A panoramic view of a city skyline, likely New York City, featuring a mix of modern glass skyscrapers and older brick buildings along a waterfront. The sky is clear and blue. In the foreground, there is a body of water with a dark red banner at the bottom containing text.

Andreas Krause

Chapter 18.1

The impact of the organisational structure

Outline

- Problem and model assumptions
- Possible organisational forms
- Optimal organisational form
- Summary

- Compared to other large organisations, investment banks have a relative flat structure, meaning that there only a small number of hierarchy levels.
- We find a similar structure in small companies only, or in some selected industries such a management consultancy.
- We will explore here why such a flat organisational structure is preferred by investment banks.

- We will first characterise the way advice can be presented to clients and then look at stylised forms of the organisation of investment banks before determining the optimal structure.

- Problem and model assumptions
- Possible organisational forms
- Optimal organisational form
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- We will first introduce the highly stylised way that advice would be introduced to clients.

Flat organisation

- We aim to find conditions under which the flat organisational structure of investment banks will be optimal.
- ▶ As mentioned, investment banks typically have only a small number of management levels and promotions might be also be given by working with more prestigious clients.
- ▶ Not only do investment banks have a flat structure, but the oversight by senior managers is much less than in most other industries.
- ▶
 - The reason for this is that given the nature of the business, providing advice based on the detailed analysis of information, more senior manager might not have the specialist knowledge to advise the client.
 - On the other hand, managers will have experience about the use of information and a 'feeling' for which advice is suitable, making their involvement also valuable.
- It is this way of organising the advice to clients we seek to recover, taking into account the nature of advice and the lack of specialist knowledge by senior managers.

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- ▶ Senior managers might lack the **specialist knowledge**

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- ▶ Senior managers might lack the specialist knowledge, but have **experience**

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Priority of ideas

- We are not developing a model of how advice is arrived at, but assume that it has been arrived at and now needs to be accepted by the client.
- ▶ We now assume that managers can generate ideas that result in specific advice to the client and that this advice is accepted with some probability and, if accepted, generates a given surplus to the client; the price charged to the client will reflect the value of this surplus and we assume that the investment bank extract this surplus fully from their client and thus represents the income from the advice if accepted.
- ▶ We assume that specialists (junior employees) also generate ideas that result in specific advice to the client and that this advice is accepted with some probability and, if accepted, generates a given surplus to the client; the price charged to the client will reflect the value of this surplus and we assume that the investment bank extract this surplus fully from their client and thus represents the income from the advice if accepted.
- ▶ We assume that given the position of managers, their ideas are put forward first and only if they are rejected by clients, are the ideas of specialists presented.
- A specialist here is an employee who works exclusively on advice to a single client, while a manager provides potential advice to multiple clients.

Priority of ideas

- ▶ Managers provide ideas for advice that are **accepted** by clients with probability π_M and generate surplus V_M

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Priority of ideas

- ▶ Managers provide ideas for advice that are accepted by clients with probability π_M and generate surplus V_M
- ▶ Specialists provide ideas for advice that are **accepted** by clients with probability π_S and generate surplus V_S

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- ▶ Specialists provide ideas for advice that are accepted by clients with probability π_S and generate surplus V_S
- ▶ The ideas of higher ranked staff have **priority** in being put forward

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- Problem and model assumptions
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- Summary

- We can now determine the profits to the investment banks from different organisational forms.
- In all cases do we consider the advice given to two companies by 4 employees of the investment bank.
- We keep the number of clients and employees fixed to have an organisational structure the same costs (wages) and revenue (client surplus if the advice is accepted).
- As the number of employees are given, we neglect their remuneration and only focus on the revenue they will generate.

Hierarchical structure

Hierarchical structure

- We first consider a strictly hierarchical structure.
 - ▶ We have a senior executive manager at the top of the investment bank.
 - ▶ He supervises a senior manager,
 - ▶ who in turn supervises a middle manager,
 - ▶ who supervises a junior manager.
 - ▶ It is then this junior manager that provides the advice to both clients. In such a structure, the junior manager cannot be a specialist as he has to address the need of multiple companies.
- For simplicity, we assume that managers at all levels are of equal ability to generate ideas that are accepted by clients and they also produce the same surplus.

