Investment bank partnerships

- Until the mid 20th century it was common for investment banks to be set up as partnerships rather than a company with limited liability. While some small investment banks retain this structure, most investment banks are now either part of a commercial (universal banks) or they have converted into companies with limited liability.
- It is still common to have partnerships in management consultancy, accountancy and law; in finance partnerships can be found for wealth management (in particular Swiss private banks), and private equity. There exist also a small number of commercial banks that are organised as partnerships; they are usually small banks focussing on banking to wealthy individuals customers.
- We will explore the reasons for the demise of partnerships in investment banking and look at some of the implications by comparing incorporated investment banks (those having limited liability) with those organised as a partnership.

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- Partnership at the main investment banks have been transformed into limited companies
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Becoming a partner

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- This was a long process that required loyalty to the employer and investment by the employer
- We will look at implications of the partnership model for investment banks

Becoming a partner

→ One of the key aspirations of those working in a partnership is to become a partner themselves. We will look at the motivations to take up such a role and thus investigate under which conditions partnerships can be sustained.

- A key feature of partnership is that employees that have shown high skills and the ability to generate significant revenue, whether it is through their technical expertise or their interactions with clients, are developed further by existing partners. This training, or 'mentoring' would increase these skills further until they have the skills combined with the experience to become partners themselves.
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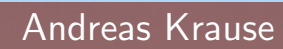

Andreas Krause

Chapter 17.1

Viability of partnerships

→ The model we are going to discuss is based on Chapter 17.1 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

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Discussion of the model results

- In partnerships the pay of associates are low to motivate them to seek becoming a partner, leading to high levels of effort
- The cost of mentoring associates cannot be too high and there must be sufficiently different skill levels for partnerships to be viable
- ? How do bonus pools for senior managers emulate partnerships?
- ! In partnerships senior managers obtain the profits of the investment bank, and bonus pools that cross divisions will similarly reflect the profits of the investment bank, making the bonus pool equivalent to the profits of the investment bank

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

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  - We have seen that at the early stages of a career in a partnership as an associate receives a relatively low pay. The aim is to motivate an associate to become partner and it is this delayed pay that makes partnerships attractive.
  - The difference to the high pay as a partner should be motivation to exert high levels of effort to be offered such an opportunity.
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  - The costs to existing partners of mentoring associates must not be too high as otherwise the costs of mentoring exceed the benefits and the partnership will not develop future partners sufficiently.
  - Similarly, partnerships are viable only if the differences in skill levels between associates are high. It is onyl then that the pay as a partner are high enough for partnerships to be attractive to employees.
- [?] Investment banks often have large bonus pools based on the performance of the company as a whole, these bonus pools are reserved for senior managers and based much more loosely on individual performance than the bonuses of more junior employees. How is that similar to a partnership?
- [!] In partnerships the profits of the investment bank are divided amongst the partners. This is similar to the bonus pool as their reward is linked to the profits of the investment bank overall. The reason to use such bonus pools is to align the interests of managers and owners, reducing moral hazard. The use of a bonus pool can be seen as an attempt of retaining the advantages of partnership in an incorporated investment bank.

→ Partnerships are difficult to sustain given competitive forces in the market and this sees investment banks bgiving up this organisational form more and more often.

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- In partnerships senior managers obtain the profits of the investment bank, and bonus pools that cross divisions will similarly reflect the profits of the investment bank, making the bonus pool equivalent to the profits of the investment bank

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Reputation of partnerships

- Partnerships are reputed to offer higher quality services to their clients than incorporated investment banks
- Clients will find it difficult to identify the quality of service investment banks provide
- We will explore why partnerships should provide a higher quality of service

Reputation of partnerships

→ The few investment banks still operating as partnerships are often boutique investment banks that have a reputation for exclusivity and excellence.

- A common perception in the market is that partnerships are offering more bespoke advice to their clients and that this advice is often better than the advice given by other investment banks.
- While this market perception is clearly there, it is difficult to assess the quality of advice provided as clients will often not have the knowledge and information to make such an assessment and over time many other influences will have affected the outcome.
- We will look at a model in which the quality of advice is compared between partnerships and incorporated investment banks to support this assertion that partnership offer better advice.

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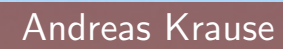
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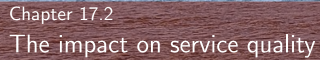
Chapter 17.2
The impact on service quality

→ The model we are going to discuss is based on Chapter 17.2 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

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Discussion of the model results

- Partnerships select more able employees as the salary of partners depends more on the ability of employees
- Clients knowing this, are willing to pay higher prices for the services, making investment banks more profitable
- ? If partnerships are more profitable, why do they not dominate the market?
- ! Maintaining partnerships is costly and they cannot offer the scale of business that is often required

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- [!] We have seen before that maintaining a partnership is costly and therefore might not be viable for larger investment banks offering a full range of services. It is probably difficult to replicate partnership successfully with a large number of partners, the result will be that each partners holds a small stake in the partnership and behaving more like a shareholder and manager, respectively.

→ We have thus seen that partnerships offer better advice to their clients and their demise can be found elsewhere.

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? If partnerships are more profitable, why do they not dominate the market?

! Maintaining partnerships is costly and they cannot offer the scale of business that is often required

Discussion of the model results

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

- We have seen that partnerships employ more capable employees that provide a higher quality of advice. We attributed the reason for this observation to the higher equity stakes the managers hold in a partnership, compared to those in incorporated investment banks.
-
  - Thus the reputation of partnerships as offering better advice is justified and will result in partnerships charging higher fees.
  - Of course, charging higher fees makes partnerships more profitable than incorporated investment banks, which is also empirically conformed.
- [?] Partnership are more profitable, therefore investment banks should all be organised in such a way. However, this is clearly not the case with only a small and shrinking minority of investment banks being partnerships.
- [!] We have seen before that maintaining a partnership is costly and therefore might not be viable for larger investment banks offering a full range of services. It is probably difficult to replicate partnership successfully with a large number of partners, the result will be that each partners holds a small stake in the partnership and behaving more like a shareholder and manager, respectively.

→ We have thus seen that partnerships offer better advice to their clients and their demise can be found elsewhere.

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Summary of key results

- Partnerships provide better services and are more profitable than incorporated investment banks
- They are also more costly to maintain as prospective partners need to be mentored, taking away resources of partners from the core business
- Partnerships have retained their place for specialist services in challenging markets

Summary of key results

→ We can now summarize the key results we have obtained about investment banking partnerships.

- ▶
  - We have seen that partnerships provide better services than incorporated investment banks,
  - and given the better result can charge higher fees, making more profits.
- ▶ However, partnerships are costly to maintain due to the mentoring and developing of partners, which limits the ability of senior managers (partners) to pay attention to the day-to-day business of the investment bank.
- ▶ In niche markets partnerships survive (and thrive) by offering specialist advice of a quality that large investment banks are often struggle to provide; as such they retain their place in the market, especially in those markets that are difficult to assess.

→ Thus, partnership are playing a less and less prominent role, but investment banks seek to retain some of the features of partnerships, such as bonus pools, to provide incentives to their employees to increase the quality of their work to that of partnerships.

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