Competition for Talent, Bankers' Pay and Financial Fragility

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Introduction

Bankers' Pay and Financial Fragility

- **High level** of pay in Finance compared to other sectors: Philippon and Reshef (2012), Oyer (2008), Goldin and Katz (2008)

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Bankers' Pay and Financial Fragility

- **High level** of pay in Finance compared to other sectors: Philippon and Reshef (2012), Oyer (2008), Goldin and Katz (2008)
- **Intense debate** among the public opinion and politicians: "*I did not run for office to be helping out a bunch of fat cat bankers on Wall Street*" – President Obama, September 2009
- Possibly strong implications on **financial fragility**

Bankers' Pay and Financial Fragility

- There is a need to identify **the sources of the high level of pay** in the finance industry to understand the implications on financial fragility
- This presentation is based on the paper

Are Bankers worth their Pay? Evidence from a Talent Measure

Claire Célérier (UZH) and Boris Vallée (HEC Paris)

Research Question

What drives the Finance Wage Premium?

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Does competition for talent explain the high level of bankers' pay?

- Scarce empirical research, likely due to the **challenge of precisely observing talent**
- A growing theoretical literature on the **negative externalities** induced by competition for talent: Acharya, Pagano and Volpin (2013), Glode and Lowery (2013), Thanassoulis (2012)...

The Finance Sector Specificities

- **Labor market conditions**
  - Talent **observability**: investment banking league tables
  - Talent **portability**: anecdotal evidence of banker churning
- **Technology and Scalability**
  - Large use of skill-biased **information technology** (Philippon and Reshef (2012))
  - Low hard-wired technological constraints
  - Strong **capital flexibility** that has been improved by capital market and banking **deregulation**

Empirical Predictions

Intense competition for talent in finance should imply:

- High **returns to talent**
- Skewness in the wage distribution: Bell and Van Reenen (2010)

Main Contribution

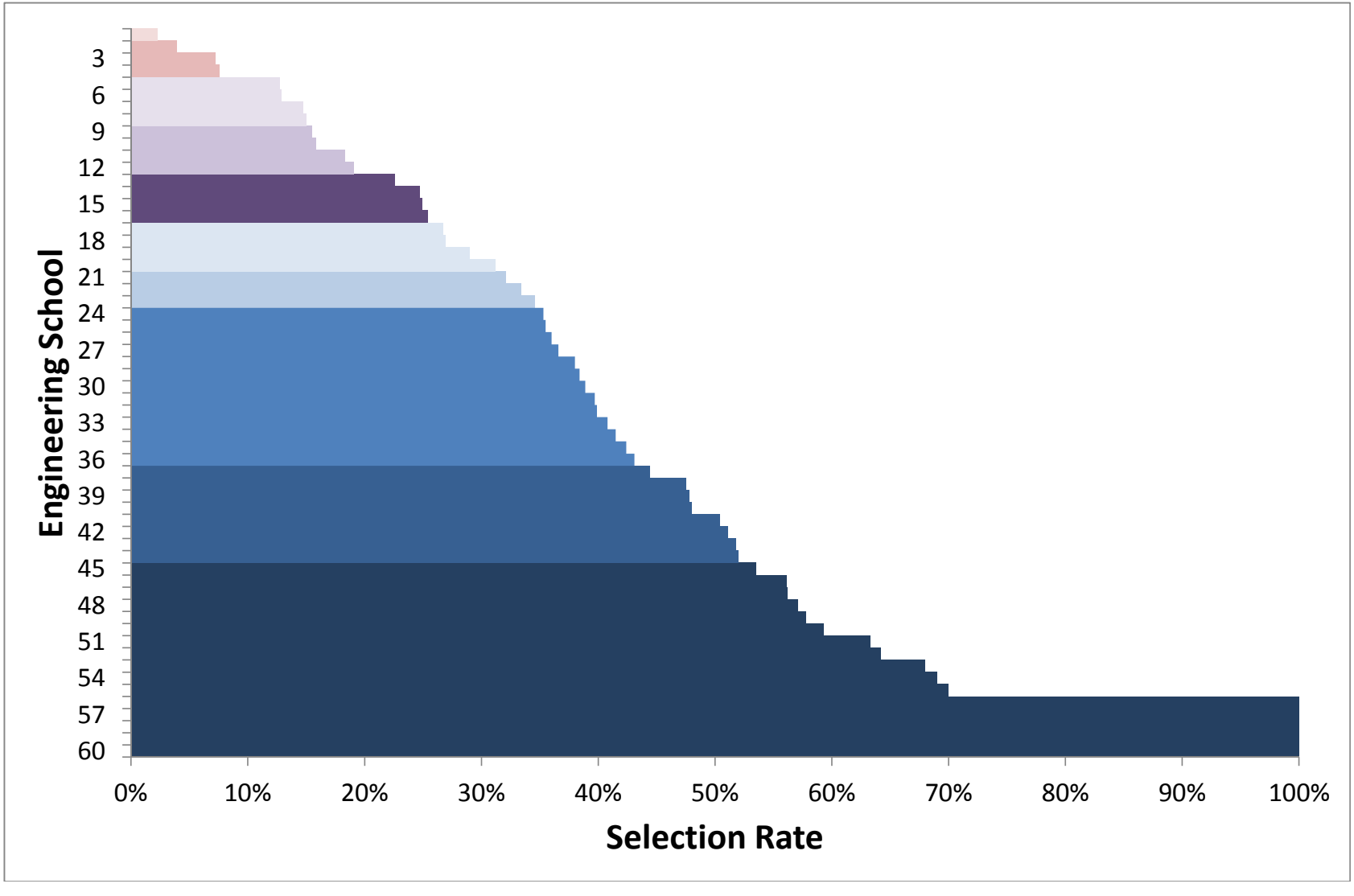
We empirically test the first prediction by using a unique measure of talent

