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ES52066 Investment banking

Indicative answers to seminar problems

The problems provided as part of this module are designed to apply the theories learned to practical and realistic scenarios, allowing students to apply their knowledge and practice their ability to explain real-world events using economic theories in plain English. Seminars are dedicated to discussing these problems, but we are not able to discuss all problems due to time constraints. Having additional problems allows students to practice their knowledge in preparation of the assessment; they can compare their solutions with the indicative answers provided and for any additional clarifications attend the office hours.

The below table gives an indication about the problems to be discussed in class for each topic. At times it will be not be possible to discuss each problem and at other times it might be possible to discuss an additional problem is time permits. It is expected that students are prepared to discuss all problems.

	Seminar problems
Topic 1	2, 3
Topic 2	10, 36
Topic 3	16, 20
Topic 4	22, 29
Topic 5	43, 48
Topic 6	52, 55
Topic 7	60, 62
Topic 8	74, 75
Topic 9	80, 83
Topic 10	85, 92

The problems are taken from the textbook and the problem numbers refer to the numbers of the problems therein. The indicative answers are provided using the original numbering of the problems in the textbook, but organised by topic.

The difficulty of problems will vary as the difficulty of questions in the exam will vary to allow for an assessment of the degree to which the learning outcomes have been met and the final mark to reflect the standards achieved. The questions discussed in the seminar will be a mix of more easy and more difficult questions. Furthermore, some problems will require the application of more than one model for a complete answer, but these are not necessarily more difficult than problems requiring the use of only a single model.

Topic 1

Problem 2

In Samia, Makka Holinen is the head of new listings at the local stock exchange. Looking back over the past few years, she finds new listings in the technology sector have overall performed disappointingly, while those in more traditional sectors have been more successful. Having taken into account the higher risks in the technology sector, this effect still persists and has lead to discussions whether the listing requirements for technology stocks should be tightened. Makka points out that while this would obviously improve the quality of listings, it would mainly be achieved by reducing the number of listings in this sectors, rather than improve the quality of companies itself. She points out that improving the prospects of technology companies is generally more difficult than for traditional sectors, not least due to rapid technological progress and uncertain demand structures for new products. Instead, she suggests to look at how listing are conducted and see whether the processes contribute to this development. The role of investment banks should be looked at in particular.

Why would investment banks distort the listing of companies such that technology stocks are faring worse than traditional stocks?

Indicative answer: *Investment banks have information on the prospects of companies and can thus more clearly distinguish between companies of different qualities. This gives companies on the one hand an incentive to take measures to improve the quality of their company, i. e. improve performance, such that they can sell shares at a higher price. On the other hand, a company that promises a good performance, is clearly distinguished from other companies and will be able to sell shares at a high price, reducing the need for further improving their performance. If the costs of improving performance are low, the higher price paid for an issue will provide the main incentive to increase performance. With traditional sectors being more easily able to do so, we should see this effect dominate. In the technology sector, however, these costs are much higher as improving the performance is more difficult to achieve. Here the clearer distinction between companies of different qualities due to investment banks might well induce companies to forego some performance and thus accept a lower share price, in order to save costs. This will result in a lower performance of technology stocks. It is not the investment bank itself that causes this 'distortion', but the effect their superior information and how this is conveyed to investors that causes this effect.*

Problem 3

Carlos Severiano has recently taken early retirement in lieu of redundancy and received a significant lump-sum in compensation. He seeks to invest this money into the stock market for long-term returns, but has not the requisite knowledge to evaluate the prospects of companies. Therefore, he seeks to acquire relevant information from a small investment bank to aid his decision-making. Upon reviewing the files he received, covering a wide range of companies, he notices that information on many companies seems to be missing and any information provided in the pack is negative in that they suggest the companies will be performing worse than expected. He complains to his contact at the investment bank that they have not provided him with information on the other companies. They respond that he has received the full set of reports they have available and only been charged for those companies he has received information on.

Why is there no information on many companies and what is the likely outlook for those companies not included?

Indicative answer: *Information cannot be verified by those buying it, hence they have to rely on investment banks providing credible evidence for its existence. They do this by holding trading positions consistent with the information they sold. However, positive information would require banks to hold long positions, something they would also do in the absence of any information, thus positive news cannot be credibly communicated. Therefore, companies on which positive news is available are not included in the pack. Only where negative information is to be reported can the investment bank communicate this credibly through holding a short position in the stock. These companies have been included into the pack. Carlos can conclude that information on the companies not included is positive, although the magnitude of this positive information will be unknown.*

Problem 4

Nusinia has strict regulations on financial services and any activities are strictly controlled, with any public statements requiring government approval and banks generally not allowed to buy or sell securities. As the government sees any activity by banks with suspicion and against the national interest, not many banks have entered the market in Nusinia. This has resulted in virtually non-existing capital markets for bonds or stocks. Business gently pressure the government to allow capital markets to develop in order that they can finance future investments more easily and attract some foreign capital. The government is hesitant and claims that investment banks offer no real benefits as they just take a slice of any capital raised, adding little value in the process. Using online platforms allows investors to buy and stocks or bonds, so investment banks are no longer needed.

Do investment banks add any value beyond distributing stocks and shares?

Indicative answer: *Investment banks are typically better informed than the general public. While they could sell this information to the public, it is difficult to convince the public that they have actually obtained this information as verification for its existence is difficult. Investment banks would have to hold the securities in such a way that it reflects the information provided; this cannot be done for positive information, limiting the information that can be made public credibly. If they are buying securities from sellers directly and then re-selling them to investors, their desire to make profits from this transaction reveals the belief of investment banks truthfully. Apart from conveying this information, this also allows for transactions to go ahead at all, as the adverse selection problem becomes less severe. This might also induce companies to work more such that they can increase the value of their stocks or bonds and thereby increase value to investors. However, if the costs of improving or maintaining company value is sufficiently high, they might be induced to reduce efforts as any dilution of value due to possible lower values are eliminated. Therefore, investment banks do not only merely pass on securities, but they add value in that they directly or indirectly reveal information about the company issuing these securities.*

Problem 7

Chandapoon Ramaswamy is a well-known trader who has made a name for himself through frequent appearances on television, mostly on programmes concerning stock market developments, but also in mainstream news reports to answer questions on significant events in the stock market. Given his status as a well-known and highly successful trader, he has set up his own company that allows subscribers to receive regular trading tips through email prior to the start of the trading day. The number of subscribers to his newsletter has been very low and not improved significantly over time, despite being given effectively free advertising opportunities during his television appearances. A common response he has heard from the public when asked why they do not subscribe to his newsletter, was that if the tips he gives, are that good, he surely has used them already and it will now be too late to make profits. The fortunes of his newsletter significantly improve once Chandapoon Ramaswamy starts to publish his trading records in nearly real-time format and changes the focus of his newletters on warnings of stocks that he believes will be underperforming in the short run. The number of subscribers significantly increases in a short period of time.

How can you explain the sudden success of the newsletter?

Indicative answer: *By publishing his trading records, Chandapoon Ramaswamy provides information on how he has acted on information he has obtained. As long as his trading record is consistent with the information he has provided in his newsletters, subscribers can verify that he actually holds the information. While only negative information can directly be verified from his trading, it would be attractive for him to copy the impact positive information has on his trading even if not holding this positive information. The absence of negative news can be interpreted as positive news; this makes the newsletter more valuable to subscribers and therefore he will gain more clients.*

Topic 2

Problem 10

Rolltech plc. has made an offer to buy their competitor Glide Inc. from its current owner. Both companies are well established with their main business focussing on ball-bearings for a wide range of applications. After months of negotiation, the deal fell through as the current owner did not accept the direction the business would take, with a stronger focus on energy generation rather than transport solutions. A few days after the negotiations had been terminated, the investment bank of Rolltech plc. sends its invoice for the termination fee that had been agreed and at the same time offers a detailed debrief for senior management to discuss ways forward. The CEO is livid about being presented with such a bill as he has come out of the negotiations with no benefits for the company. While he accepts that this was part of the contract they signed and was thus payable, he continues to rant in the debrief the coming week that now he understands why the investment bank did not really advise him well. He claims that as they were being apid anyway, they had no interest in the outcome whatsoever and should have put more effort in advising him better.

