

Chapter 16.2

Promotion practices

Outline

- Problem and model assumptions
- Task allocation after failure
- Task allocation after success
- Initial allocation of a low-risk task
- Initial allocation of a high-risk task
- Summary

■ Problem and model assumptions

- Task allocation after failure
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Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Hire and fire mentality

Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Hire and fire mentality

- ▶ Investment banks give **high responsibilities** to employees in **early career** stages

Hire and fire mentality

- ▶ Investment banks give high responsibilities to employees in early career stages
- ▶ Not performing well in the early stage of a career is easily a **bar** to promotion

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- ▶ Successful employees are **promoted quickly**

Hire and fire mentality

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- ▶ Not performing well in the early stage of a career is easily a bar to promotion
- ▶ Successful employees are promoted quickly

Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Task types

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- ▶ This will include **corporate finance** and **proprietary trading**

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- ▶ This will include corporate finance and proprietary trading, but also **middle office** roles such as risk management

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Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Benefits of tasks

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- ▶ If the high-risk task is **successful** the investment bank obtains benefits V_H

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- ▶ Employees exert **effort** to increase the probability of success

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- ▶ Employees can be **freely moved** between tasks

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Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Wage structure

Wage structure

- ▶ Wages are paid at the end of the **second** time period

Wage structure

- ▶ Wages are paid at the end of the second time period
- ▶ They will depend on the success in **both** time periods

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■ Problem and model assumptions

■ Task allocation after failure

■ Task allocation after success

■ Initial allocation of a low-risk task

■ Initial allocation of a high-risk task

■ Summary

Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Optimal effort

Optimal effort

- We consider the **second** time period initially

Optimal effort

- ▶ We consider the second time period initially, assuming that the employee has **failed** its task in time period 1

Optimal effort

- ▶ We consider the second time period initially, assuming that the employee has failed its task in time period 1
- ▶ His wages are w_{FS} ,
- ▶ Expected salary: $\Pi_M^2 = w_{FS}$

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Optimal effort

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- ▶ His wages are w_{FS} if he is **successful**, if he **fails** again he gets w_{FF}
- ▶ Expected salary: $\Pi_M^2 = \pi_2 w_{FS} + (1 - \pi_2) w_{FF}$

Optimal effort

- ▶ We consider the second time period initially, assuming that the employee has failed its task in time period 1
- ▶ His wages are w_{FS} if he is **successful**, if he **fails** again he gets w_{FF} , and he faces **costs** of effort
- ▶ Expected salary: $\Pi_M^2 = \pi_2 w_{FS} + (1 - \pi_2) w_{FF} - C_2$

Optimal effort

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- ▶ His wages are w_{FS} if he is successful, if he fails again he gets w_{FF}
- ▶ Expected salary: $\Pi_M^2 = \pi_2 w_{FS} + (1 - \pi_2) w_{FF} - C_2$
- ▶ Employees are choosing the **optimal success probability**

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- ▶ $\frac{\partial C_2}{\partial \pi_2} = w_{FS} - w_{FF}$

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- ▶ $\frac{\partial C_2}{\partial \pi_2} = w_{FS} - w_{FF}$
- ▶ Highest effort if $w_{FS} - w_{FF}$ is **maximized** as $\frac{\partial^2 C_2}{\partial \pi_2^2} > 0$

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- ▶ Investment bank will set $w_{FF} = 0$ as this maximizes their profits

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Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Investment bank profits

Investment bank profits

- ▶ Investment bank obtain the benefits V_i if **successful**
- ▶ Low risk task: $\Pi_B^{2L} = \pi_2 V_L$
- ▶ High risk task: $\Pi_B^{2H} = \pi_2 V_H$

Investment bank profits

- ▶ Investment bank obtain the benefits V_i if **successful**, pays the **wages**
- ▶ Low risk task: $\Pi_B^{2L} = \pi_2 V_L - (\pi_2 w_{FS} + (1 - \pi_2) w_{FF})$
- ▶ High risk task: $\Pi_B^{2H} = \pi_2 V_H - (\pi_2 w_{FS} + (1 - \pi_2) w_{FF})$