Measuring Talent

Methodology

- We use a specificity of the **French educational system**
- Engineering schools recruit students based on their **national ranking** to a **competitive exam**
  - Selectivity varies across schools
  - There is very little overlap
  - Schools are small: fine granularity
- We use the level of selectivity of each school as a **proxy for talent**

The Selection Process of French Engineering Schools



Key Advantages of our Talent Measure

- **Comprehensive**: Maps all the skills and personality traits necessary to successful careers
- **Accurate**: Homogeneity in education and personal investment make our talent measure very sensitive
  - Same level of education and years of schooling
  - Same educational path with a Science major
  - Self selection in terms of personal investment
- **Reliable**: No distortions due to networking or donations
- **Persistent**: It covers the total population of engineers even since 1980

Measure of Talent within Schools

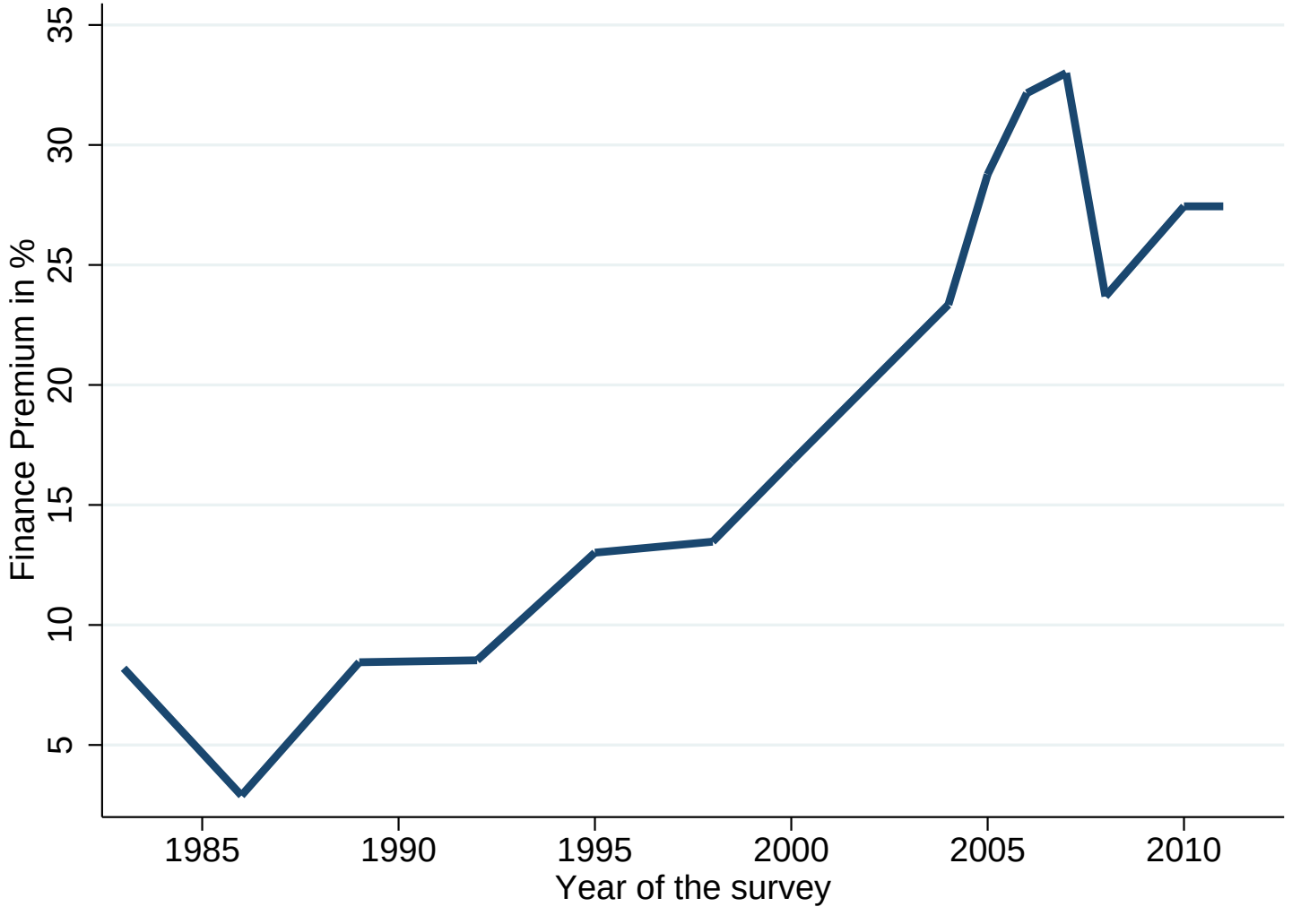
- We use age at graduation as a second **proxy for talent**:
  - High performing schoolkids often skip a year at primary school
  - Up to 25% of students preparing engineering schools repeat the second year of preparation to improve results
- This talent proxy is **not school specific**
- We can control for **school fixed effects** and reject **treatment effects**