How would you as a member of the team advising Rolltech plc. react to this allegation?

Indicative answer: *Firstly, the termination fee covers only some of the costs of the investment bank and therefore completing the merger would have been in the investment bank's interest as they are making a loss from this deal that never was. In addition, the termination fee is not extra income for the investment bank as the full fee on completion of the deal would have been added on top of the termination fee. The termination fee was set so that it was not in the interests of the investment bank to abandon the deal while the company wanted to continue with it. While in general, there is such a problem and the investment bank might give up too easily, the termination fee was set such that this was not to happen. As much as the investment bank did not push for a completion of the deal which is not in the interests of the company, only to earn a higher fee. This was perfectly balanced with the termination fee that was agreed.*

Problem 13

PrecGlass Inc. has been bought by PrecisionMeasure plc., both supplying laboratories with highly specialised glass and measurement products, respectively. Both, having taken advice from investment banks during the acquisition, are subsequently unhappy about the advice given. While not agreeing on much as the acquisition was not entirely friendly and tension between the business are still high, both feel they have been pressured by their investment banks into a deal that could have been much better. PrecGlass Inc. mainly complains about the way its main shareholders and senior managers have been integrated into the management structure of the joint company and PrecisionMeasure plc. thinks they have overpaid. Both blame their advisors for this situation. After the investment banks both suggested to reject the initial offer, in both cases they wanted to continue to negotiate and hope for a better offer, but the investment bank strongly suggested to accept the deal they finally agreed, on after the first revision.

Can it be that both parties can be aggrieved into accepting deals that could have been improved?

Indicative answer: *It is reasonable to assume that both companies had contingent fee contracts as this is standard and as such investment banks generally push companies to accept deals more readily than is optimal for the company in the circumstances. This could apply to both sides as they have different interests as shown here, such as the price paid and the integration of management structures, both affecting the merger benefits. With other contracts, such as conditional fee contracts or fixed fees, the investment bank would have advised them to accept the first offer, while here they suggested to reject an offer that was very likely to improve. While there is a clear conflict of interest, the contingent contract minimises it.*

Problem 15

The CEO of Hammond plc., a national house builder, has been in very preliminary talks with the CEO of Paring plc., a competitor, about a possible merger. Both have signalled interest and decided to take things to the next level. Presenting this state of discussions to the board of Hammond plc., the board is critical about employing an investment bank for advice. Some members state that of course the investment bank will advise us to go ahead with the merger, it's how they make money, whether it's good for the company or not.

Are they correct in their criticism of investment banks' incentives?

Indicative answer: *Investment banks have an interest in companies completing deals. To achieve this, they will advise to accept offers that a company itself would not want to accept but would prefer attempting to negotiate better conditions. They do so as with longer negotiations their costs increase, this might include having to decline giving advice on other deals as their resources are bound, while not obtaining higher fees, or even putting the currently agreed fee at risk if a better deal is not agreed and the merger abandoned. However, these conflicts of interest are minimized through the use of contingent fee contracts. Here the investment bank also benefits from increased merger values as their fees increase accordingly. While there are incentives to suggest to companies they accept conditions that could be improved on and where it would be beneficial for companies to hold out for them, the contingent fee contract limits the extent of this issue.*

Problem 36

Spice & More plc. has recently acquired a competitor and while integrating this company into their own operations, they discover that there are significant problems with the ability of their customers to pay outstanding invoices. The wide customer base was one of the main reasons for the acquisition. Given they have made it clear to the investment bank advising them that this was their main objective, they are unhappy with the advice given by the investment bank to proceed once they had conducted a due diligence assessment of their competitor in confidence. The CEO of Spice & More plc. in particular points out that the way the investment bank is paid, provides the investment bank with strong incentives for the acquisition to be completed. He points in particular to a clause where the majority of the fee is payable to the investment bank only if the acquisition is completed, while only a small break-up fee would be payable otherwise. He argues that the investment bank was driven by their desire to complete the acquisition such that they could obtain their fee, but instead should have either advised on abandoning the acquisition or negotiated a much lower price.

How would the investment bank respond to this complaint?

Indicative answer: *The investment bank should point out that while they receive the majority of their fee income only once the acquisition is completed, they do not have only an interest in such a completion. Firstly, a break-up fee was agreed and that would have allowed the investment bank to obtain some fee income regardless of the outcome of the acquisition. Furthermore, it is not that the investment bank only obtains a higher fee income if the acquisition is completed, but they will also face significantly higher costs. These costs for continuing with the acquisition after the due-diligence assessment are a dis-incentive for the investment bank to continue recommending the acquisition if they think it is not in the interest of their client. These two aspects are optimally balanced to ensure the advice the investment bank gives is honest and in the* *interest of their client.*

Topic 3

Problem 16

Modern Antiques Ltd. buys and restores used furniture and sell these online and in a small number of stores around the country. They have been a family business since they were founded over 30 years ago, but now some family members want to leave the business and in order to prepare for an envisaged expansion of their business, they seek a listing on the stock exchange. They are a well-recognised name in the furniture business with a solid outlook, steady income, and their expansion of the business is generally seen as a positive move. In preparing their forthcoming public offering, they have been meeting with their investment bank and been told the usual procedure is to gauge the market interest through book building, and based on the feedback returned there, set an offer price. This offer price would then be guaranteed by the investment bank. Thomas Asburton, the majority shareholder and CEO, is surprised by this procedure. Sounding a little bit annoyed he says to the investment banking team he meets with: "So, I pay you a lot of money to underwrite these shares, but you do only do so once you know that it will sell at that price? This sounds like a great business model for you, buy what you already sold and then charge a big fee on top. If you just sound out the market, you are not doing anything, I cannot see why that is good for us."

Being in the investment banking team, how would you respond?

Indicative answer: *Book-building is in the interest of Modern Antiques Ltd. as that way we can gauge the full market demand. If we do not know for certain the market demand, which we will not if we have to rely on our inferences of investor interest alone, we will have to set a price which guarantees to sell all the shares based on those inferences. We will have to deduct a safety margin from the price to cover any potential losses. This safety margin is not needed if book-building is used as we base this on actual demand. Therefore, you should receive more for your shares. The fee covers our work, which moves from analysing the market demand to trying to sell your company to investors and creating this demand. This involves much less uncertainty for us and you if we base this on actual demands. Thus your company benefits and the final firm commitment contract is your final insurance in case something unexpected happens in the market during the last few days between closing the book-building and taking actual orders.*

Problem 19

Hoffmann Ltd. has appointed a lead underwriter who now seeks to assemble a syndicate to ensure a wider investors base can be reached. To this effect, members of the team at Hoffmann Ltd. pressure their lead underwriter to increase the size of the syndicate from the proposed five investment banks. They argue that by including more banks, they could reach a wider range of investors, making the issue more successful, even if it costs them a bit more to compensate for the larger number of investment banks involved. The lead underwriter resists this move and points out that this would be counterproductive to the issue. Hoffmann Ltd. is accusing their investment bank of refusing to increase the syndicate size so they can obtain a larger share of the fees and it is purely for the investment banks' own benefit, rather than improving the success of the issue.

Is the lead underwriter right in suggesting to limit the syndicate size to five members?

