

LECTURE 9.2

HIRING: RISK

WHO TO HIRE

Consider the problem faced by a bank in hiring someone. There are two candidates:

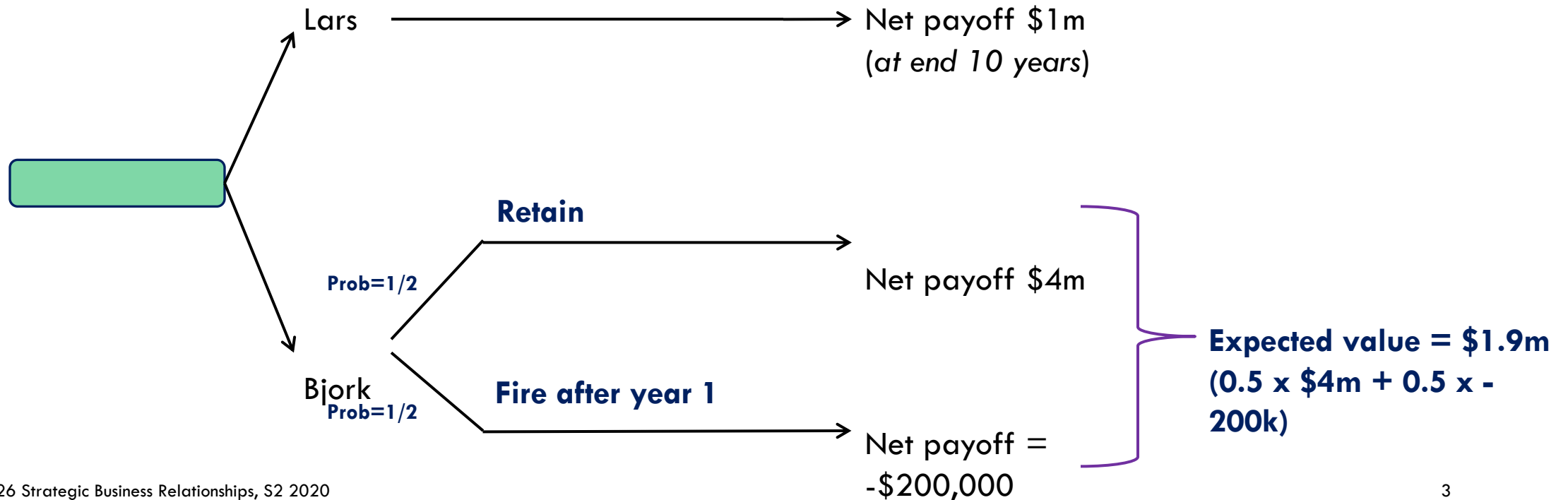
- Lars: good pedigree, degree in economics, MBA, summer internship. Certain he can generate \$200,000 in revenue per year.
- Bjork: appears to be extremely talented but you are not sure. She may be a star and generate \$500,000 in revenue (probability = 0.5) or be a dud and generate a \$100,000 loss each year (probability = 0.5).
- Salary for either is \$100,000 per year

Looking at expected value of revenue generated by each candidate doesn't help. It is the same.

Suppose talents are revealed at end of first year and either employee is expected to work at firm for 10 years. Who should you hire? Why?

WHO TO HIRE

If the bank hires Bjork, they retain her after probation only if she is productive.



WHO TO HIRE

Go for the risky option because you can always fire or 'let go'. The probation period gives the firm insurance against risk.

If termination is difficult, the firm may be reluctant to gamble

But this is a simple model. We might need to consider:

- Terminations costs
- The firm may be risk averse.
- The longer the probation, the greater the potential risk the firm exposes itself to.
- Length of employment: Affects the value of making a hire, a star who stays a long time is valuable
- The reliability of the assessment of quality
- If Bjork is a star, will she stay? Can the firm benefit from asymmetric information and retain the star? Would she be a star elsewhere (firm specific productivity)?