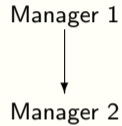
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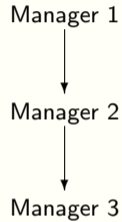
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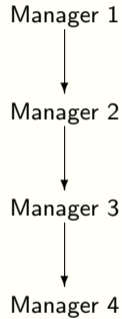
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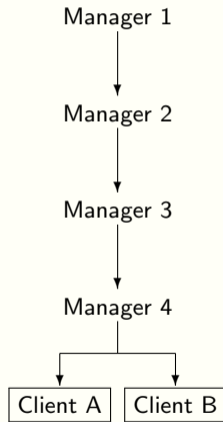
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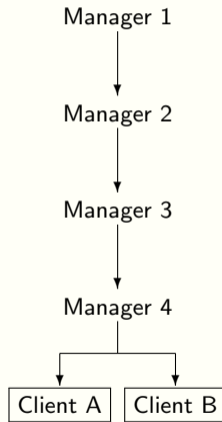
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Investment bank profits in hierarchical structures

- We can now look at the implications of such an organisational structure on the revenue investment banks generate.
- ▶
 - We might find us in the situation in which none of the managers have an idea that is accepted by the client.
 - The inverse is that at least one manager has an idea that is accepted by one client.
 - And if the advice is independent, they may have ideas that are accepted by both clients
 - Then these ideas both generate some revenue for the investment bank.
 - ▶
 - Alternatively, there might only be ideas that are accepted by a one client,
 - while the other rejects the idea.
 - In this case revenue is generated from the single client accepting the idea.
 - ▶ *Formula*
 - ▶ If no ideas are accepted, the investment bank receives no revenue.
- We have thus determined the revenue of the investment bank with a hierarchical structure.

Investment bank profits in hierarchical structures

▶ **None** of the four managers have an idea that is accepted

▶ $\Pi_H = (1 - \pi_M)^4$

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Investment bank profits in hierarchical structures

▶ Managers have an idea that is accepted by **one** of the clients

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Investment bank profits in hierarchical structures

▶ Managers have an idea that is accepted by **both** clients

▶ $\Pi_H = \left(1 - (1 - \pi_M)^4\right)^2$

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Investment bank profits in hierarchical structures

- ▶ Managers have an idea that is accepted by both clients and generates the **surplus** from **both**
- ▶ $\Pi_H = 2 \left(1 - (1 - \pi_M)^4\right)^2 V_M$

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- ▶ Managers have an idea that is accepted by both clients and generates the surplus from both
- ▶ or it has an idea for **one client**, but
- ▶ $\Pi_H = 2 \left(1 - (1 - \pi_M)^4\right)^2 V_M + \left(1 - (1 - \pi_M)^4\right)$

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Flat structure

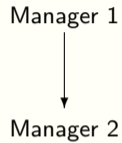
- We can now continue exploring a flat organisational structure in which there are less managers.
- ▶ We again have the senior manager at the top
- ▶ to which a middle manager answers.
- ▶ Now, however, this middle manager supervises a specialist,
- ▶ which only advises a single client.
- ▶ The middle manager also supervises a second specialist,
- ▶ which also only advises a single client.
- We can now determine the revenue in this case.

Flat structure

Manager 1

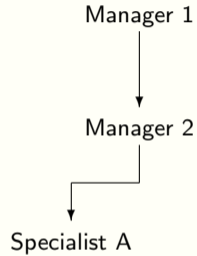
- We can now continue exploring a flat organisational structure in which there are less managers.
 - ▶ **We again have the senior manager at the top**
 - ▶ to which a middle manager answers.
 - ▶ Now, however, this middle manager supervises a specialist, which only advises a single client.
 - ▶ The middle manager also supervises a second specialist, which also only advises a single client.
- We can now determine the revenue in this case.