Indicative answer: *Increasing the syndicate size, also increases the moral hazard of investment banks in that they may not put the requisite efforts into selling the issue to potential investors. With their contribution to the success being small, they may want to free-ride on the efforts of others and as all banks think alike, the overall effort level will decrease. This can then well have the effect of the revenue raised from the issuance of the security to reduce.*

Problem 20

Ramsey Inc. is a family-owned business mainly specialising in the production of pipes for chemical plants and power stations. Having grown significantly in recent years and seeking to expand overseas, they have decided to raise capital through a listing on the stock exchange. In preparing for the first steps in the process, the board, consisting of 7 family members, has to decide on the approach to appoint an investment bank as underwrite for their issue. Having very little knowledge of the procedures involved, never having had dealings with investment banks before, and a relationship with a commercial bank that does not offer underwriting services, they do not know how to approach an investment bank. During the discussion, quickly two factions emerge, one wants to appoint a single underwriter but have them compete for this business through a tendering process, while the other faction wants to approach an investment bank exclusively, which they have heard lots of good comments about, but because of their limited size, suggest this investment bank should form a syndicate with other banks.

Which approach is preferable?

Indicative answer: *Both approaches are not optimal. A single underwriter, as was noted, might not have sufficient contacts with investors and many potential investors might be left out, resulting in issuing the shares at a price lower than could have been possible. Here a syndicate, if not too larger to avoid moral hazard in making an effort, might well be beneficial. If putting the underwriting out to tender, the uncertainty for investment banks participating as to who obtains the contract, will result in sub-optimal search efforts and hence not all investors interested in the shares will be identified. This will also lead to a lower than necessary price for the issue. Hence neither approaches are optimal, though the losses from which approach is higher, cannot easily be determined. It is preferable to appoint an investment bank directly as lead underwriter and let them appoint a syndicate, avoiding both problems leading to lower search efforts.*

Problem 37

Gerhard Bank AG has been hired by Inform GmbH to manage their initial public offering. During the first meeting between the investment banking team and the working group from Inform GmbH managing the process internally, the investment bankers explain in detail the process of going public from this point until the shares are listed on the local stock exchange. When explaining the book-building mechanism they seek to employ, the Chief Financial Officer of Inform GmbH interjects that this sounds way too complicated to him. Why does Gerhard Bank AG go to such great lengths of determining the price and share allocation if all that is needed is an auction platform for investors to submit bids. Similarly, why do banks buy the shares first and then sell them on just a few days later, this seems an unnecessary step.

How would you explain the advantages of the processes typically followed in underwriting?

Indicative answer: *The processes investment banks follow serve two purposes, firstly to minimize the conflicts of interests between investment banks and their clients and secondly to maximize the issue price, while still selling the full issue. Investment banks need to attract investors to subscribe to the issue and to this effect they make use of their contacts. Making use of their contacts will be costly and they need to ensure that investors provide any interest in the issue truthfully. The costs associated to investment banks when contacting potential investors can lead to a moral hazard situation where the investment bank will not exert the level of effort that is optimal for their client, the issuer of the security. The contractual arrangements ensure that the investment banks exert optimal effort levels form the perspective of their client, while at the same time the book-building mechanism has been shown to generate the highest issue price for the client.*

Topic 4

Problem 22

Longsoft plc. has recently gone public and generally the offering has been judged a success with high investor demand and a price realised at the upper end of the initial estimate. At the debriefing a week after the listing, Longsoft plc.'s team complain about the high level of underpricing. Having seen the allocation, they see that the investment bank benefitted a range of long-standing clients that have a known allegiance with their lead underwriter. Their stance is that those investors should have paid more and the investment bank has been giving them free money at their expense. The underwriter points out that while these investors are loyal clients of theirs, they are well informed and would not participate if they do not obtain adequate returns. On being prompted to justify how a return of nearly 30% would be adequate rather than excessive in a market where annual returns are about 10-15%, the investment bank representative looks around his team in search for an answer.

How would the lead underwriter justify the underpricing?

Indicative answer: *The underpricing is needed to provide an incentive for such informed investors to reveal their information correctly. Informed investors revealing their interest in the shares will cause the issue price to be higher. Thus, there is an incentive to not reveal the information they have and that way the issue would be priced lower and informed investors could then pick the shares up in the IPO at a lower price. The underpricing, and the allocation of shares that goes with it, is their reward for providing this information truthfully. It benefits Longsoft plc. as the issue price was higher than it would otherwise have been.*

Problem 23

Sterling & Co. is a boutique investment bank specialising in the issuing of fixed income instruments to issuers from smaller and emerging countries. It has a range of investor contacts, ranging from highly sophisticated hedge fund managers to wealthy, but not very informed, individuals. One such wealthy individual, Jorge Sobrano, has recently changed his broker to Sterling & Co. and on this broker's advice participated in a zero-bond issue by a large government-backed road construction company in a developing country and he was allocated a large amount, his full subscription. Shortly after the bond starts trading, it falls below its issue price and Jorge Sobrano complains to his broker about being used by Sterling & Co. as a dumping ground for bad issues. Also, he adds, he had never his full subscription being honored, only now when he makes a loss.

How can you convince Jorge Sobrano that this is an unfortunate start to their relationship and how will you seek to maintain his custom?

Indicative answer: *Some issues are turning out to be less popular than we think and in this case many of our traditional clients were choosing to not buy the bonds. This will then inevitably lead to customers who do not share that view being allocated a larger fraction of the issue, as in your case. While this might look like the bonds have been dumped, this is not the case, the investment bank believed in the value, but unfortunately was mistaken. However, there will also be more successful bond issues in the future, and those issues will be over-subscriped. This will allow the investment bank to allocate the bond also to Jorge Sobrano, allowing him to recover the losses just made.*

Problem 29

Looking at the trading in the first few days after an IPO, you observe that more underpricing is commonly associated with more trading volume, but also with stock prices that fluctuate less. As you work in the newly set-up department for investor relations of Abbott Ltd. and prepare for the upcoming IPO of the company, you suggest in a meeting with senior management that they should aim for very little underpricing. The benefits in terms of trading volume and less fluctuations for the stock price does not really affect the company at all, while underpricing costs money. In addition, you question how there can be a relationship between underpricing and trading, as stock markets are difficult to predict. The investment banks that have joined the meeting, look down on their papers as you make this remark and hold back laughing.

Why are you wrong in your assertion?

Indicative answer: *Firstly, underpricing and trading volume are connected. A high underpricing will result in many investors losing out on the allocation of shares, but many would be interested even at the higher price and seek to buy, while others that have been allocated shares do not value them highly and would be willing to sell.*

The higher the underpricing, the more such investors are found and hence the more trading occurs. This trading results in lower volatility, which reduces investor risk, and therefore investors will require a lower risk premium, which reduces the cost of capital of companies, making them more valuable. Thus companies benefit from it. Of course these benefits have to be weighed against the losses from receiving lower proceeds due to underpricing.

Problem 38

The Competition Commission investigates the behaviour of investment banks in IPOs. They have heard the view of companies who have recently gone public that underpricing to them is equivalent to an additional fee they have to pay and which is not detailed in the underwriting contract. One company director suggested that investment banks should issue the stocks at their full value and instead charge a higher fee for their services. This way the costs of going public would become more transparent to companies.

Would this suggested transparency work?