Investment bank profits

- ▶ Investment bank obtain the benefits V_i if **successful**, pays the **wages**, and for the high-risk task loses **equity** if **not successful**
- ▶ Low risk task: $\Pi_B^{2L} = \pi_2 V_L - (\pi_2 w_{FS} + (1 - \pi_2) w_{FF})$
- ▶ High risk task: $\Pi_B^{2H} = \pi_2 V_H - (\pi_2 w_{FS} + (1 - \pi_2) w_{FF}) - (1 - \pi_2) E$

Investment bank profits

- ▶ Investment bank obtain the benefits V_i if successful, pays the wages, and for the high-risk task loses equity if not successful
- ▶ Low risk task: $\Pi_B^{2L} = \pi_2 V_L - (\pi_2 w_{FS} + (1 - \pi_2) w_{FF})$
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Task allocation

Task allocation

- ▶ The low-risk task must be profitable $\Pi_B^{2L} \geq 0$

Task allocation

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 $V_L \geq w_{FS}$

Task allocation

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- ▶ $\frac{\partial \Pi_B^{2L}}{\partial \pi_2} = V_L - (w_{FS} - w_{FF}) = V_L - w_{FS} \geq 0$

Task allocation

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 $V_L \geq w_{FS}$
- ▶ $\frac{\partial \Pi_B^{2L}}{\partial \pi_2} = V_L - (w_{FS} - w_{FF}) = V_L - w_{FS} \geq 0$
- ⇒ Investment banks want employees to choose the **highest success rate and hence**
 $V_L = w_{FS}$

Task allocation

- ▶ The low-risk task must be profitable $\Pi_B^{2L} \geq 0$, and with $w_{FF} = 0$ we need $V_L \geq w_{FS}$
- ▶ $\frac{\partial \Pi_B^{2L}}{\partial \pi_2} = V_L - (w_{FS} - w_{FF}) = V_L - w_{FS} \geq 0$
- ⇒ Investment banks want employees to choose the highest success rate and hence $V_L = w_{FS}$
- ▶ For high-risk task: $\Pi_B^{2H} = \pi_2 (V_H - V_L) - (1 - \pi_2) E$

Task allocation

- ▶ The low-risk task must be profitable $\Pi_B^{2L} \geq 0$, and with $w_{FF} = 0$ we need $V_L \geq w_{FS}$
- ▶ $\frac{\partial \Pi_B^{2L}}{\partial \pi_2} = V_L - (w_{FS} - w_{FF}) = V_L - w_{FS} \geq 0$
- ⇒ Investment banks want employees to choose the highest success rate and hence $V_L = w_{FS}$
- ▶ For high-risk task: $\Pi_B^{2H} = \pi_2 (V_H - V_L) - (1 - \pi_2) E$
- ▶ If $E > \frac{\pi_2}{1 - \pi_2} (V_H - V_L)$, then $\Pi_B^{2H} < 0$

Task allocation

- ▶ The low-risk task must be profitable $\Pi_B^{2L} \geq 0$, and with $w_{FF} = 0$ we need $V_L \geq w_{FS}$
- ▶ $\frac{\partial \Pi_B^{2L}}{\partial \pi_2} = V_L - (w_{FS} - w_{FF}) = V_L - w_{FS} \geq 0$
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- ⇒ If the losses are too high, the high-risk task is **not allocated**

Task allocation

- ▶ The low-risk task must be profitable $\Pi_B^{2L} \geq 0$, and with $w_{FF} = 0$ we need $V_L \geq w_{FS}$
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- ▶ If $E > \frac{\pi_2}{1 - \pi_2} (V_H - V_L)$, then $\Pi_B^{2H} < 0$
- ⇒ If the losses are too high, the high-risk task is not allocated
- ⇒ After failure, the employee is allocated the **low-risk task**

Task allocation

- ▶ The low-risk task must be profitable $\Pi_B^{2L} \geq 0$, and with $w_{FF} = 0$ we need $V_L \geq w_{FS}$
- ▶ $\frac{\partial \Pi_B^{2L}}{\partial \pi_2} = V_L - (w_{FS} - w_{FF}) = V_L - w_{FS} \geq 0$
- ⇒ Investment banks want employees to choose the highest success rate and hence $V_L = w_{FS}$
- ▶ For high-risk task: $\Pi_B^{2H} = \pi_2 (V_H - V_L) - (1 - \pi_2) E$
- ▶ If $E > \frac{\pi_2}{1 - \pi_2} (V_H - V_L)$, then $\Pi_B^{2H} < 0$
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■ Problem and model assumptions