Flat structure



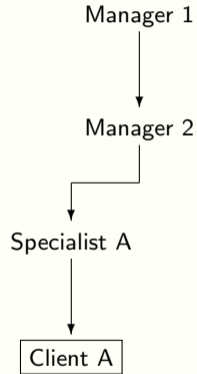
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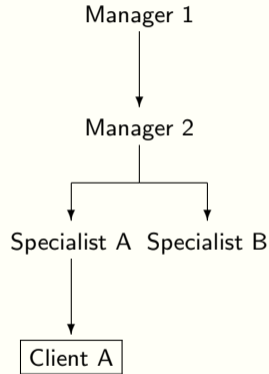
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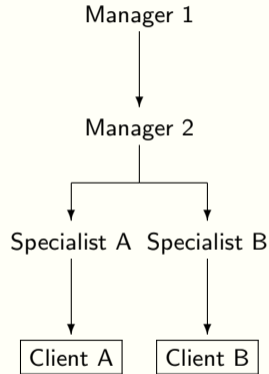
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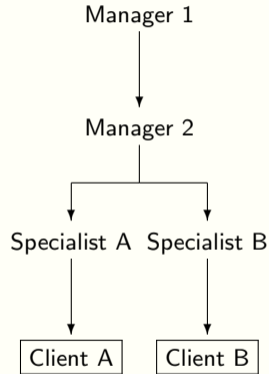
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Investment bank profits in flat structures

- We now determine the revenue to the investment bank if they only employ two instead of four managers and instead employ an additional two specialists, each advising a single client.
- ▶
 - Let us first assume that the two managers have an idea that is accepted.
 - Furthermore, both companies accept their ideas.
 - In this case both companies generate revenue to the investment bank. Note that ideas of specialists are irrelevant in this case as the ideas of managers are put to the clients first.
 - ▶
 - Managers might have ideas that are only accepted by one of their clients
 - but the other rejects their ideas. There are two possible scenarios, client A accepting and client B rejecting the idea, or vice versa.
 - This then generates revenue from the client accepting the idea.
 - For the company rejecting the idea of managers, they might accept an idea from the specialist they are working with.
 - This would generate the appropriate revenue for the investment bank.
 - ▶
 - Finally managers might not have any ideas that are accepted,
 - However, the specialists might have generated an acceptable idea
 - This generates revenue for the bank from both or one of the clients.
 - ▶ *Formula*
 - ▶ If no ideas are accepted, the investment bank receives no revenue.
- This gives us the revenue of the investment bank with a flat structure.

Investment bank profits in flat structures

- ▶ The managers **have an idea that is accepted**

- ▶ $\Pi_F = 1 - (1 - \pi_M)^2$

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Investment bank profits in flat structures

- ▶ The managers have an idea that is accepted by **both clients**

- ▶ $\Pi_F = \left(1 - (1 - \pi_M)^2\right)^2$

- We now determine the revenue to the investment bank if they only employ two instead of four managers and instead employ an additional two specialists, each advising a single client.
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 - Let us first assume that the two managers have an idea that is accepted.
 - **Furthermore, both companies accept their ideas.**
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Investment bank profits in flat structures

- ▶ The managers have an idea that is accepted by both clients, and generate the surplus

- ▶ $\Pi_F = 2 \left(1 - (1 - \pi_M)^2 \right)^2 V_M$

- We now determine the revenue to the investment bank if they only employ two instead of four managers and instead employ an additional two specialists, each advising a single client.
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Investment bank profits in flat structures

- ▶ The managers have an idea that is accepted by both clients, and generate the surplus
- ▶ or the managers have an idea that is accepted by **one client**

- ▶
$$\Pi_F = 2 \left(1 - (1 - \pi_M)^2\right)^2 V_M + \left(1 - (1 - \pi_M)^2\right)$$

- We now determine the revenue to the investment bank if they only employ two instead of four managers and instead employ an additional two specialists, each advising a single client.
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Investment bank profits in flat structures

- ▶ The managers have an idea that is accepted by both clients, and generate the surplus
- ▶ or the managers have an idea that is accepted by one client, but **not the other**

- ▶
$$\Pi_F = 2 \left(1 - (1 - \pi_M)^2 \right)^2 V_M$$
$$+ 2 \left(1 - (1 - \pi_M)^2 \right) (1 - \pi_M)^2$$