Data

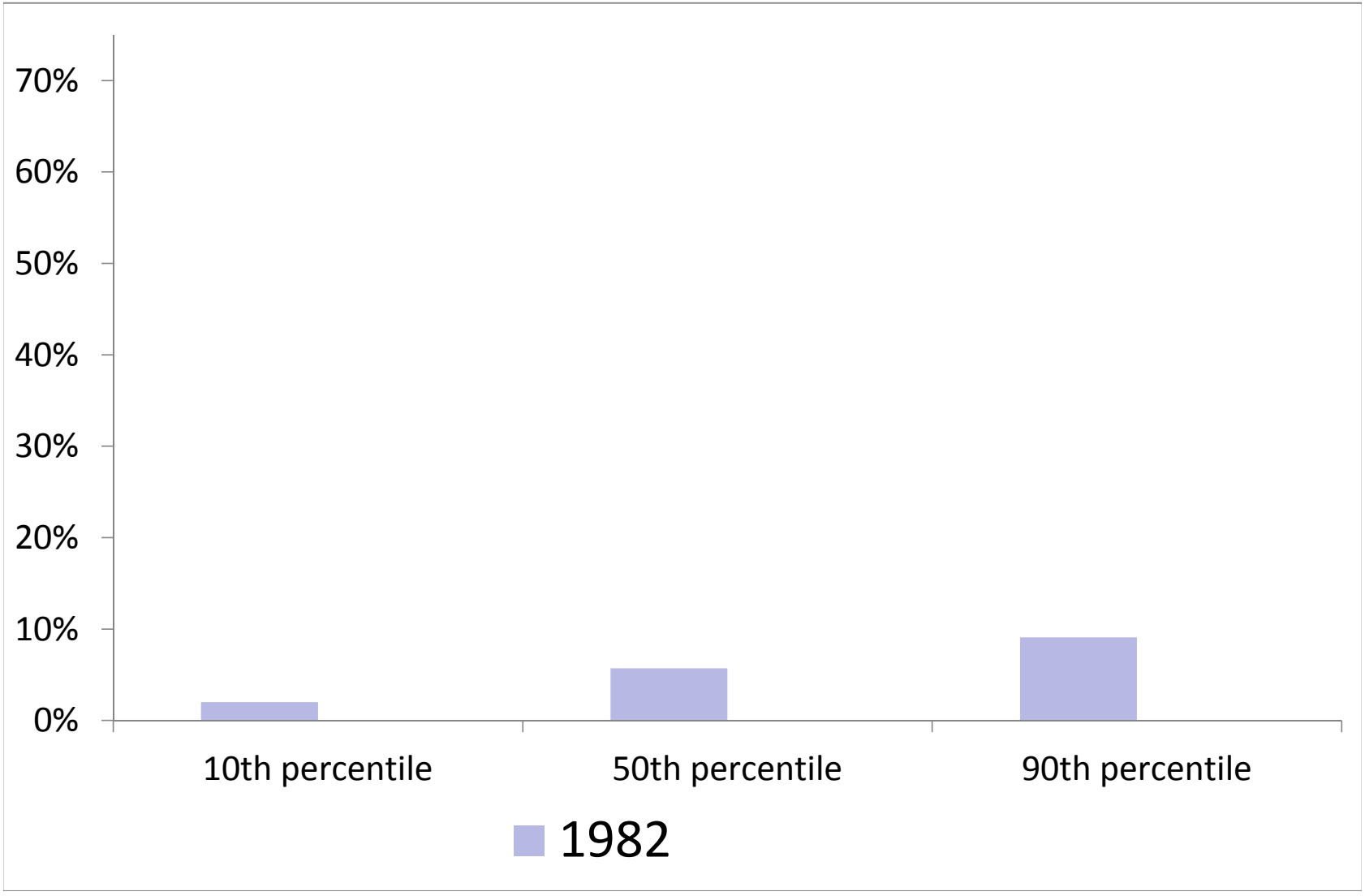
The Survey

- We use a **compensation survey** among French engineers
- The survey is conducted by a French Alumni Organization gathering **most of all engineering schools** in France (144)
- It spans **from 1983 to 2011** (15 surveys)
- There are on average 30,800 individuals in each survey, representing a **7% coverage** of the total engineer population

