Andreas Krause

The decision-making process in investment banks

- The decision-making process in investment banks can be characterised as being very much delegated to individual employees or teams that work with a client and manageraial oversight is minimal. In addition, investment banks have a flat structure, characterised by only a small number of managerial levels, much less than other organisations of comparable size.
- We will investigate why such structures have established themselves in investment banks and why they are optimal.

Flat structures and decentralized decisions

- Investment banks are characterised by flat hierarchical structures with only few management levels
- Decision-making is also decentralised in that decisions on how to advise clients are made at relatively low levels
- Most other companies have a much more hierarchical structure and key decisions on clients are taken by senior managers
- We will investigate why investment banks have adopted such a management system

Flat structures and decentralized decisions

→ The way investment banks are organised and how decisions are made are different to most other organisations.

- There are only few management levels within investment banks and it is much more common that employees and managers of different levels work together providing advice to clients. Even where hierarchies exist, they are much less pronounced than in other organisations.
- Similarly, even decisions with wide-ranging implications for the relationship with a client or a significant impact on the revenue of the investment bank are often left to relatively junior staff members, those advising clients directly.
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  - Investment banks, with a few other types of companies, are unique in this respect with a more hierarchical structure much more common.
  - It is also more common that all but minor decisions will in most organisations be at least approved by more senior managers, depending on the importance of the decision.
- We will look at both of these aspects and why it is optimal for investment banks to use such a different model.

→ We will see that given the nature of investment banking, such structures are indeed optimal for investment banks.

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- This suggests that advice is given by less able employees, to the detriment of clients
- We will establish that is not necessarily true and how the flat management structure is suited to the business of investment banks

Few management levels

→ A characteristic of investment banks is that they have only few management levels and that employees of different levels of seniority often work closely together on more or less equal terms when advising clients.

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Chapter 18.1

The impact of the organisational structure

→ The model we are going to discuss is based on Chapter 18.1 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.

Discussion of the model results

- Managers lack the specialist knowledge and might therefore not offer the best advice to clients, making the involvement of senior managers less effective
- Managers might be better at extracting surplus from clients, but this would not benefit clients, which might find the advice to be of lower quality
- ? If flatter structures are better for investment banks, why are management levels needed at all?
- ! Clients have many needs and will interact with many different teams providing advice; this advice needs to be coordinated and capacities need to be planned

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.

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- Managers might be better at extracting surplus from clients, but this would not benefit clients, which might find the advice to be of lower quality

? If flatter structures are better for investment banks, why are management levels needed at all?

! Clients have many needs and will interact with many different teams providing advice; this advice needs to be coordinated and capacities need to be planned

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 argued that managers might lack the specialist knowledge necessary to provide advice to clients.
  - For this reason they might not be able to provide the best possible advice for them.
  - This implies that the involvement of managers is less beneficial to the client and eventually to the profits of the investment bank.
- - It was argued that managers might better to extract surplus from clients,
  - which would only benefit the investment bank but might damage the long-term reputation of the investment bank and reduces the value of the advice to clients, reducing profits.
- [?] We have seen flatter structures are generally better for investment banks, so why do investment banks not eliminate all management structures and have individuals working under a franchising system?
- [!] Managers might have a role in managing the overall relationship with the client; specialists seen only the immediate needs of clients and may also not be able to have access to experience in other areas of the investment bank. Thus managers are needed to coordinate advice for clients.

→ It is often such a client management role that managers in investment banks have, while the specific advice is provided by specialists without the manager's input.

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Delegating decisions

- Decisions in investment banks on how to advise clients are taken at a relatively junior level
- Senior managers might have better knowledge and their experience might benefit clients
- We will look into the reason why delegating decision-making to junior employees is beneficial for investment banks

Delegating decisions

- → Investment banks do not only have a flat structure, their decision are also made locally by those that are directly providing the advice in what is refereed to a delegated decisions.
- ▶ Most decisions on the advice clients receive are made the level of the team working with the client and the advice is not referred up to more senior managers for approval.
- ▶ We might argue, however, that senior managers have a better knowledge overall and their experience might improve the decisions.
- ▶ We will see why it is often optimal to not have senior managers involved in decision-making, even if they are better informed.
- → The nature of investment banking in that they rely on incentives for individuals to exert effort when advising clints are one of the key features that need to be addressed.

