Andreas Krause

Employing investment bankers

- Working in investment banks is popular due to the high salaries that are paid in this industry, especially in corporate finance.
- It is also known for requiring a high level of commitment to their employer due to long working hours and high levels of pressure in most of the client-facing roles.
- On the other hand, investment banks are allowing employees in the early stages of their career to take significant responsibilities, that in other industries is only available to more experienced staff.
- In addition to the high pay, high pressure, and high responsibilities, investment banks are also known for dismissing low-performing employees.
- We will look at these aspects of working in investment banks and see why such employment practices are optimal for investment banks.

High pay and quick promotions

- Investment banks are known for high salaries, associated with high workloads
- Promotions can be come early in the career, but it is also easy to lose the job
- We will investigate why investment jobs have such characteristics

High pay and quick promotions

→ The key characteristics of investment banks that make them attractive to employees are the high salaries they pay even junior employees. Another attraction is that promotions can be very quick in investment banks are much more based on performance than on the time an employee has been in his current position.

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  - but in exchange for these high salaries there workload is also substantial in most cases.
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  - Promotions can be obtained very quickly and will be much more based on merit, thus the ability of the employee, than in other industries where promotions are also being given as a reward for the time spent in a specific role and performance is not always the main decision variable.
  - On the other hand, employees not performing well in this environment are easily dismissed.
- We will look at the origins and rationale for such characteristics. We will mainly focus on the high salaries investment banks pay and the high level of responsibilities employees are given at an early stage in their career, but will touch on other aspects as well.

→ We will start our investigation by focussing on the high salaries investment banks are offering.

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High salaries within the financial sector

- Salaries in the financial sector are generally high, attributed to a high productivity
- Investment banks pay considerably more than most other businesses in the financial sector
- There is no evidence that the productivity of investment banks is particularly high
- We will explore the reason why investment banks pay more than other businesses in the industry

High salaries within the financial sector

→ High salaries are widespread within the financial sector and not only be found in investment banks; however, investment banks are typically paying even more than other financial institutions.

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  - The financial sector is generally paying high salaries, not only to their client-facing staff, but also to staff in the back office completing administrative tasks.
  - These higher salaries are generally justified by the higher productivity of the financial sector compared to other industries.
- Even within the high-paying financial sector, investment banks are typically paying even higher salaries.
- While this might be attributed to an even higher productivity of investment banks, there is not much evidence for this.
- We will look at reasons why salaries in investment banks are higher than in commercial banks, for example, or other financial institutions.

→ We will therefore look at the optimal remuneration, neglecting whether it is performance-related or paid as a fixed wage; our focus will be on the total value of the remuneration and not the components it is made up of.

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Chapter 16.1

Optimal remuneration

→ The model we are going to discuss is based on Chapter 16.1 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

Discussion of the model results

- Investment banks pay higher salaries in order to deprive competitors of able employees generating profits at their expense
- Investment banks redistribute wealth rather than create it and an employee does not only generate profits to his employer, but reduces profits for competitors
- ? Senior staff in investment banks commonly have to sign noncompete clauses in their contracts, how would this affect the salary?
- ! It would prevent an employee working for a competitor and reducing his former employer's profits, but high salaries would still be agreed to attract the employee in the first place

→ Now that we have derived the main results of the model, as far as relevant for us, we will briefly discuss some implications as well as limitations of this model. This will allow us to interpret the model in its context of the initial problem and enables us to apply it appropriately in a realistic context.

- We have seen that investment banks pay higher salaries as a way to attract more employees that then not only are unable to generate profits to competitors, but also not able to reduce its own profits through trading in a zero-sum game.
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  - Investment banks mainly re-distribute wealth and do not create it. However, there are benefits of investment banks as they reduce adverse selection between companies and investors; such benefits are overall small compared to the redistributive effects of their activities.
  - An employee working for an investment bank will, hopefully, generate profits for its employer through his skills and ability.
  - In addition, the informational advantage will also allow investment banks to reduce the profits of other market participants, such as competitors. With investment banks mainly redistributing wealth, this will increase their own profits if other obtain less profits; it is this additional benefit that will increase the salaries of investment bankers.
- [?] It is common that if an investment banker in a more senior position resigns, he will not be able to become employed at a competitor for a certain period of time. Would this limit of options outside their current employers increase the salary they are paid?
- [!] It would limit competition for employees as an employee cannot be hired by another investment bank; thus he would not be able to work against his former employer and reduce its profits for the benefit of his new employer. This should reduce the salary as the marginal benefit the employee provides, is reduced. However, there will be competition to attract any employees in the first place to an investment bank and not to its competitors; this competition will increase salaries and compensate for the limots on options when resigning.

→ We have seen that high salaries are the result of investment banks not only benefitting from the profits the employee generates, but also the profits he does not take off the investment bank when working for a competitor.

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! It would prevent an employee working for a competitor and reducing his former employer's profits, but high salaries would still be agreed to attract the employee in the first place

Discussion of the model results

→ Now that we have derived the main results of the model, as far as relevant for us, we will briefly discuss some implications as well as limitations of this model. This will allow us to interpret the model in its context of the initial problem and enables us to apply it appropriately in a realistic context.

