compensation was entitled to some employees. Performance based compensation is a method of compensation designed to reward employee performance (Gomez, 2007; Lawler, 2000 and Taylor, 2008).

Figure 5.1 Employees entitled to performance based compensation
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary
The following was the summary of the research findings upon which the conclusion and recommendations of the study were made. The study noted that majority of the managers stated that commercial banks practiced performance based compensation. The findings also showed that bonuses were the main compensation systems used. There was also piece rate incentive, gain sharing, commission schemes, merit pay and profit sharing.

Majority of the managers stated that commission was calculated as a percentage of the gross margin of sales. The managers stated that stock ownership plans were based on the company’s performance as measured by the firm’s stock price. Profit sharing was allocated as a percentage of annual profit. Gain sharing was mainly measured by productivity compared to measurement by quality.

Managers stated that straight line piece rate system was calculated by multiplying the number of units produced by the piece rate for one unit. Majority of the managers stated that differential piece rate system paid employees one piece rate wage if they produce less than a standard. The study shows that bonuses and merit pays were paid annually. Employee performance was rated as good thus that majority of the managers stated that award of percentage mark was on different criteria. The study showed that majority of the managers stated that all employees were entitled to performance based compensation.

5.2 Conclusion
The study concluded that the commercial banks practiced performance based compensation. The study also concluded that stock ownership plans were based on the companies’ performance as measured by the firm’s stock price. This concurs with Hahn (2006), Employee stock ownership plans (ESOPs) are based on the entire corporation’s performance as measured by the firm’s stock price. The study concluded that differential piece rate system paid employees one piece rate wage if they produce less than a
standard. The piece rate system however does not pay a higher piece rate wage if they produce more than the standard. This differed with Price (2007), piece rate systems can either be the straight piece rate systems in which wages are determined by multiplying the number of units produced by the piece rate for one unit or a differential piece rate which pays employees one piece rate wage if they produce less than a standard output and a higher piece rate wage if they produce more than the standard. Employee performance was rated as good and thus the average percentage mark was on the basis of different criteria.

5.3 Recommendations

Performance based compensation practices refer to how the performance based compensation is implemented. Organizations must align their compensation and reward systems with performance, for when they do they will increase productivity and achieve sustainable growth. Therefore, as profits and losses of different activities of a financial firm are realized over different periods of time, variable compensation payments should be deferred accordingly. Payments should not be finalized over short periods where risks are realized over long periods. As specified by the relative standard, a substantial portion of variable compensation should be payable under deferral arrangements over a period of years, and these proportions should increase significantly with the level of seniority and/or responsibility.

Incentive-based compensation arrangements should balance risk and financial reward. The proposed compensation arrangement should identify several non-exclusive methods for balancing risk and reward, including deferral of payments significantly beyond the end of the performance period, risk adjustment of awards, utilizing longer performance periods to determine the amount of any award and reducing the sensitivity of award amounts to short-term performance metrics. Incentive-based compensation arrangements should be appropriate and compatible with effective controls or risk management. Further they should be supported by strong corporate governance, including active and effective oversight by the board of directors or an appropriate committee.

Lastly the Boards of Directors and senior managers should take primary responsibility for ensuring that incentive compensation programs effectively align employees’ motivation
with the long-term interests. This could be accomplished, for example, by adopting corporate governance structures that would include a separate compensation committee of the board of directors (this structure may be adjusted to accommodate the realities of staffing boards of directors in smaller institutions). The committee can review and approve the compensation programs for senior executives and other highly compensated employees. This will ensure transparency and equity in distribution of compensation among employees.

5.4 Suggestions for further studies
The researcher recommends the following areas for future studies. The researcher recommends that future study could be conducted on the risks posed by incentives compensation practices. A structured questionnaire was used to collect data from respondents in management level. The researcher suggests that future studies to be conducted using interview guide and involve respondents from all levels into discussions. This would help the researcher direct the conversation toward the topics to determine performance based compensation practices among commercial banks in Kenya. The sample size should be also increased.

5.5 Implications for policy and practice

For commercial banks in Kenya to increase productivity and achieve sustainable growth, the study found out that they must align their compensation and reward systems with performance. When performance based compensation practices are implemented, the commercial banks in Kenya will develop effective strategies that will reflect an employee’s performance and contributions, improve employee and customer engagement, increase productivity, focus employees on clear, objective and measurable outcomes, link to the organization’s strategic direction and business goals and reward employees who achieve results.

The study also found out that for the commercial banks to continue positioning themselves strategically, they need to have professionals to train the managers so that the managers are aware of the information used to make pay decisions. This is because the
effectiveness of compensation stems largely from the communication of pay practices by managers.

5.6 Limitations of the study
The study focused on establishing the responses to performance based compensation practices mainly from commercial banks located within Nairobi, Kenya. Views expressed by human resource functions from other towns would have been of great significance. This was not possible because of inadequate time and financial resources.

Most of the respondents were very busy due the nature of their work and therefore did not fully respond to all the questions while others filled them in a hurry and therefore did not give detailed information.