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■ Initial allocation of a low-risk task

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After failure
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Low risk
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Initial high-risk task

Initial high-risk task

- ▶ Suppose after **succeeding** with the high-risk task, the employee is allocated the low-risk task afterwards

Initial high-risk task

- ▶ Suppose after succeeding with the high-risk task, the employee is allocated the low-risk task afterwards
- ▶ If failing in period 1, he is allocated the **low-risk task**

Initial high-risk task

- ▶ Suppose after succeeding with the high-risk task, the employee is allocated the low-risk task afterwards
- ▶ If failing in period 1, he is allocated the low-risk task, hence success or failure in period 1 would make **no difference**

Initial high-risk task

- ▶ Suppose after succeeding with the high-risk task, the employee is allocated the low-risk task afterwards
- ▶ If failing in period 1, he is allocated the low-risk task, hence success or failure in period 1 would make no difference
- ▶ The considerations in period 2 after failure apply

Initial high-risk task

- ▶ Suppose after succeeding with the high-risk task, the employee is allocated the low-risk task afterwards
- ▶ If failing in period 1, he is allocated the low-risk task, hence success or failure in period 1 would make no difference
- ▶ The considerations in period 2 after failure apply and the employee is **never** allocated the high-risk task

Initial high-risk task

- ▶ Suppose after succeeding with the high-risk task, the employee is allocated the low-risk task afterwards
- ▶ If failing in period 1, he is allocated the low-risk task, hence success or failure in period 1 would make no difference
- ▶ The considerations in period 2 after failure apply and the employee is never allocated the high-risk task

⇒ Therefore, if **succeeding** in the high-risk task, the employee **stays** in this task

Initial high-risk task

- ▶ Suppose after succeeding with the high-risk task, the employee is allocated the low-risk task afterwards
- ▶ If failing in period 1, he is allocated the low-risk task, hence success or failure in period 1 would make no difference
- ▶ The considerations in period 2 after failure apply and the employee is never allocated the high-risk task

⇒ Therefore, if succeeding in the high-risk task, the employee stays in this task

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After failure
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After success
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Low risk
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Summary
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Initial low-risk task

Initial low-risk task

- ▶ Which task has been allocated first is **irrelevant** for the incentives in the second time period

Initial low-risk task

- ▶ Which task has been allocated first is irrelevant for the incentives in the second time period
- ▶ If the task is **successful**, the employee will be allocated the **high-risk task**

Initial low-risk task

- ▶ Which task has been allocated first is irrelevant for the incentives in the second time period
- ▶ If the task is successful, the employee will be allocated the high-risk task
- ▶ Similar to above, we get $w_{SF} = 0$ and $w_{SS} = V_L$

Initial low-risk task

- ▶ Which task has been allocated first is irrelevant for the incentives in the second time period
- ▶ If the task is successful, the employee will be allocated the high-risk task
- ▶ Similar to above, we get $w_{SF} = 0$ and $w_{SS} = V_L$
- ⇒ Employees **failing** in time period 1 will be allocated the **low-risk task** in time period 2

Initial low-risk task

- ▶ Which task has been allocated first is irrelevant for the incentives in the second time period
- ▶ If the task is successful, the employee will be allocated the high-risk task
- ▶ Similar to above, we get $w_{SF} = 0$ and $w_{SS} = V_L$
- ⇒ Employees failing in time period 1 will be allocated the low-risk task in time period 2

Employees **succeeding** in time period 1 will be allocated the **high-risk task** in time period 2

Initial low-risk task

- ▶ Which task has been allocated first is irrelevant for the incentives in the second time period
- ▶ If the task is successful, the employee will be allocated the high-risk task
- ▶ Similar to above, we get $w_{SF} = 0$ and $w_{SS} = V_L$
- ⇒ Employees failing in time period 1 will be allocated the low-risk task in time period 2
Employees succeeding in time period 1 will be allocated the high-risk task in time period 2

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Problem and assumptions
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After success
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Low risk
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High risk
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Summary
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Period 2 profits

Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Period 2 profits

- ▶ Assume that employees failing in period 1 are making **zero profits**

Period 2 profits

- ▶ Assume that employees failing in period 1 are making zero profits, this ensures employees putting **maximum effort** into succeeding in period 1

Period 2 profits

- ▶ Assume that employees failing in period 1 are making zero profits, this ensures employees putting maximum effort into succeeding in period 1
- ▶ Profits in period 2: $\Pi_M^2 = \pi_2 w_{FS} + (1 - \pi_2) w_{FF} - C_2 = \pi_2 V_L - C_2 = 0$

Period 2 profits

- ▶ Assume that employees failing in period 1 are making zero profits, this ensures employees putting maximum effort into succeeding in period 1
- ▶ Profits in period 2: $\Pi_M^2 = \pi_2 w_{FS} + (1 - \pi_2) w_{FF} - C_2 = \pi_2 V_L - C_2 = 0$
- ▶ This gives $C_2 = \pi_2 V_L$

Period 2 profits

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Problem and assumptions
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After failure
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After success
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Low risk
oo●

High risk
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Summary
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Period 1 profits

Problem and assumptions
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After failure
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After success
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Low risk
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High risk
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Summary
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Period 1 profits

- ▶ If allocated the low-risk task, the employee makes zero profits if he **fails**

Period 1 profits

- ▶ If allocated the low-risk task, the employee makes zero profits if he fails
- ▶ If he **succeeds**, he will be allocated the high-risk task in period 2 and obtains those **profits**
- ▶ $\Pi_M^L = \pi_1 (\pi_2 w_{SS} + (1 - \pi_2) w_{SF} - C_2)$

Period 1 profits

- ▶ If allocated the low-risk task, the employee makes zero profits if he fails
- ▶ If he **succeeds**, he will be allocated the high-risk task in period 2 and obtains those **profits**, less the **costs** of effort in period 1
- ▶ $\Pi_M^L = \pi_1 (\pi_2 w_{SS} + (1 - \pi_2) w_{SF} - C_2) - C_1$

Period 1 profits

- ▶ If allocated the low-risk task, the employee makes zero profits if he fails
- ▶ If he succeeds, he will be allocated the high-risk task in period 2 and obtains those profits, less the costs of effort in period 1
- ▶ $\Pi_M^L = \pi_1 (\pi_2 w_{SS} + (1 - \pi_2) w_{SF} - C_2) - C_1 = -C_1 < 0$

Period 1 profits

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- ▶ $\Pi_M^L = \pi_1 (\pi_2 w_{SS} + (1 - \pi_2) w_{SF} - C_2) - C_1 = -C_1 < 0$
- ⇒ Allocating the employee the low-risk task, would **not** be profitable to him

Period 1 profits

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- ▶ $\Pi_M^L = \pi_1 (\pi_2 w_{SS} + (1 - \pi_2) w_{SF} - C_2) - C_1 = -C_1 < 0$
- ⇒ Allocating the employee the low-risk task, would not be profitable to him
- ⇒ The low-risk task is **never allocated** in time period 1

Period 1 profits

- ▶ If allocated the low-risk task, the employee makes zero profits if he fails
- ▶ If he succeeds, he will be allocated the high-risk task in period 2 and obtains those profits, less the costs of effort in period 1
- ▶ $\Pi_M^L = \pi_1 (\pi_2 w_{SS} + (1 - \pi_2) w_{SF} - C_2) - C_1 = -C_1 < 0$
- ⇒ Allocating the employee the low-risk task, would not be profitable to him
- ⇒ The low-risk task is never allocated in time period 1

- Problem and model assumptions
- Task allocation after failure
- Task allocation after success
- Initial allocation of a low-risk task
- Initial allocation of a high-risk task**
- Summary

Problem and assumptions
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After failure
oooo

After success
ooo

Low risk
ooo

High risk
o•ooo

Summary
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Optimal effort

Optimal effort

- ▶ To incentivize employees, they are making profits if they **succeeded** in period 1

Optimal effort

- ▶ To incentivize employees, they are making profits if they succeeded in period 1
- ▶ Profits are again $\Pi_M^H = \pi_1 (\pi_2 w_{SS} + (1 - \pi_2) w_{SF} - C_2) - C_1$