The Finance Premium over the Years



The Finance Premium across Percentiles of the Wage Distribution



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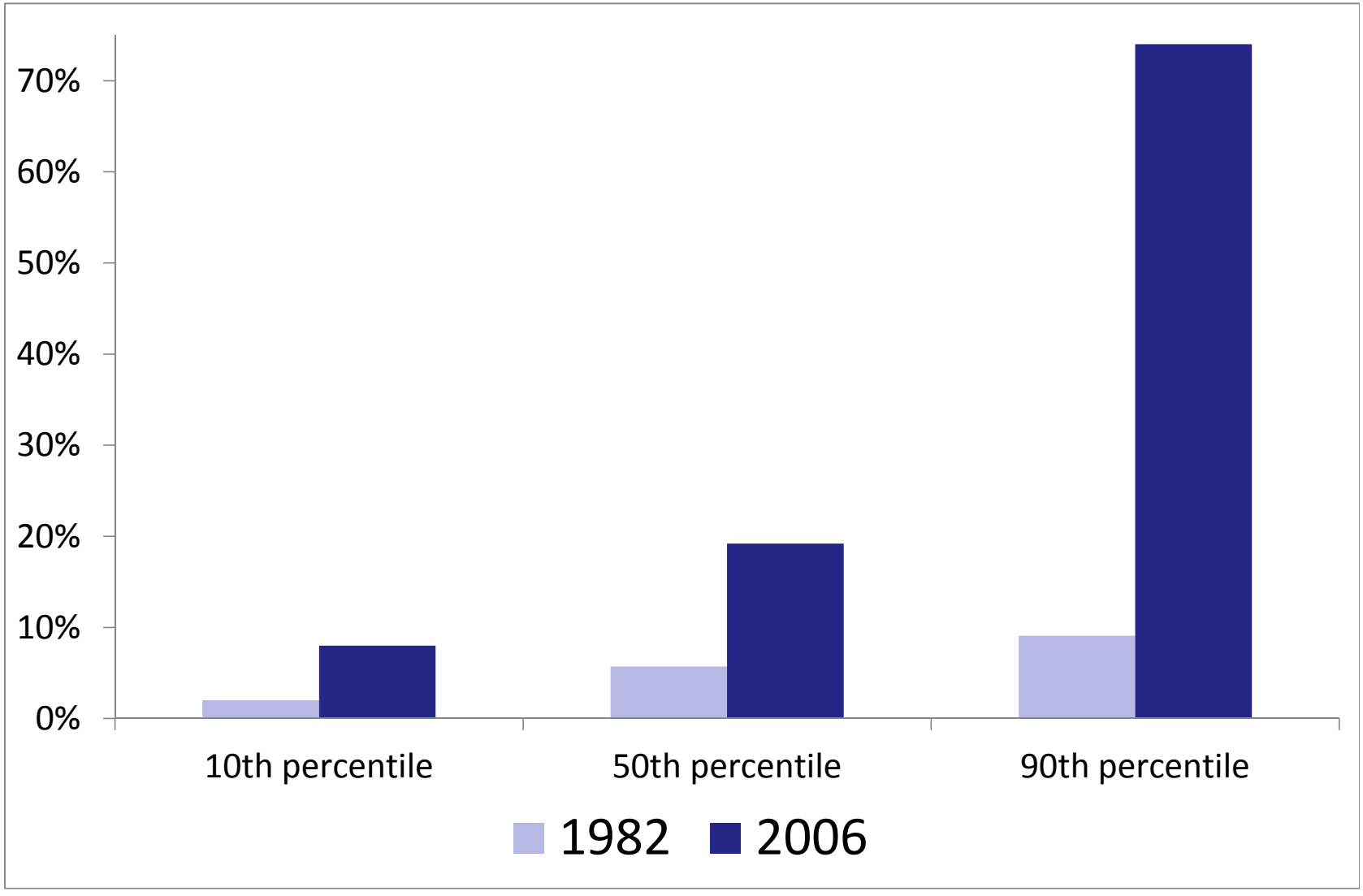
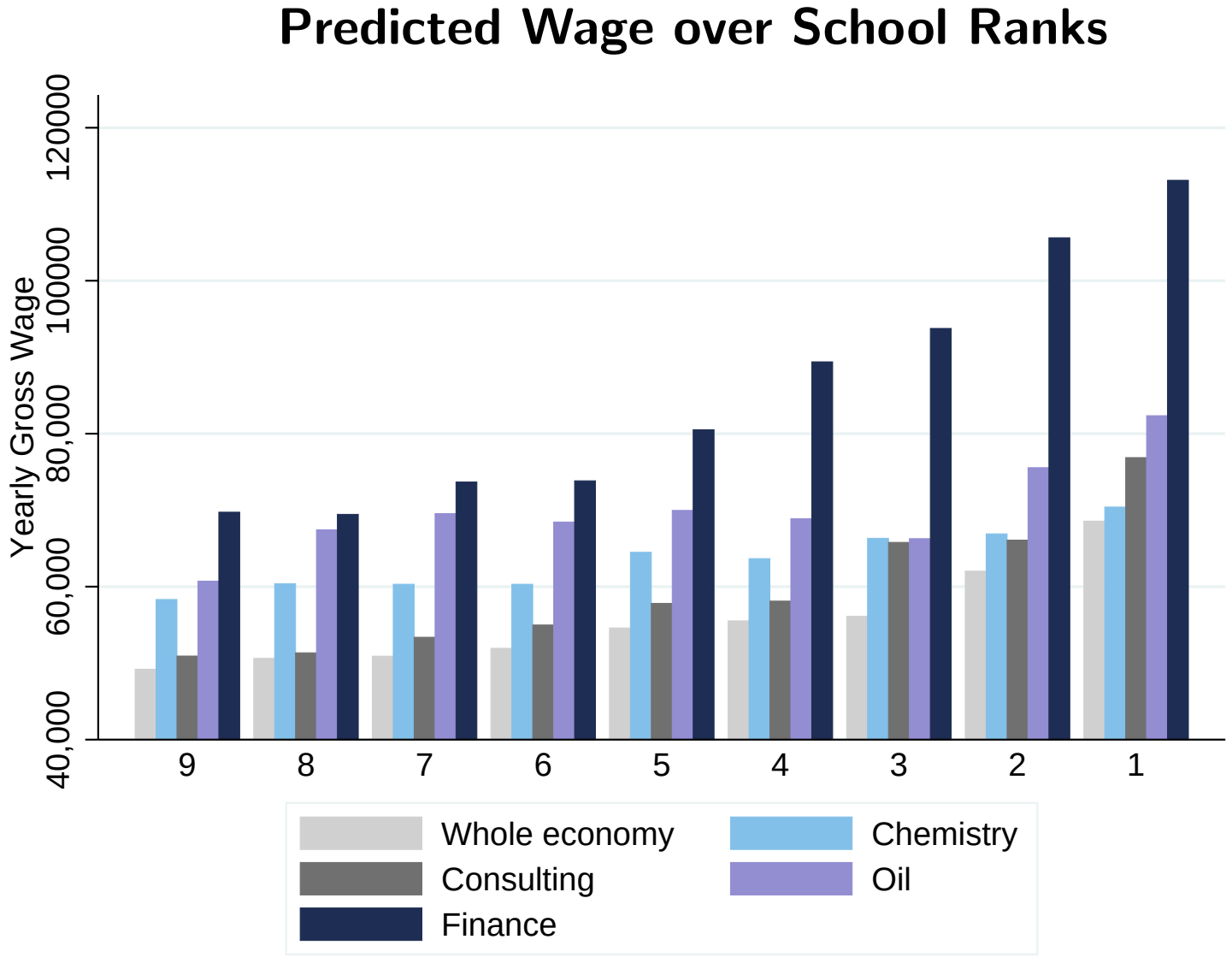