- We have seen that investment banks pay higher salaries as a way to attract more employees that then not only are unable to generate profits to competitors, but also not able to reduce its own profits through trading in a zero-sum game.
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    - Investment banks mainly re-distribute wealth and do not create it. However, there are benefits of investment banks as they reduce adverse selection between companies and investors; such benefits are overall small compared to the redistributive effects of their activities.
    - An employee working for an investment bank will, hopefully, generate profits for its employer through his skills and ability.
    - In addition, the informational advantage will also allow investment banks to reduce the profits of other market participants, such as competitors. With investment banks mainly redistributing wealth, this will increase their own profits if other obtain less profits; it is this additional benefit that will increase the salaries of investment bankers.
- [?] It is common that if an investment banker in a more senior position resigns, he will not be able to become employed at a competitor for a certain period of time. Would this limit of options outside their current employers increase the salary they are paid?
- [!] It would limit competition for employees as an employee cannot be hired by another investment bank; thus he would not be able to work against his former employer and reduce its profits for the benefit of his new employer. This should reduce the salary as the marginal benefit the employee provides, is reduced. However, there will be competition to attract any employees in the first place to an investment bank and not to its competitors; this competition will increase salaries and compensate for the limots on options when resigning.

→ We have seen that high salaries are the result of investment banks not only benefitting from the profits the employee generates, but also the profits he does not take off the investment bank when working for a competitor.

Discussion of the model results

- Investment banks pay higher salaries in order to deprive competitors of able employees generating profits at their expense
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High responsibilities early in the career

- Investment banks give high responsibilities to employees early in their career
- If employees are not performing well they are dismissed or sidelined
- We will investigate why investment banks have such employment practices

High responsibilities early in the career

→ Apart from high salaries in investment banks, employees are also given a high level of responsibilities at a very early stage in their career. We will now investigate the rationale for such an observation.

- It is from the start of employment in client-facing roles that employees are actively involve din decision-making and they are given high responsibilities in analysing data and making suggestions on how to proceed. The level of supervision given to junior employees is low compared to most other industries, including in other parts of the financial industry. A similar arrangement is typically only found in management consulting firms.
- However, this high level of responsibility comes with the risk of being dismissed or sidelined into other roles if the employee does not perform as well as expected. The scope to make errors in the early stage of their career is much less than in other industries.
- We will look at the reasons for such an observation and why this arrangement is optimal for investment banks.

→ We will now look at a model which will allow us to place a new employee into a role with high or low responsibility and subsequently promote or demote that employee in response to their success in the role they have been given.

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Andreas Krause

Chapter 16.2

Promotion practices

→ The model we are going to discuss is based on Chapter 16.2 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

Discussion of the model results

- The nature of the business makes it difficult to identify able employees and monitoring them to ensure they are providing high-quality work.
- Investment banks use the threat of dismissal or demotion to motivate employees exerting high levels of effort.
- ? What are the different motivations to exert high effort for early-career employees and those well established in the industry?
- ! Early-career employees exert effort to retain their position and those established seek to retain their high pay.

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→ Thus high responsibilities at an early stage are used so that employees build a stake in their future progress in the industry (and the associated high pay) and with this stake being built quickly they are better motivated than having such a stake available in the future only; exerting low effort in the latter case would not imply a loss to the investment banker, unlike in the model employed by investment banks.

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→ Thus high responsibilities at an early stage are used so that employees build a stake in their future progress in the industry (and the associated high pay) and with this stake being built quickly they are better motivated than having such a stake available in the future only; exerting low effort in the latter case would not imply a loss to the investment banker, unlike in the model employed by investment banks.

Summary of key results

- Investment banks pay high salaries to prevent employees from working for competitors and thereby directly reducing their profits
- In order to motivate employees and identify high-achievers, investment banks give them high responsibilities and dismiss them if not successful
- The lack of success can be the result of low ability or low effort

Summary of key results

→ We can now summarize the key results we have obtained about the remuneration and promotion of investment bankers.

- We have seen that high salaries are paid to prevent employees defecting to competitors and when working for them reducing their former employer's profits by working against them.
- High responsibilities are given so that investment bankers 'have something to lose' if they do not exert effort, which motivates them more than the prospect of future rewards.
- Investment bankers not being successful and being demoted to back-office roles or being dismissed, for example, might be because they do not have the ability to succeed or they are not willing to exert the requisite efforts, for example if their marginal costs of effort are very high.

→ We thus see that the characteristics of investment banking practices towards their employee are the optimal responses to the nature of the investment banking business. The unique features of investment banking in terms of the difficulty in monitoring employees and assessing their performance objectively, has lead investment banks to give high responsibilities to 'test' employees and dismiss them if they are not performing sufficiently well. The high salaries are not only a result of high productivity and high workloads, but also reflect the nature of the re-distributive nature of investment banks and the fact that investment banks compete for a given resource rather than expand their market. The onyl other comparable industry in these respects is management consulting.

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