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- ▶ With $\Delta w = w_{SS} - w_{SF}$ we get

Optimal effort

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- ▶ $\frac{\partial C_1}{\partial \pi_1} = w_{SF} + \pi_2 \Delta w - C_2$

Optimal effort

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- ▶ $\frac{\partial C_1}{\partial \pi_1} = w_{SF} + \pi_2 \Delta w - C_2$
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Optimal effort

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Problem and assumptions
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After failure
oooo

After success
ooo

Low risk
ooo

High risk
oo●oo

Summary
oooo

Bank profits

Bank profits

- ▶ Allocating the high-risk task, investment banks obtain benefits V_H if the task succeeds
- ▶ $\Pi_B = \pi_1 V_H$

Bank profits

- ▶ Allocating the high-risk task, investment banks obtain benefits V_H if the task succeeds and loose E if it fails
- ▶ $\Pi_B = \pi_1 V_H - (1 - \pi_1) E$

Bank profits

- ▶ Allocating the high-risk task, investment banks obtain benefits V_H if the task succeeds and loose E if it fails
- ▶ If the task **succeeds**, the investment bank allocated the high-risk task in period 2

Bank profits

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- ▶ If the task **succeeds**, the investment bank allocated the high-risk task in period 2
- ▶ This tasks pays V_H if it **succeeds** and the investment bank loses E if it **fails** and pays the **wages**

- ▶
$$\Pi_B = \pi_1 V_H - (1 - \pi_1) E + \pi_1 (\pi_2 V_H - (1 - \pi_2) E - \pi_2 w_{SS} - (1 - \pi_2) w_{SF})$$

Bank profits

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- ▶ If the task **fails**, the investment bank allocates the low-risk task in period 2

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Bank profits

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Bank profits

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Problem and assumptions
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After failure
oooo

After success
ooo

Low risk
ooo

High risk
ooo•o

Summary
oooo

Optimal wages

Optimal wages

- If $E \leq \frac{\pi_1(1+\pi_2)}{1-\pi_1\pi_2} (V_H - V_L)$ investment banks are profitable

Optimal wages

- ▶ If $E \leq \frac{\pi_1(1+\pi_2)}{1-\pi_1\pi_2} (V_H - V_L)$ investment banks are profitable and the **high-risk task** will be allocated in period 1

Optimal wages

- ▶ If $E \leq \frac{\pi_1(1+\pi_2)}{1-\pi_1\pi_2} (V_H - V_L)$ investment banks are profitable and the high-risk task will be allocated in period 1
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- ▶ Combining this with the first order conditions of employees, $\frac{\partial C_1}{\partial \pi_1} = w_{SF} + \pi_2 \Delta w - C_2$ and $\frac{\partial C_2}{\partial \pi_2} = \Delta w$, we get

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$$\Rightarrow \frac{\partial \Pi_B}{\partial w_{SF}} = \frac{\partial \pi_1}{\partial w_{SF}} (V_H - w_{SF}) - \pi_1 = 0$$
$$\frac{\partial w_{SF}}{\partial \pi_1} = \pi_2 \frac{\partial \Delta w}{\partial \pi_1}$$

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 - ⇒ $\frac{\partial \Pi_B}{\partial w_{SF}} = \frac{\partial \pi_1}{\partial w_{SF}} (V_H - w_{SF}) - \pi_1 = 0$
 - $\frac{\partial w_{SF}}{\partial \pi_1} = \pi_2 \frac{\partial \Delta w}{\partial \pi_1}$
- ▶ These can be solved for the wages w_{SF} and w_{SS}

Optimal wages

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Problem and assumptions
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After failure
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After success
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Low risk
ooo

High risk
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Summary
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Success rates

Success rates

- ▶ Assume $\pi_1 > \pi_2$

Success rates

- ▶ Assume $\pi_1 > \pi_2$, then marginal costs in period 1 are higher $\frac{\partial C_1}{\partial \pi_1} > \frac{\partial C_2}{\partial \pi_2}$

Success rates

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- ▶ Using the **employee first order conditions**, we get $w_{SF} > (1 - \pi_2) \Delta w + C_2$ and using $\Delta w = V_H + E$, we get

Success rates

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⇒ $\Pi_B < \pi_1 (\pi_2 V_H - C_2) - (1 + \pi_1 - \pi_1 \pi_2) E$