- We now determine the revenue to the investment bank if they only employ two instead of four managers and instead employ an additional two specialists, each advising a single client.
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Investment bank profits in flat structures

- ▶ The managers have an idea that is accepted by both clients, and generate the surplus
- ▶ or the managers have an idea that is accepted by one client, but not the other, generating surplus

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Investment bank profits in flat structures

- ▶ The managers have an idea that is accepted by both clients, and generate the surplus
- ▶ or the managers have an idea that is accepted by one client, but not the other, generating surplus, for this remaining client the **specialist** might have an idea

$$\begin{aligned} \text{▶ } \Pi_F &= 2 \left(1 - (1 - \pi_M)^2 \right)^2 V_M \\ &\quad + 2 \left(1 - (1 - \pi_M)^2 \right) (1 - \pi_M)^2 (V_M + \pi_S V_S) \end{aligned}$$

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$$\Pi_F = 2 \left(1 - (1 - \pi_M)^2\right)^2 V_M$$
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- ▶ or **no managers** have ideas that are accepted

$$\begin{aligned}\Pi_F = & 2 \left(1 - (1 - \pi_M)^2\right)^2 V_M \\ & + 2 \left(1 - (1 - \pi_M)^2\right) (1 - \pi_M)^2 (V_M + \pi_S V_S) \\ & + (1 - \pi_M)^4\end{aligned}$$

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- ▶ or no managers have ideas that are accepted, but the **specialists** might have

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Independent units

- We can now even go further and eliminate all managers by having only specialists, that is no central oversight by a manager at all.
 - ▶ We might have a senior specialist, such as a team leader.
 - ▶ This team leader supervises a more junior specialist, who works with a single client.
 - ▶ The same structure is repeated for the second client. Again, we have a senior specialist supervising a junior specialist, who works with a single client.
- As before, we will now determine the revenue such an organisational structure would generate.

Independent units

Specialist A1

Independent units

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 - ▶ **We might have a senior specialist, such as a team leader.**
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 - ▶ The same structure is repeated for the second client. Again, we have a senior specialist
 - ▶ supervising a junior specialist,
 - ▶ who works with a single client.
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Independent units



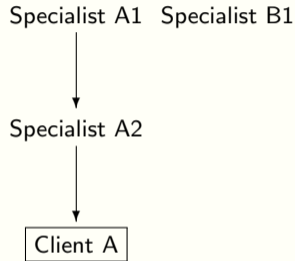
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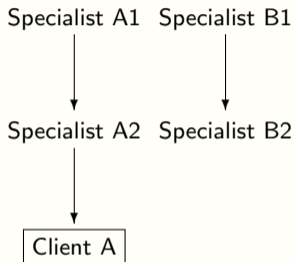
Independent units



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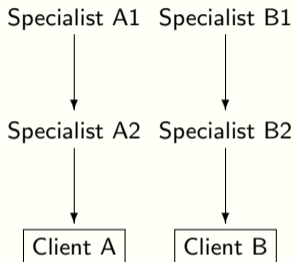
Independent units



Independent units

- We can now even go further and eliminate all managers by having only specialists, that is no central oversight by a manager at all.
 - ▶ We might have a senior specialist, such as a team leader.
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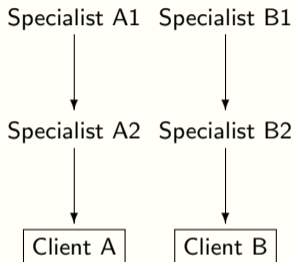
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Investment bank profits with independent units

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- We can now determine the revenue for the investment bank if they operate independent units without managerial supervision.
- ▶
 - For each of the clients, the two specialists might produce advice that is accepted by the client
 - and this will generate the surplus from this client.
 - This is repeated for the second client.
- ▶ *Formula*
- ▶ If no ideas are accepted, the investment bank receives no revenue.
- We have thus determined the revenue of investment banks employing three different organisational structures and we will now proceed to compare this revenue.

Investment bank profits with independent units

- ▶ Specialists might have ideas accepted
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- Problem and model assumptions
- Possible organisational forms
- Optimal organisational form**
- Summary

- We can now compare the revenue that each of the organisational structures generates and determine which will provide the highest revenue and is therefore optimal for the investment bank.