Results

Heterogeneous Wage Returns to Talent across Industries



Identification Strategy

Equation

$$w_{i,t} = \beta \times I_i + \gamma \times X_{i,t} + \mu_t \times Y_t + \lambda_{i,t}$$

- $w_{i,t}$ is the log yearly gross wage
- $I_{i,t}$ stands for the vector of industry dummies
- $X_{i,t}$ for a vector of individual characteristics
- Y_t for the vector of year dummies

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$$w_{i,t} = \beta \times I_i + \epsilon \times Talent_{i,t} + \gamma \times X_{i,t} + \mu_t \times Y_t + \lambda_{i,t}$$

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Heterogeneous Wage Sensitivity to Talent across Industries

	Log(Wage)		
Talent Measure	School Level		Graduation Age
	(1)	(2)	(3)
Finance	0.243***	0.023***	0.17***
	(0.003)	(0.006)	(0.008)
Talent	0.027***	0.025***	0.025***
	(0.000)	(0.000)	(0.001)
Talent *Finance		0.052***	0.038***
		(0.001)	(0.005)
Talent *Consulting		0.025***	0.019***
		(0.001)	(0.006)
Talent *Oil		-0.005***	-0.001
		(0.002)	(0.006)
Talent *Chemistry		-0.004***	-0.004
		(0.001)	(0.005)
Individual Controls	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
School FE	No	No	No
Observations	194,593	194,593	52,766
R^2	0.704	0.708	0.709

Increasing Wage Sensitivity to Talent in Finance

	Log(Wage)		
	1980s	1990s	2000s
	(1)	(2)	(3)
Finance	0.018	0.007	0.021***
	(0.015)	(0.013)	(0.008)
Talent	0.023***	0.024***	0.027***
	(0.001)	(0.000)	(0.000)
*Talent*Finance*	0.011***	0.028***	0.065***
	(0.003)	(0.002)	(0.002)
Individual Controls	Yes	Yes	Yes
Year FE	Yes	Yes	Yes
Observations	40,844	51,510	102,239
R^2	0.721	0.724	0.700

Implications

Implications of Excessive Pay in the Finance Industry

Competition for talent and relatively high wages in finance can imply:

- **Bank Fragility**
- **Risk taking**
- **Task Screening**

Implications of Excessive Pay in the Finance Industry

- **Risk taking**: Managers who take tail risks while moving rapidly between firms raise their short term performance and pay, while reducing their accountability for failures (Acharya et al. (2013))
- **Task Screening**: Bankers may screen tasks and shift away from less contractible but more socially efficient tasks such as risk management (Benabou and Tirole (2013))
- **Bank Fragility**: Big compensation payments can potentially make the difference between investors having and losing confidence in a bank (Thanassoulis (2012))

Conclusion

Take Away

- Bank competition for talent explains both the **level and evolution** of bankers' pay
- Bank competition for talent may have implications on **financial stability**

Thank you!