Success rates

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Success rates

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Success rates

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- ▶ As $\frac{\partial C_2}{\partial \pi_2} = \Delta w = V_H + E > V_H$, we have $C_2 > \pi_2 V_H$
- ▶ The first term is then negative and the second term is positive, hence $\Pi_B < 0$
- ⇒ If $\pi_1 > \pi_2$ investment banks would **not** be profitable

Success rates

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 - ▶ The first term is then negative and the second term is positive, hence $\Pi_B < 0$
 - ⇒ If $\pi_1 > \pi_2$ investment banks would not be profitable
 - ⇒ Success rates are **increasing** with experience

Success rates

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■ Problem and model assumptions

■ Task allocation after failure

■ Task allocation after success

■ Initial allocation of a low-risk task

■ Initial allocation of a high-risk task

■ Summary

Problem and assumptions
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After failure
oooo

After success
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Low risk
ooo

High risk
ooooo

Summary
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High responsibilities for early career investment bankers

Problem and assumptions
ooooo

After failure
oooo

After success
ooo

Low risk
ooo

High risk
ooooo

Summary
oooo

High responsibilities for early career investment bankers

- ▶ New employees are allocated **high-risk tasks**

High responsibilities for early career investment bankers

- ▶ New employees are allocated high-risk tasks and only demoted to low-risk tasks if they **fail** to succeed

High responsibilities for early career investment bankers

- ▶ New employees are allocated high-risk tasks and only demoted to low-risk tasks if they fail to succeed
- ▶ With experience the success rates **increase**

High responsibilities for early career investment bankers

- ▶ New employees are allocated high-risk tasks and only demoted to low-risk tasks if they fail to succeed
- ▶ With experience the success rates increase
- ▶ The increase of the success rate is driven by the losing the **entire pay** if failing in period 2

High responsibilities for early career investment bankers

- ▶ New employees are allocated high-risk tasks and only demoted to low-risk tasks if they fail to succeed
- ▶ With experience the success rates increase
- ▶ The increase of the success rate is driven by the losing the entire pay if failing in period 2, making this period **more important**

High responsibilities for early career investment bankers

- ▶ New employees are allocated high-risk tasks and only demoted to low-risk tasks if they fail to succeed
- ▶ With experience the success rates increase
- ▶ The increase of the success rate is driven by the losing the entire pay if failing in period 2, making this period more important
- ▶ Success in period 1 is only important to **remain** in high-risk tasks

High responsibilities for early career investment bankers

- ▶ New employees are allocated high-risk tasks and only demoted to low-risk tasks if they fail to succeed
- ▶ With experience the success rates increase
- ▶ The increase of the success rate is driven by the losing the entire pay if failing in period 2, making this period more important
- ▶ Success in period 1 is only important to remain in high-risk tasks and retain the possibility of making **profits**

High responsibilities for early career investment bankers

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- ▶ With experience the success rates increase
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Problem and assumptions
ooooo

After failure
oooo

After success
ooo

Low risk
ooo

High risk
ooooo

Summary
ooo•o

Pressure remains on experienced employyes

Pressure remains on experienced employyes

- ▶ Being given high responsibilities at an **early stage**, investment bankers will exert effort to retain these responsibilities

Pressure remains on experienced employyes

- ▶ Being given high responsibilities at an early stage, investment bankers will exert effort to retain these responsibilities and **continue** to obtain high salaries

Pressure remains on experienced employyes

- ▶ Being given high responsibilities at an early stage, investment bankers will exert effort to retain these responsibilities and continue to obtain high salaries
- ▶ After initial success, investment bankers will **increase** their efforts to ensure their careers are not jeopardised by failure

Pressure remains on experienced employyes

- ▶ Being given high responsibilities at an early stage, investment bankers will exert effort to retain these responsibilities and continue to obtain high salaries
- ▶ After initial success, investment bankers will increase their efforts to ensure their careers are not jeopardised by failure
- ▶ Investment banking put **high pressure** of success on career starters

Pressure remains on experienced employyes

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- ▶ After initial success, investment bankers will increase their efforts to ensure their careers are not jeopardised by failure
- ▶ Investment banking put high pressure of success on career starters



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