Comparison of profits to investment banks

Comparison of profits to investment banks

- The optimal organisational form will be the one that generates the highest revenue to investment banks.
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- ▶ The hierarchical structure is preferred over the flat structure if the condition in the *formula* is fulfilled.
- ▶ The hierarchical structure is preferred over independent units if the condition in the *formula* is fulfilled.
- ▶ The flat structure is preferred over independent units if the condition in the *formula* is fulfilled.
 - We can show that if the surplus managers generate are less than the surplus specialists generate, the revenue of the flat structure is always less than that of independent units.
 - Consequently, in this case, a flat hierarchical structure can never be optimal.
- We can now continue to analyse the conditions for different organisational structures to be optimal.

Comparison of profits to investment banks

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Using the expressions on the revenue as determine above, we now compare these pairwise.

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- ▶ $\Pi_H > \Pi_F$ if $\frac{V_M}{V_S} > \frac{\pi_S}{1-(1-\pi_M)^2}$

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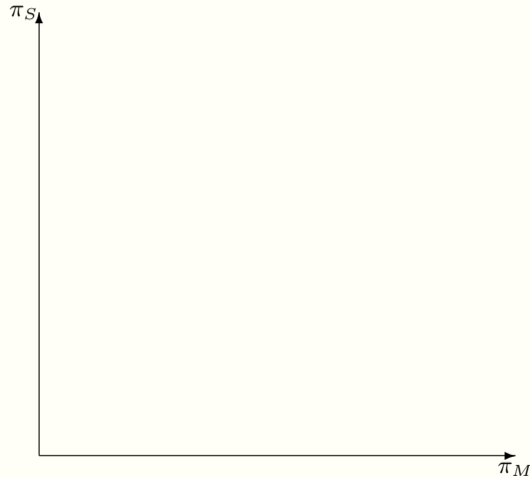
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- We will first consider the case where the surplus generated by managers is higher than the surplus generated by specialists, provided their respective ideas have been accepted by the clients.
 - ▶ We will explore the probabilities with which ideas by managers and specialists are accepted.
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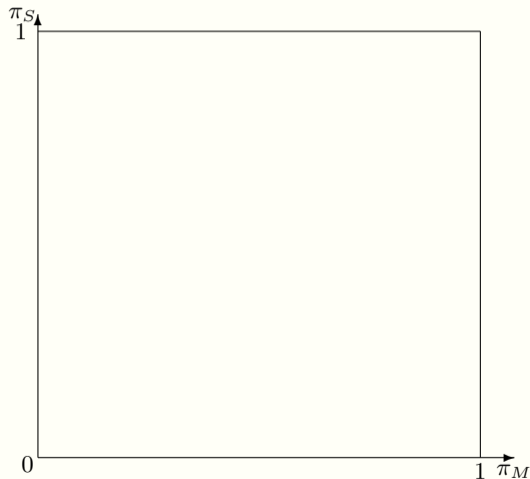
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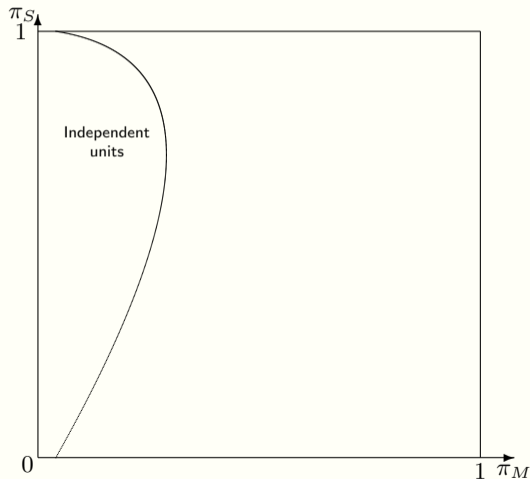
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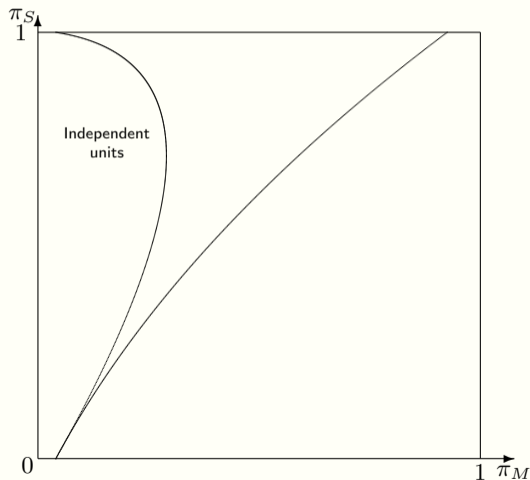
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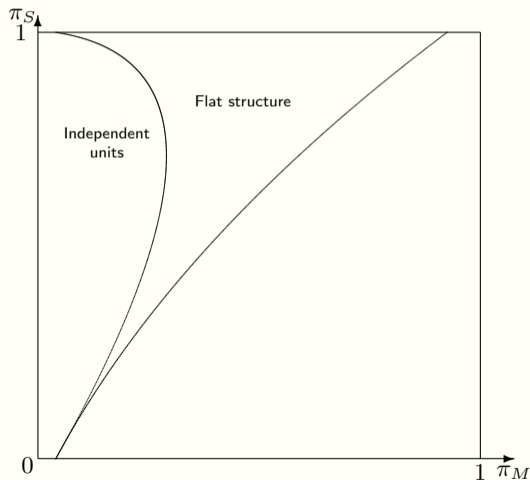
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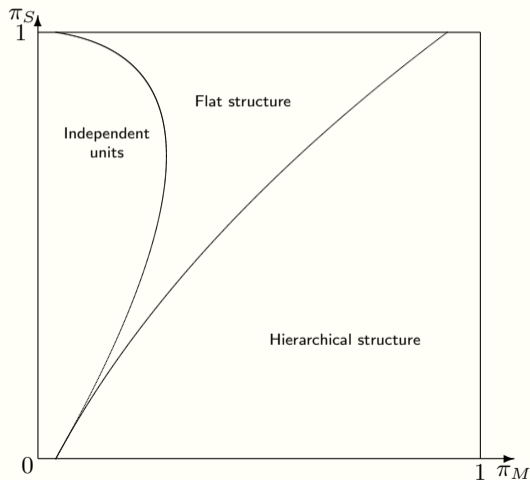