Indicative answer: *Underpricing does not directly benefit the investment bank, but those investors that subscribe to the issue and are allocated shares. Hence, while it might be seen as a fee by companies, it is not a fee that is paid to investment banks. Of course, most shares are allocated to investors that have provided the investment bank with information during the book-building process and are duly rewarded with an allocation of shares. It can be argued that investment banks should pay these investors out of the underwriting fees they charged companies, rather than relying on underpricing. But underpricing has a number of additional benefits, it reduces the threat and costs of any legal actions against the investment bank and/or the company, enables a liquid market in the stocks from the start of the listing, and can attract investors to weaker IPOs that would otherwise not be successful. These benefits could be included into the fee investment banks charge, but they would be cumulative, rather than allowing them to occur concurrently. This reduces the overall costs to companies and thus underpricing is an efficient mechanism to ensure a successful IPO.*

Topic 5

Problem 42

Contex plc. is a leading provider of technology for contactless payments. Their business is going strongly and they have attracted a number of analysts providing positive coverage of their prospects. The head on the investor relations team that is also the first point of contact for financial analysts seeking information about the company, is overall very satisfied with the reports published by the analysts. There is, however, one analyst whose reports, although overall positive, are consistently much less upbeat than any other analyst report. He puts this down to some bad blood between the investment bank this analyst works for and the CEO of Contex plc. After a dispute over advice received in an acquisition a few years ago, he has made it clear to that bank, they as long as he has any say, they will never again advise the company on any transactions.

Is it correct to attribute the less positive coverage to the dispute on previous advice?

Indicative answer: *The investment bank the analyst concerned works for has no prospect of obtaining future business from Contex plc. As usually companies prefer positive coverage and by giving future business to those most positive about their prospects, they incite analysts to be more positive to gain this business. In this case the incentive to seek future business from the company does not work as they have been excluded by the CEO from any such business. Consequently their reports will not be that positive as that of others seeking such business. Therefore, the less positive coverage of the analyst is not a revenge on Contex plc. but the consequence of not being considered for future investment banking business.*

Problem 43

Looking across analyst reports and comparing their recommendations as well as forecasts, you notice when comparing the affiliation of analysts with investment banks, that if investment banks had been advising a company on any transaction in the last few years, the reports were usually more positive than those that did not advise the company, even though these were still more positive than would be justified by subsequent performance.

Are you right to attribute this observation to the fact they have been advising the company recently and the overall positive, although less positive, coverage of all the other analysts to their hope of advising the company in the future?

Indicative answer: *It is not the past business that drives this result, but the future business that might be gained. Investment banks that have been used in the past are most likely investment banks that will be chosen in the future again. Hence, to make themselves attractive to the company, these banks issue reports that are overly positive. This would be the case whether they had advised the company in the past or not. Thus any investment bank seeking the business of the company should be submitting overly positive reports. In addition, all analysts rely on access to the company to gain more information for a better assessment of the company. If such access is more easily given by companies if the coverage is positive, they will bias their reports accordingly. This will bias the reports of all analysts, while those seeking, or having a realistic chance of gaining future investment banking business from the company, have an additional incentive to provide positive coverage, leading to an even more biased view.*

Problem 45

Priska Romain is the CEO of SwissMade Plc., a holding company with a portfolio of Swiss-based producers covering the high-end of the market, such as mechanical watches, medical equipment, and specialist construction machines. During a rather informal meeting with financial analysts and journalists at the reception held for the opening of a new headquarter, she responds to questions how it is that her company is consistently underperforming the predictions of analysts. In her reply she embarrasses the present analysts by stating that if their employers would not tout for business by trying to please her with ever more upbeat public statements, they might be a bit more realistic in what can be achieved. Another problem, she says, is not only that they try to be unnecessarily positive, but that many analysts seem to have very little understanding of the company and do not understand much of the industry she operates in. So going back to study those finance and strategy book might improve things. A junior analyst says that they are not paid for the business she gives to his bank, but his and other pay packages are purely based on the quality of their reports. Priska Romain, laughs and says that in that case he probably should pay the bank to work there. Before turning away, she says, in the old days it was analysts like you openly vying for business and I am sure you were on a bonus if I signed up, but things have not really changed since then.

Can you explain why the quality of reports seems unchanged despite the changes that have occurred?

Indicative answer: *Banks used to base the pay of analysts on their contribution to gaining investment banking business through positive reports that attract companies. The change that is referred to, is that payment can now only be based on the performance of the financial analyst in producing reports. However, banks have changed the way contracts are structured such that while formally they are only based on the quality of analyst reports, they provide exactly the same incentives as the old contracts, so the quality of financial analysts has not improved.*

Problem 48

Constantin Bulgakin is a financial analyst providing coverage for a range of companies in the pharmaceutical industry. Due to regulatory changes, his employment contract has been amended and rather than obtaining a fraction of the revenue the companies generate for his employer, he will only be rewarded for the accuracy of his reports. He fears that this new arrangement will lead to a reduction in his remuneration and he will lose access to companies that he relies on to provide him with information for his reports.

Are these concerns justified?

Indicative answer: *The investment bank can structure his contract such that his remuneration will not change overall. Using a high base salary that is commensurate with his current remuneration based on the amount of revenue his contacts to the companies generate, he will not be worse off. He will not lose access to companies as they would still want to relay information to the analysts covering them, in exchange for positive reports; this will also ensure that he obtains sufficient information to provide reports that are as accurate as previously.*

Topic 6

Problem 52

Jérôme Cheniers is the head of the treasury department of an internationally operating company. In response to ever more restrictive practices in many countries to increase the tax businesses pay, he has relied on new financial instruments developed by their investment banks to shift revenue and profits between jurisdictions and across different time periods legally. As the company has grown considerably in the last few years, thought is given to establish a link with larger investment banks to reflect the wider needs of the company. Jérôme Cheniers objects to this suggestion, remarking that the smaller investment bank they currently deal with are providing them with excellent service for his department. In his experience, larger investment banks are much less innovative, having less of a big vision, and instead develop any innovations only slowly and in a piecemeal fashion in many steps, depriving them of a lot of the benefits the full innovation would have had.

From his perspective, is Jérôme Cheniers right to object to engaging larger investment banks?

Indicative answer: *Larger investment banks more often than not divide innovations up as that maximizes their profits. This is because larger investment banks do not seek to attract that many new customers through their innovations and can therefore seek to extract more surplus from their customers. Thus the company has to constantly update their instruments to take full advantage of the innovations, which makes them more costly. However, large investment banks also buy innovations from smaller competitors and as such might be able to offer innovations that other banks have developed and to which the smaller current investment bank would have no access. Thus the costs to the company might well increase and benefits be more staggered, but it also opens up the possibility of gaining access to a wider range of innovations.*

Problem 53

Nisa Chanda has taken over the family business, EduChan Ltd., providing outsourcing solutions to education providers, such as schools and colleges, but in some cases also universities. To improve knowledge of local requirements, EduChan Ltd. has set up a network of subsidiaries in its main markets. This has complicated the management of the company considerably as now many rules and regulations have to be followed, but it also allows innovative ways to finance their business by tapping into local resources that had thus far not been available. Given the complexity of the issues on hand, advice would be required on these issues. For this reason and an immediate need to hedge the revenue from a large new contract, Nisa Chanda has thought about seeking more advice with an investment bank. From her family, many sitting on the board of EduChan Ltd., she gets conflicting advice. Some suggest that she should always go to the investment bank that is best for the specific circumstances as they all have different expertises, others say that having a single investment bank to go for is better. There are also those advocating to use a small boutique investment bank as they provide better service and EduChan Ltd. is not big enough to be of interest to the market leaders, while others suggest to at least try the market leaders as they have better all-round knowledge.

Focussing on the current needs of EduChan Ltd. in the area of seeking innovative solutions in managing the financial and regulatory aspects of their expansion, how would you advise Nisa Chan?