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Chapter 18.2

Delegation of decision-making

→ The model we are going to discuss is based on Chapter 18.2 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.

Discussion of the model results

- Employees need to apply their knowledge when working with clients and positive incentives motivate them to exert effort.
- If employees disagree with decisions of senior managers their efforts may reduce leading to lower benefits to their clients and lower profits to the investment bank.

? Why would employees disagreeing with decisions be detrimental to the advice given?

! Employees might not seek to implement a decision they disagree with and they might implement it only partially; the client might also sense that different opinions exist and be less than satisfied with the advice provided, especially if the advice turns out to be wrong.

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  - We have argued that employees working with clients need to use their knowledge to provide good advice to clients and that it is impossible to monitor whether they do this diligently.
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  - Existing incentives might not be sufficient if employees have information that disagrees with the decisions made by others, such as managers.
  - Investment banks would need to increase the incentives to overcome this reluctance, increasing the costs to the investment bank. These additional costs would make delegated decision-making more attractive to investment banks.
- It is not uncommon that employees disagree with decisions their supervisor has made, so why is this a particular problem in investment banking?
- As monitoring is difficult, employees disagreeing might not put the requisite effort in to implement the decision that has been taken, which would lower the value of the advice given and reduce profits, the key here is that effort cannot be effectively monitored. Different opinions that are voiced towards clients might also lead to clients questioning the advice they have actually received, know that there are different views; this will be a particular problem is subsequently alternative views were proven correct. Investment banks would suffer reputational losses in these cases.

→ Thus delegated decision-making is used to reduce the moral hazard of employees not exerting the effort required when implementing the decisions others have made and with which they disagree based on their own information.

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Summary of key results

- Flat structures are optimal for investment banks as they allow specialist knowledge to prevail to the benefit of clients, increasing the investment bank's long-term profits
- Allowing junior employees to make decisions motivates them and allows to identify their ability, leading to higher effort
- Investment banks rely on the knowledge of those in direct client contact and taking decisions away to higher management levels lowers the quality of advice

Summary of key results

→ We can now summarize the key results we have obtained about how investment banks are organised.

- We have seen that in most cases flat structures are optimal as they allow specialists to advise clients directly and provide clients with better advice than managers could do, even if their different viewpoints might lead to an overall better advice.
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    - If junior employees implement decisions they ahve made themselves, moral hazard has been eliminated.
    - Observing their decisions also allows to identify their ability as the decision and the final outcome are observable. If they implement the decision of a manager, the outcome may be driven by the employee's implementation of the initial decision by the manager, making an assessment more difficult.
    - Overall, both aspects will lead to higer effort by the employee, resulting in better advice to clients, fr which a higher fee can be charged.
- The way investment banks are structured and how decisions are made is the result of the reliance on the use of knowledge by their employees. We have argued that taking decisions to higher management levels reduces the quality of advice provided and there is therefore less space for additional management layers as they do not add much value.

→ Investment banks have reacted to the nature of their business buy making arrangements how employees work that maximize their profits.

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→ Investment banks have reacted to the nature of their business buy making arrangements how employees work that maximize their profits.

Summary of key results

- Flat structures are optimal for investment banks as they allow specialist knowledge to prevail to the benefit of clients, increasing the investment bank's long-term profits
- Allowing junior employees to make decisions motivates them and allows to identify their ability, leading to higher effort
- Investment banks rely on the knowledge of those in direct client contact and taking decisions away to higher management levels lowers the quality of advice

Summary of key results

→ We can now summarize the key results we have obtained about how investment banks are organised.

- We have seen that in most cases flat structures are optimal as they allow specialists to advise clients directly and provide clients with better advice than managers could do, even if their different viewpoints might lead to an overall better advice.
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  - If junior employees implement decisions they ahve made themselves, moral hazard has been eliminated.
  - Observing their decisions also allows to identify their ability as the decision and the final outcome are observable. If they implement the decision of a manager, the outcome may be driven by the employee's implementation of the initial decision by the manager, making an assessment more difficult.
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