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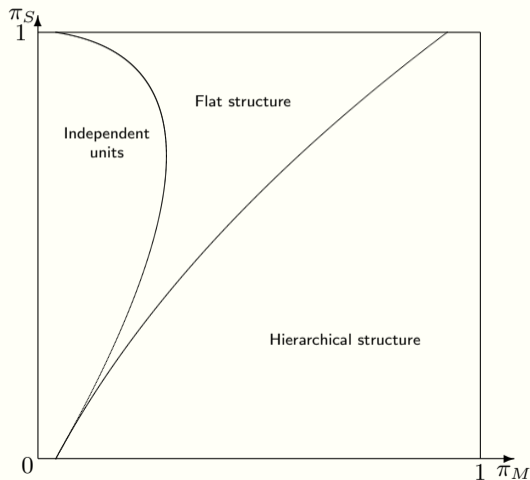
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Trade-off between many ideas and good ideas

Trade-off between many ideas and good ideas

- For the revenue of investment banks it is firstly paramount that an idea they generate is accepted, that the revenue from the ideas of managers is higher is secondary.
- ▶ What we see that we have a trade-off between the larger number of ideas that managers generate (all managers provide ideas to each client, but specialists only create an idea to their own client), in a hierarchical structure each client receives four ideas, in a flat structure three ideas, and with independent units two ideas. This will benefit structures with more managers. However, if specialist ideas are more likely to be accepted, then the chances of any of the ideas being generated by specialists being accepted are higher than those ideas generated by managers. Thus the number of specialists involved should be maximized. This trade-off gives rise to the observed pattern.
- ▶ Consequently, if ideas by specialists are more and more likely accepted, then a flatter and flatter structure will be preferred, where more and more specialists are involved.
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 - With very high acceptance rates of ideas from specialists, the involvement of managers can be beneficial as even if their ideas are rejected, the subsequent specialist idea will be accepted.
 - Even if managers' ideas are unlikely to be accepted, a loss of revenue is unlikely and there is a small chance of managers' ideas being accepted and generating a higher revenue to the investment bank.
- ▶ The overall tendency is, however, that as specialist advice is becoming more likely to be accepted, relative to management advice, a flatter structure is optimal.
- Specialist advice is more likely to be accepted if there are specific circumstances in the client's case or managers have generally a low level of knowledge about the client, the industry or the service they seek advice about.