Indicative answer: *Different aspects need to be separated here. Firstly the question of transaction banking compared to relationship banking and then the question of small or large investment banks. On the subject of relationship banking, we know that banks who engaged in relationship banking extensively will in general be more innovative. The reason is that the relationship with customers allows them to recover the costs of developing innovations from other business these customers provide and also makes the loss of a customer to a competing bank more severe. Hence, while EduChan Ltd. could engage in transaction banking, it would be beneficial to seek out banks that otherwise are mainly engage in relationship banking. In terms of the size of the investment bank to choose, smaller investment banks might introduce innovation faster rather than stagger them to extract more profits from their customers. They do this as their size makes gaining new customers less likely than for small banks. But on the other hand, they might be able to buy up innovative solutions from other smaller banks, so can potentially have access to more innovations they can offer their customers. Thus the answer is not straightforward and these two aspects need to be balanced.*

Problem 55

Connor Strange has grown up in a family of considerable fortune from a number of businesses. Having shown neither aptitude nor interest in running these businesses, he has happily agreed for his sister to take over once their father retires. In return for this arrangement, he has been given a lump sum to provide him with a good living.

Having no experience of investing and on the advice of his father, he has instructed Forlong & Sons with the management of his wealth. Having his annual meeting to discuss the arrangements Forlong & Sons have made and any changes for the future that might become necessary, Connor Strange is surprised to hear that the last year had been rather difficult in investment terms and while his wealth did not decline, the return generated was very low. When questioning that, he is told that in the interest of long-term growth, they had invested into some more risky stocks, and this did not pay off as many lost value this year, but, so the advisor re-assures him, this is likely to reverse. Connor Strange looks at him puzzled and says that he remembers well from last year that they agreed to not take any unnecessary risks as that was not to his liking. He tells his advisor to reduce the risk for the coming year, but is assured that his perception of the risk is exaggerated as they have much better information on these stocks and it appears much more risky to him than it actually is.

Unconvinced, Connor Strange leaves the meeting to think about his response. Is it that the higher risk he perceives is due to him having less information or does the bank take excessive risks?

Indicative answer: *If the bank has more precise information, they will invest a larger fraction of the wealth into these risky assets than an investor without such information has and the investment would appear to be more risky, even though it is not. However, banks generate their income from the performance fee they charge customers. Thus they are interested in a high return, which is associated with a higher risk. Therefore, banks have an incentive to increase the risks of investments they manage. His perception of the risks taken is higher than it is to the informed bank, but in addition they take on more risk such that risk ntaken, even adjusting for the superior information, is higher than he feels comfortable with.*

Problem 56

Having taken responsibility for the investment of the family trust from his uncle, Sibolu Arassawake considers next steps. His uncle had over many decades managed the investments successfully and had considerable knowledge in such investments, but his ill health does not allow him to continue this role, nor to teach his nephew the required skills. Therefore, Sibolu Arassawake's first thought is to seek out an experienced asset manager to perform most of the duties, allowing him to focus on developing the general principles on which investments should be based, such as the family's commitment to environmental concerns and human rights. In a discussion with his uncle on handing over the role, he remarks that Sibolu Arassawake could instead manage the investments himself, he always got tips from his bank when buying or selling assets. That way he would retain much more control and it would be cheaper, too, as the advice comes free.

Investigating the brokerage fees a full-service broker would charge, and comparing this with the fees of asset managers, shows that based on average returns, the asset manager is actually cheaper. Why are the broker fees more expensive and is it therefore better to engage the asset manager?

Indicative answer: *Brokerage fees of full-service brokers will include a surcharge for the value of the information they provide, making the information they provide not free, but paid for by a relatively high broker fee. This higher fee is not paid by the asset manager as he does not require this information, having conducted his own analysis. While the asset manager may look cheaper, they will manage the assets as to maximize their own profits, that is the fee income. This leads to an asset allocation that is more risky than the customer usually would find acceptable. Hence the lower costs will come at a price. Seeking the advice of the bank and then conducting the investment separately, Sibolu Arassawake could obtain a level of risk suitable for the family's preferences.*

Topic 7

Problem 60

You are working at the trading desk of a leading investment bank and have performed well for many years. During your annual review, the topic of additional training requirements comes up. Having gone through lots of training since starting in your role many years ago, you have not seen that your performance has increased. Nor is there evidence that traders at other banks have caught up with your skills. Therefore you suggest that no training is required, benefitting the bank in saving money for these expensive courses and gives you a few more days to generate profits for the bank.

Your manager rejects your suggestion and says that if you do not maintain your skills, you will soon generate less profits for the bank. Is he right?

Indicative answer: *With additional training probably sought by all traders, the benefits of such training will be low, probably outweighing the costs. However, not keeping your skills up while other traders do so, will expose you to fiercer competition and you will generate less profits. Overall this is a race for skills in which no one wins, but not participating will ensure you lose.*

Problem 61

Peter Hillier and Nijs van Steen are traders and were hired together by Bell Bros. after graduating from university. While Nijs van Steen has been specialising in trading small companies in emerging markets, Peter Hillier has been allocated to trade US bonds. Having both been successful in their careers, Nijs van Steen has been moved to a contract that sees him receiving a much lower base salary, but also a much higher component of performance related pay, mostly based on the returns he generates. Peter Hillier, however, has not seen a change to his contract and remains on a largely fixed wage with a small performance component only. During one of their after-work meets Nijs van Steen quips that he is clearly much better than his friend and therefore given a better contract.

Is Nijs van Steen right to claim that he must have superior performance to be moved to his new contract?

Indicative answer: *Peter Hillier trades bonds and thus faces much less uncertainty from which he can generate profits than Nijs van Steen, who trades quite high-risk shares. Thus he will be much less able to generate profits, even if having the same skills. Therefore, his skills will generate less profits if he were to leave the trading desk and set up his own trading, allowing the bank to pay him less than Nijs van Steen, who faces high uncertainty and hence high potential profits from trading. These high profits allow investment banks to pay performance-related wages to their staff as that way they only reward highly skilled traders. In low risk markets, such as government bond markets, the profits are too low and hence fixed wages are used, as otherwise highly-skilled traders would not join the trading desk. In addition, finding skilled traders for small cap markets will probably be more difficult than for government bond markets, where much more information is generally available. This reinforces the use of fixed-wage contracts in government bond markets. The small number of low-skilled traders in these markets can be tolerated in a fixed wage contract while with more low-skilled traders, this would be too costly for the bank. Thus, the different contracts are not a reflection of the skills of the two traders but only the different characteristics of the markets they operate in.*

Problem 62

Constantin Navonin has received extensive training over the last three years to change trading desks from trading exotic derivatives to fixed income. His move was motivated by being able to adhere to better working hours after the birth of his first child. After a year in his new role, his existing contract is renewed, as agreed, but he is surprised to find that his new contract only has a small bonus component related to his trading performance, while this was previously a main part of his salary. He feels that during his first year his performance was comparable to his previous role, even though profits generated were less, but he feels the market environment is much more difficult. In addition he has extensive training even during his year and he feels this has improved his skills. He sees his new contract as a punishment for seeking to change trading desks.

Is he right in his assessment of the motivations of his employer?

Indicative answer: *The training Constantin Navonin received, apart from him gaining skills on the new trading desk, will have little effect on his performance and hence remuneration as this is the usual race to upskill by all traders and does not affect the performance overall. Having moved to a trading desk that is much less profitable due to the nature of the instruments traded, there will be less profits to share with traders. Rewarding only highly-skilled traders through bonuses, would not be sufficient to attract these traders in the first place, given the costs of monitoring. Therefore traders at this trading desk will mostly be paid fixed wages, which negates the need for monitoring* *their performance and verifying it.*

Problem 63

Selkirk & Co are a long standing investment bank that have suffered a substantial loss due to the losses accumulated by a rogue trader. He had secretly accumulated losses that were for a time threatening the survival of the bank, but through a lucky turn in the market, this could be avoided with some losses recovered as positions were liquidated. The banking regulator has asked for a complete audit of the internal processes of the trading desks at Selkirk & Co, but nothing was found to suggest that controls were more lax than at other investment banks. The regulator is quite surprised by these findings as they expected to find deficits in the internal processes and in response suggests that banks overall should improve their monitoring of traders by their managers. Having put the suggested improvements out for consultation, the overwhelming response is that the new rules are mainly burdensome but would not change the risk of future rogue traders emerging.