All the respondents did not give feedback. Only 34 out of the 43 questionnaires were given back to the researcher.
REFERENCES


Jensen, M. V and Murphy K.J CEO Incentives – It is not how much you pay, but how, Harvard Business Review (1990)


Williams R.S (2001), Managing Employee Performance, Design and Implementation in Organizations, Pat Bond, Britain
APPENDIX I: LETTER OF INTRODUCTION

Peninah W. Muchai
P.O Box 26704, 00504
Nairobi
Tel: 0721770952

Dear Sir/ Madam,

I am a student undertaking a Master of Business Administration Degree at the University of Nairobi. As a requirement to complete the program, I will need to submit a project report on a management problem. I would like to do a research on the area of Human Resource Management and in particular, ‘The Extent of Adoption of Performance Based Pay Practices among Commercial Banks in Kenya.’

I do hereby request for your permission to interview you and for your time.

The results will be used solely for academic purposes and a copy of the same will be availed to you on request.

Thank you.

Yours faithfully,

Peninah Muchai
Reg No. D61/75265/2009
APPENDIX II: QUESTIONNAIRE

Section A

Respondent's Profile

Please give answers in the spaces provided and tick (V) appropriately the box that matches your response to the questions where applicable.

1) Name (optional): ----------------------------------------------------------

2) Gender   Female ( )         Male ( )

3) What is your age bracket?

   a) Under 18 years ( )
   b) 19 - 25 years ( )
   c) 26 - 30 years ( )
   d) 31 - 40 years ( )
   e) 41 - 50 years ( )
   f) Over years ( )

4) Length of continuous service with the bank

   a) Less than two years ( )
   b) 2 - 5 years ( )
   c) 6 - 15 years ( )
   d) Over 15 years ( )

Section B

Performance Compensation Systems

1) Does your organization practice performance based compensation?

   Yes ( )            No ( )
2) What type of performance based compensation has your company implemented?

<table>
<thead>
<tr>
<th>Compensation Type</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commission schemes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Profit sharing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gain sharing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonuses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Piece rate incentives</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merit pay</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Any other (please specify)

3) How are the following performance based compensation practices determined

(i) Commissions – as a percentage of the gross margin of sales?

Yes ( ) No ( )

(ii) Employee stock ownership plans

Are they based on the company’s performance as measured by the firm’s stock price? Yes ( ) No ( )

Are employees rewarded with company stock as an outright grant Yes ( ) No ( ) or

At a favorable price that may be below the market value? Yes ( ) No ( )

(iii) Profit sharing

Is it allocated as a percentage of annual profit? Yes ( ) No ( )
When is profit sharing done? Quarterly? Yes ( ) No ( )
Annually? Yes ( ) No ( )
Any other (please specify) .............

(vi) Gain sharing

Is gain sharing measured financially ( ), by productivity ( ) or by quality ( )?

What percentage of profit do employees receive? __________

When are they paid monthly ( ), quarterly ( ), semiannually ( )? or annually ( )?

(vii) Piece rate system

What type of piece rate system does your bank practice?

Straight line piece rate system Yes ( ) No ( )
Differential piece rate system Yes ( ) No ( )

How is each practiced?

Straight line piece rate system – by multiplying the number of units produced by the piece rate for one unit Yes ( ) No ( )

Differential piece rate system – does it pay employees one piece rate wage if they produce less than a standard Yes ( ) No ( ) or does it pay a higher piece rate wage if they produce more than the standard Yes ( ) No ( )

(viii) Bonuses
Are they paid annually Yes ( ) No ( )

(ix) Merit pay

Is merit pay paid annually?

Are the following ratings used to rate employee performance

a) Excellent? Yes ( ) No ( )
b) Good? Yes ( ) No ( )
c) Satisfactory? Yes ( ) No ( )
d) Inadequate? Yes ( ) No ( ) or

do supervisors award a percentage mark against different criteria?
Yes ( ) No ( )

4) Which employees are entitled to performance based compensation?

All employees Yes ( ) No ( )

Some employees Yes ( ) No ( )

5) If some, explain ____________________________________________

-END-
# APPENDIX III: COMMERCIAL BANKS IN KENYA

<table>
<thead>
<tr>
<th>Bank</th>
<th>Peer Group</th>
<th>Number of Branches</th>
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</thead>
<tbody>
<tr>
<td>African Banking Corporation Ltd</td>
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<td>10</td>
</tr>
<tr>
<td>Bank of Africa Kenya Ltd</td>
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<td>18</td>
</tr>
<tr>
<td>Bank of Baroda (K) Ltd</td>
<td>Large</td>
<td>11</td>
</tr>
<tr>
<td>Bank of India</td>
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<tr>
<td>Barclays Bank of Kenya Ltd</td>
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<td>CFC Stanbic Bank Ltd</td>
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<tr>
<td>Charterhouse Bank Ltd 9 Under Statutory Management</td>
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</tr>
<tr>
<td>Chase Bank (K) Ltd</td>
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<tr>
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<tr>
<td>Diamond Trust Bank Kenya Ltd</td>
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<tr>
<td>Bank Name</td>
<td>Size</td>
<td>Rating</td>
</tr>
<tr>
<td>-----------------------------------------</td>
<td>--------</td>
<td>--------</td>
</tr>
<tr>
<td>Ecobank Kenya Ltd</td>
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