Trade-off between many ideas and good ideas

- ▶ Investment banks face a **trade-off** between more ideas by managers in a hierarchical structure and fewer but better ideas in flatter structures

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- ▶ A higher acceptance of ideas from specialists favours a **flatter structure**

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- ▶ What we see that we have a trade-off between the larger number of ideas that managers generate (all managers provide ideas to each client, but specialists only create an idea to their own client), in a hierarchical structure each client receives four ideas, in a flat structure three ideas, and with independent units two ideas. This will benefit structures with more managers. However, if specialist ideas are more likely to be accepted, then the chances of any of the ideas being generated by specialists being accepted are higher than those ideas generated by managers. Thus the number of specialists involved should be maximized. This trade-off gives rise to the observed pattern.
- ▶ **Consequently, if ideas by specialists are more and more likely accepted, then a flatter and flatter structure will be preferred, where more and more specialists are involved.**
- ▶
 - With very high acceptance rates of ideas from specialists, the involvement of managers can be beneficial as even if their ideas are rejected, the subsequent specialist idea will be accepted.
 - Even if managers' ideas are unlikely to be accepted, a loss of revenue is unlikely and there is a small chance of managers' ideas being accepted and generating a higher revenue to the investment bank.
- ▶ The overall tendency is, however, that as specialist advice is becoming more likely to be accepted, relative to management advice, a flatter structure is optimal.
- Specialist advice is more likely to be accepted if there are specific circumstances in the client's case or managers have generally a low level of knowledge about the client, the industry or the service they seek advice about.

Trade-off between many ideas and good ideas

- ▶ Investment banks face a trade-off between more ideas by managers in a hierarchical structure and fewer but better ideas in flatter structures
- ▶ A higher acceptance of ideas from specialists favours a flatter structure
- ▶ If the acceptance rate are very high, the added layer of management can **improve** the overall revenue at low cost

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- ▶ A **flatter structure** is preferred if specialists are producing advice that is more likely to be accepted by clients

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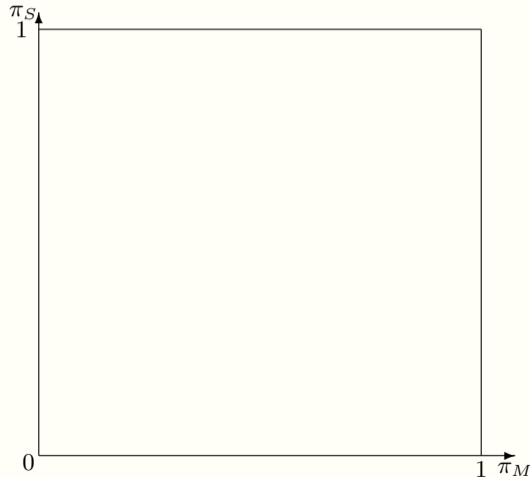
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Managers providing lower surplus than specialists ($V_M < V_S$)

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- We can now consider the second case where the specialist advice generates a higher revenue than the management advice.
- ▶ We will again explore the probabilities with which ideas by managers and specialists are accepted. The flat structure will never be optimal as we have discussed above.
- ▶ We will therefore have a split between independent units and the hierarchical structure.
- ▶ We see similar to before that if the acceptance rate of ideas generated by specialists is high, a flatter structure is preferred, here the independent units.
- ▶ If manager's ideas are more likely to be accepted than those of specialists, a hierarchical structure is optimal.
- We can now provide a brief rationale for this result.