Why is focussing on the monitoring of traders unlikely to succeed and what would have been a better approach?

Indicative answer: *Managers of traders are commonly rewarded for the performance of the group of traders they supervise, thus the incentives to managers and traders are very similar. Monitoring traders to ensure they adhere to rules are not in the interest of managers in this situation as long as breaking any rules will also benefit managers. To provide incentives to monitor their traders, and hence ensure a better compliance, managers themselves need to be monitored. Such an audit of the managers and their efforts in monitoring would align the incentives of managers more with that of the bank as a whole. Even though the managers will still retain an incentive to allow traders to bend rules, this will be much more limited. Thus changing rules on monitoring of traders would not be very helpful, but instead provide incentives to managers to actually conduct their task by monitoring their activities, would reduce the likelihood of future rogue traders emerging.*

Topic 8

Problem 72

Olesa and Jorge have known each other since becoming neighbours during their school years, have attended the same school and studied the same subject at university. Even though they attended different universities, both were seen as providing an education of similar quality. Having lost contact during their student days they are very surprised to see each other again on their first day at work at the same bank. Olesa had secured a role within the investment banking division, while Jorge was assigned to corporate clients in the lending division of the bank. Having both successfully completed the graduate training programme in different locations, they find themselves once again working in the same building, just four floors apart. Catching up after work, it becomes very obvious that Olesa must earn significantly more than Jorge, judging by the flat she rents, the car she owns, and the holidays she has taken in the last year. As the evening progresses, Jorge complains that he believes the bank does not really value him and his work, he feels he contributes much more than what he is paid. And while it is good pay, so he concludes, and others are unlikely to be paid much more than him, he is looking to find employment elsewhere. Olesa suggests he might want to join her side of the business. While she thinks that the hours can be long and the pressure extremely high, the pay more than makes up for that. During this conversation they have been joined by a common acquaintance, who has completed training as a lawyer and been advising banking clients. He throws in that investment bankers do not do really much, they merely take money away from each other or their clients, not adding much value. In corporate lending there is, however a lot of skills involved to manage the loans and indirectly the investments of companies that generate actual profits for the company and bank, without taking it away from someone else. So he cannot understand why banks pay investment bankers so much more.

What is an explanation for this discrepancy of pay between investment bankers and other parts of the bank?

Indicative answer: *Investment bankers and those in lending divisions both create value to the bank by applying their skills to generate profits. The difference is that those in lending divisions do not only benefit their bank, but also other banks and their borrowers. If loans they originated are monitored well and this leads to the investment being more successful, the bank benefits through higher repayment rates but the borrower does so by retaining a larger fraction of the investment outcome, too. Also if the loan needs to be sold, the value created is not fully recovered as the full value of the loan is unlikely to be realised. Thus, not only does the effort of an employee only partially benefit the bank, it could well be reduced if the loan is sold at less than full value and the fruits of the effort only partially recovered. Furthermore, employing additional* *staff might well cause other banks to face a staff shortage and reduce the quality of their loans. If a bank were to buy these loans, they would make less profits from doing so, limiting the benefits of hiring additional staff. The bank will take these aspects into account and hence not be able to fully reward the banker. In contrast, investment bankers fully benefit from putting efforts into their activities. Not only can they increase their profits by having better information than their competitors, but by hiring additional staff they deprive other banks of obtaining improved information, increasing the benefits to the bank of hiring additional staff. Taking this into account, the banks are willing to pay more for investment bankers as they benefit from their skills and from depriving other banks of these skills.*

Problem 74

'Whether you make a career in investment banks is more down to luck than ability and hard work. I know of many people that work very hard and very quickly were sidelined from the well-paying client-facing roles, while others seem to be doing the bare minimum and are rewarded with ever higher positions and salaries. I agree that those who made a career have all performed well, while those that did not get promoted were at the lower end of expectations. In both groups, though, are some that worked hard while others did not put a lot of effort in. It therefore just comes down to luck, being involved in the right deal or avoiding deals that later turn out to be bad.'

This statement is made during a careers talk at university given by a student and addressed to a recruiter from a leading investment bank. Apart from luck, is there another explanation for the observations the student reports?

Indicative answer: *Of course, luck is an element of making progress, as being involved in good deals and avoiding bad deals is even with the greatest foresight not perfectly achievable. However, inherent ability is a strong component as well. In order to succeed in any role, employees need to exert efforts and will do so in an optimal way, balancing the costs of this effort and the benefits it will bring. More effort in investment banks would increase the likelihood of being successful and successful employees are typically advancing their careers. The benefits to the employee is the remuneration the investment bank pays. If an employee needs to put a lot of effort in to achieve an improvement in his success rate, he will typically not obtain a high success rate as the costs of doing so outweigh the benefits. This could be the situation of someone who has a low ability for the role and needs to work very hard to increase his success rate. Hence employees with low ability would not have high success rates and would therefore unlikely to make career progress. On the other hand, those with a high innate ability for their roles would have to put very little effort in to achieve a significant improvement of their success rate. This would then imply that even though they do not work hard, they are performing well and thus are more likely to make a career.*

Thus hard working employees might lack the ability for their roles and despite the hard work, the costs of doing so is too high to achieve the required success rates, while those with high ability do not need to put much effort in to achieve their target success rate. This would also explain that those not working hard are more likely than not to make a career in investment banking, it would only those unlucky to fail to make progress. On the other hand, those working hard will struggle to achieve the success rates possible and often fail in their career ambitions.

Problem 75

Facing a downturn of the economy, trade unions in Thuringistan demand legislation to protect employees from redundancies, unjustified pay cuts and generally a fairer treatment of all staff. Special attention has been given to investment banks, who serve the entire region as a financial hub and thus are an important part of the economy. Trade unions bemoan the differences between those directly involved in banking activities and other staff in banks and elsewhere. They notice that, compared to their productivity, investment bankers are paid more than other professions, and get paid such salaries from an early stage in their career. They feel their pay should be limited in line with their productivity as in other sectors and the money the investment banks save be used for a pay rise of those who are paid less. Investment bankers are also, however, easily made redundant if the bank feels they are not performing sufficiently well. The trade unions suggest that this is due to a lack of training in the early stages of their career and demand enhanced training in all aspects of their future roles, combined with protection from redundancy for under-performance. Only once employees have shown that they are capable of performing tasks should they be allowed to take these up.

Representatives of investment banks dismiss the demand by trade unions and point out that it would make them unable to compete with investment banks elsewhere and in general harm the performance of the banks and ultimately their ability to provide jobs. What is the basis for their claim?

Indicative answer: *Investment banks have to pay more than the productivity (marginal product) employees produce as competition for high-ability employees means that banks do not only benefit from the ability of the employee, but also reduce the ability of other banks. Other banks could thus benefits from increasing the quality of service they provide, increasing revenue, and reduce the quality of service the original bank could provide, giving them an additional advantage in the market, potentially increasing revenue even further. Not being able to pay employees above their productivity would mean that foreign banks could easily outbid us and the best employees would leave. Similarly, additional training and therefore limited salaries, makes investment* *banking in Thuringistan less attractive. The reason is that giving employees responsibilities early on allows them to show their ability and work hard to generate income for the bank, but they are also highly rewarded for this. Joining an investment bank without taking on these responsibilities and instead relying on being promoted to them, makes employees exert less effort and the bank overall will perform less well. This will limit the ability of investment banks to pay well in international comparison, but also make employment in other countries more attractive as early career employees can earn higher salaries. The downside is that unsuccessful employees cannot continue in their roles, but this provides an incentive to work hard and as mentioned, is adequately rewarded.*

Problem 90

During a discussion on employment rights, the discussion has drifted towards the level of compensation employees receive, especially in the financial services industry. Simon Baker, advocating the rights of manual workers, cites a study in which investment banking pay is highest for those working in mergers and acquisitions advisory as well as proprietary trading, while the lowest pay is in underwriting, when measured against the revenue generated. He uses this finding as evidence that pay in investment banks is heavily skewed in favour of those adding no value but just buying and selling companies, while value-enhancing roles are not rewarded accordingly.

How could a representative of the financial industry justify this difference in pay?

Indicative answer: *Proprietary trading as well as advice in mergers and acquisitions is a zero-sum game between investment banks. If a higher price is paid by one bank, or their clients, another investment bank reduces profits by having to pay a higher price, be it in proprietary trading or if the company advised by the investment bank is a bidder in a merger. As information and expertise in interpreting this information are a central element to generate profits, investment banks would not only lose that expertise if an employee takes up a position at a competitor, but would then also be in a worse position if that employee uses his expertise against his previous employer. To prevent such defections to competitors, investment banks pay high compensation. In contrast, in underwriting, no such situation arises. The expertise, if lost to another investment bank would result in a lower level of expertise at that investment bank, but it would not be used against them by their former employee. Therefore, these additional costs do not need to be considered when setting the compensation of their employees in underwriting, resulting in lower compensation.*

Topic 9

Problem 80

Norris & Partners is one of the oldest investment banks, having been established in 1758 as a merchant house importing tea, coffee and spices from all over the world. It quickly expanded to finance the import of such goods by other merchants and in the early nineteenth century gave up the importing of goods focussing on financing other merchants. In the mid-1800s their business changed again in light of the industrialisation and they commenced activities that today would be described as investment banking. It was not until about five decades ago that the bank was re-organised as a partnership to include non-family members in an expansion drive. This era has now come to an end and it has been decided to transform Norris & Partners into Norris Bank Ltd., abandoning the partnership structure. This move has surprised many industry insiders as Norris & Partners has not been expanding its business and is thus not in need of fresh capital to require this move. The reasons they give is that recently they have struggled to attract high-calibre applicants to their bank, despite having an excellent name in the industry and offering competitive salaries for these more junior roles. While applicants are in no short supply and many of these looking promising recruits, very few fulfilled the high expectations, despite additional support and training put into place. In addition, of the five staff members that were offered partnerships, only two accepted the offer, both of which were not their first choice candidates. In light of these problems, they decided to abandon the partnership structure.

What is the rationale for Norris & Partners to abandon the partnership?

Indicative answer: *The current situation suggests a twofold problem. On the one hand, they seem to have problems in recruiting staff that is able to generate high profits to the bank. This has a direct effect in diminishing the differences between those able to generate high surpluses and those generating low surpluses. By making these differences lower, the bank will struggle to maintain the quality of partners as evidenced by not appointing their first choices. This will in the long run be detrimental to the quality of the work the bank can offer. A second effect is that the costs of training and development of new staff members have increased. This means that facing such costs, many potential partners may refuse the offer of joining the bank as partners, as the costs they have to bear training new recruits might be too high. The lower skills of the newly appointed partners will also have the effect that the resources available to generate profits and fund the requisite training will be reduced, reducing the threshold in term of costs that can be incurred in this training. All these points taken together suggest that Norris & Partners will in the future struggle to maintain the quality of partners at the current level. The lack of truly high-quality applicants suggests that the prospect of becoming a partner is much less enticing than before, further deteriorating* *the situation.*

Problem 81

Remo Suter is the CEO of Suter Mechanics Ltd. a specialist provider of precision-machined parts used in a wide variety of applications requiring low tolerances, including space exploration, submarines, but also medical apparatuses. Over the years he has expanded his business through the acquisition of a few competitors but also bought into suppliers of tools his company needs. The specialist nature of his business is not well understood by many and the small market in which he very successfully operates in, is often not considered to be sufficiently different from other markets that provide specialist parts to industries like train or car manufacturers. Having sought advice on structuring and financing previous acquisitions, he has become frustrated by their lack of skills and knowledge that he needs to make most of the advice they provide. He appreciates that in his line of business a lot of random factors might influence decisions that are generally not foreseeable and any advice might easily be outdated by events. When he approached some of the leading and even second-tier investment banks, he often has been turned down with the unconvincing argument that his business does not fit their expertise. A friend suggests to try a boutique investment bank instead, he would deal with senior partners who actually own the business rather than employees generating money for anonymous shareholders. Remo Suter points out that he has heard that these type of banks are usually more expensive and he doubts they will be any better, if they even take him on.

How would you argue that he nevertheless gives these boutique investment banks serious consideration?

Indicative answer: *The boutique investment banks in question are partnerships, while previous investment banks used were shareholder-owned. Partnerships usually provide better services as the staff hired is overall more highly skilled than in shareholder-owned investment banks as they have larger stakes in their banks and thus ensure higher quality services. They will charge a higher fee for these services, but this is justified by the service quality. Furthermore, boutique investment banks might not turn down businesses that are operating in unusual markets and markets that are more subject to random fluctuations. The reason is that the higher service quality will still allow them to remain profitable and offer advice, even if often the quality of their advice is not easily appreciated and they can only charge a relatively low price for that reason.*

Problem 83

Commercial Bank plc. has in recent years expanded its business by acquiring a number of smaller investment banks and has grown this part of the business through promoting their use with its existing borrowers. Part of the investment banking business is a trading desk that has been the backbone of the investment banking division by providing the majority of profits as the business grew. Now, however, it has accumulated large losses that, although not threatening the survival of Commercial Bank plc., have lead to the board questioning the strategy of engaging in investment banking at all. While many arguments for and against this strategy have been made during this discussion, a non-executive director without any meaningful banking experience, Constantin Ionu, remarked that banks in any case should not be run in this form. On receiving looks that show no one understands what he means by that, he elaborates that he thinks banks should not be owned by shareholders, but senior management should take more personal responsibility for their actions. He continues that the biggest mistake was that in the mid-nineteenth centuries banks were allowed to be set up as joint stock companies rather than as partnerships run by senior managers with significant stakes in the bank. After all, he kind of concludes, investment banks used to be run like this until recently, and were very successful with that model. His remarks are mostly ignored and the discussion carries on.

Would a return to partnerships for commercial banks be a good step?

Indicative answer: *Leaving apart the capital requirements of modern commercial banks that would require a very large number of partners to be viable, there are merits in having a bank organised as a partnership. The stakes of the partners ensure they are providing higher quality services to their customers. While this might not directly affect loan and deposit rates in commercial banks, the other services might be improved and thereby higher fees might be charged. However, whether this leads to an increase in profits is debatable. Investment banks usually provide advice on transactions in a highly volatile environment, making it often difficult to judge the quality of advice received as the environment can change unpredictably. On the other hand, commercial banks will provide services such as payment facilitation, access to funding, and similar that are much easier to assess. In such a situation, the value of services is apparent to customers and the fee they can be charged can be close to the value it provides, giving banks high profits even if the quality of service is not very high. The fees of investment banks however, will take into account the uncertainty on their quality and to generate profits they will have to rely on the higher quality of services in general to generate profits. Thus the lower cost base of commercial banks due to lower capital held, should give shareholder-owned banks an advantage over partnerships. Given the uncertainty of the quality of investment banking advice, the higher quality might be needed to achieve profits and partnerships might be more profitable. In contrast to that, we could argue that training investment bankers is much more time-consuming and hence costly than training commercial bankers as the envirnment they operate in is much more stable and less aspects are to be considered. These higher costs of training employees in investment banks might make them less attractive for partners and could be behind their demise. The lower costs would make partnerships in this respect more* *viable in commercial banking. But then, given the lower level skills generally required, the benefits of having this training and being highly skilled might not be sufficient to maintain partnerships with high-calibre partners.*

Problem 93

Salcombe Ltd. are looking at a listing on the stock exchange and seek to appoint an investment bank as advisor for this transaction. The CEO of Salcombe Ltd., Carl Salcombe, suggests to investigate only boutique investment banks as they are usually providing better advice. He links this to the fact that the senior management are commonly partners in the investment bank and as such have an inherent interest in providing high-quality advice. Furthermore, their small size makes it necessary for them to specialise in an specific area, such that their level of expertise will be more focussed than that of the larger bulge-bracket investment banks. His son, Simon Salcombe, is against this suggestion and argues to foremost consider larger investment banks as they are able to provide them with not only advice in the planned listing, but in most other future needs they might have.

Whose argument can you support?

Indicative answer: *It is true that boutique investment banks are often organised as partnerships and this provides incentives for a higher level of expertise due to the direct participation of partners in the profits generated, as well as the desire of associates to be promoted to partner. As noted, these investment banks are often specialising in a niche market while larger investment banks will cover the entire spectrum of services. If the future needs of Salcombe Ltd. are different to those currently, the chosen boutique investment bank might not be able to meet their needs and they would have to seek the services of another investment bank. This imposes switching costs on the company, such as the need to build a new relationship with a new investment banking team, proving additional information, or delayed decision-making by the investment bank as they are unfamiliar with the company. These costs have to be balanced against the better advice that might be provided for the current transaction.*

Topic 10

Problem 85

Siversky Bank, an investment bank specialising in companies in the defence industry, has lost a number of senior managers on the back of a few years making significant losses in proprietary trading operations and the subsequent lack of bonuses at higher levels. The departure of the most senior managers, who were all highly regarded in their areas of expertise, has also led to many less senior managers leaving the bank. With the injection of fresh capital, Siversky Bank has been able to hire a number of new senior managers, however, they are much less experienced overall and have less knowledge about the markets that Siversky Bank mainly operates in. One of the first tasks of the new management is to re-organise the bank's management structure. They replace the old system in which at all levels managers were highly involved in any decisions and deals, to one in which teams of employees work together with clients and senior management does not interfere in the process. Many intermediate management positions are not being replaced in the process and the new senior management team sees itself as ambassadors of Siversky Bank and their role as that of acquiring new clients.

What might have caused this re-organisation of Siversky Bank?

Indicative answer: *The expertise of the old senior management made their contributions to client advice highly valuable, but the lack of experience by the new managers with the specific type of clients, would make their contributions much less valuable. It is even reasonable to suggest that the staff working with clients is more knowledgeable in these specific roles than senior managers. Therefore, excluding senior managers from client work will not reduce the quality of the work, but might give the more knowledgeable staff a greater say in the advice they provide to clients. This therefore will result in a flatter hierarchical structure as previously.*

Problem 86

Angeley Bank Ltd. is a new investment bank that has been set up by a small group of investment bankers from various leading investment banks. They have assembled teams of staff that have been selected carefully from the owners' previous roles and that largely share their outlook as they have been former or very recent mentors of the staff they hired. In the industry, Angeley Bank is very quickly highly regarded in their niche of advising clients in developing countries due the standing of their owners as well as the similar calibre of the more junior staff they could convince to join them. Despite their outstanding reputation from the start, the number of deals they advise on in the first months after setting up, is relatively low. At various stages of advising the few clients, the founders and other employees appointed to more senior positions at Angeley Bank are all involved in developing such advice. Having been carefully selected, junior staff respect senior managers and the founders highly, keen to learn from their suggestions and ideas to improve their own skills. Seeking to recruit more widely and expand their expertise, potential junior staff are reluctant to apply once they learn more about the way Angeley Bank operates.

Why is Angeley Bank less attractive to junior staff than other investment banks?

Indicative answer: *It seems that senior management is highly skilled and their suggestions is valuable when developing advice to clients, making their involvement beneficial. This is because they have the expertise in the narrow area of knowledge that is required in their market, which is in contrast to other investment banks. At most investment banks, senior management will lack the subject specific knowledge required to provide good advice to clients and hence their involvement will be much less beneficial. Granting more autonomy to junior staff is justified in those cases, but here a more centralised structure will be preferable. With the devotion of the current junior staff to senior managers, there will not be much reluctance to implement any suggestions they make, meaning there are virtually no conflicts of interest that would hamper implementation of advice not developed by junior staff. Additional hiring will be outside of the confines of staff having a close relationship with the existing management, meaning that they would feel reluctant to accept decisions that have been made by management. In most investment banks, for this reason, junior staff are given freedom to develop and implement their own advice. That this is not possible to the same extent at Angeley Bank, will make it less attractive to new staff members, unless additional rewards are offered.*

Problem 87

Walton plc. is a mid-sized investment bank that until recently enjoyed a good reputation in advising smaller companies in going public. Companies seeking their advice always liked the close involvement of a number of senior managers in the development of their IPO strategy. However, over time clients became less and less satisfied with the outcome of their IPO, often citing that the advice given by senior managers was not good and many have been recorded mentioning that more junior staff members were often overheard discussing alternatives that, in retrospect, would have been preferred. In receiving such feedback, Walton plc. changed their business practice and have since removed the active involvement of senior staff in most cases. Since then, the satisfaction of clients has increased. Staff were allocated into teams and great care was given to ensure that each team is balanced in terms of their expertise and the team leader is supposed to act as primus-inter-pares rather than a manager and this role should rotate regularly. There are, however, two teams that show consistently low satisfaction by clients. In both cases you find that the team leader takes a much more dominant position, imposing its suggestions on the team. It is generally accepted that the suggestions made by these two team leaders are slightly better than those developed in other teams, but the implementation of this advice is often lacking quality.

How can you explain this result?

Indicative answer: *The team leaders in these two units act as managers and having no superior ability, the reluctance of other team members to implement suggestions they disagree with, will reduce the performance overall. While the other teams do not face this problem, they have no implementation problem; this will give an overall better satisfaction of clients.*

Problem 92

Conrad & Co have suffered substantial losses from their trading desk that have endangered the survival of the investment bank. They were eventually bought by a competitor to avoid its potential collapse. During a parliamentary inquiry into the circumstances of the demise of Conrad & Co, members of parliament are questioning Georgios Saragiannis as a representative of an investment banking lobby group. It is put to him that investment banks are taking excessive risks and that this is the result of a practice that gives high responsibilities to inexperienced staff, giving them high pay to incentivise them to take such risks, and generally providing very little oversight of their activities.

How would Georgios Saragiannis defend the practices of investment banks?

Indicative answer: *Investment banks rely in the expertise of their staff as they need to acquire and process a large amount of information to provide the best advice to clients and also trade on their own account. To acquire this expertise and exert the requisite effort, staff members need to be highly motivated and giving them responsibilities early on in their career, allows the investment bank to assess their abilities. Given the soft skills in analysing information, it is only when taking on responsibilities* *that their abilities can be assessed adequately. The high pay serves as a motivation to exert this effort and compensates for the high work load, stress, and long working hours. Investment banks generally have a flat organisational structure and decisions are made decentral. This is due to the nature of the business, where specific information is required in decision-making, any managers supervising staff would not have the same information and it would therefore be difficult for them to provide guidance and feedback. It is therefore that extended management structures and long decison-making processes do not exist and are not feasible.*

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