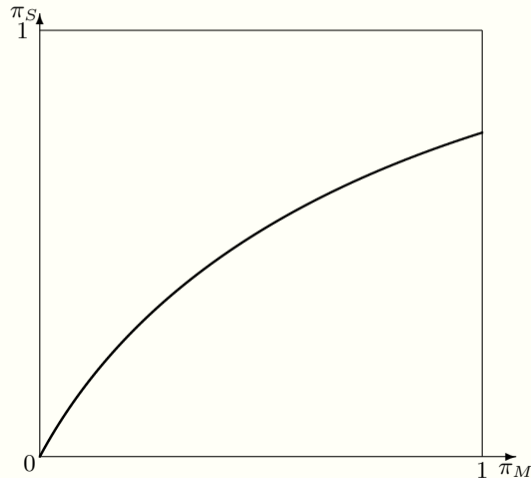
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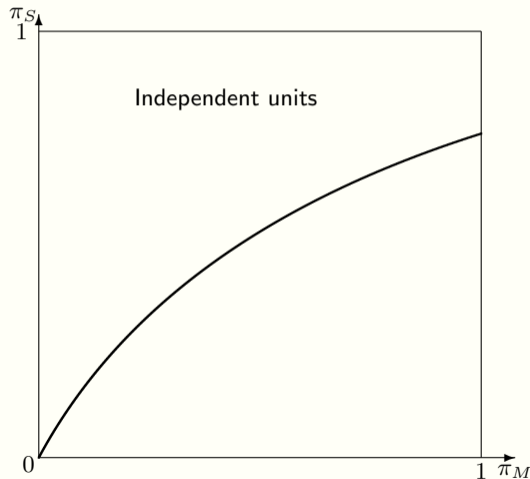
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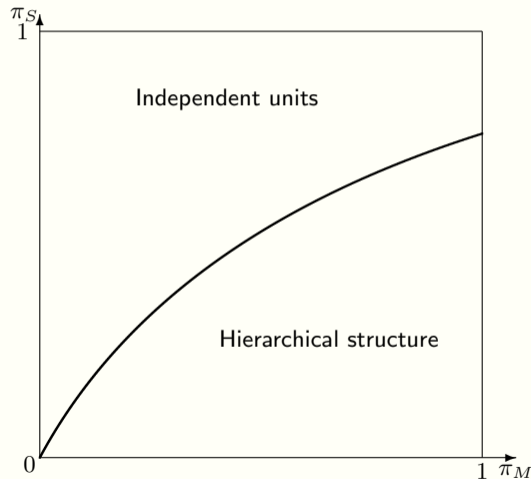
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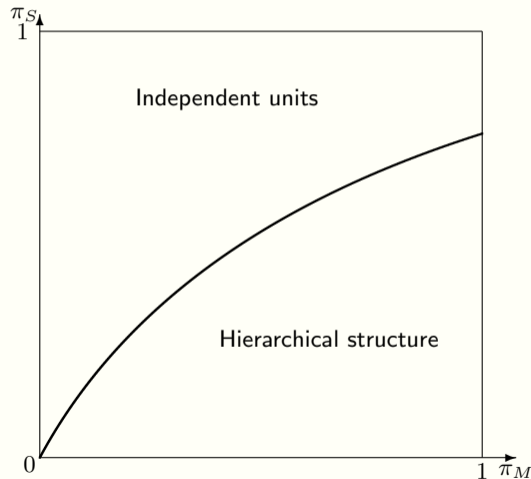
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Specialist involvement is preferred

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- The higher surplus specialists generate favours a flatter structure with more specialists.
- ▶ Managers provide less surplus than specialists, hence flatter structures with more specialists and less managers yield a higher revenue to the investment bank. Compared to the previous case with higher surplus generated by managers, the region optimal for flatter structures should expand.
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 - We have seen above that a flat structure is not optimal, but instead we move from a hierarchical structure directly to independent units.
 - The lower revenue of managers makes their partial involvement not profitable. The larger number of ideas they generate allows the hierarchical structure to be optimal if managers' ideas are much more likely accepted than specialist ideas.
- ▶ We therefore find that independent units are preferred, even if managers' ideas are more likely to be accepted, although not too much more, due to the higher revenue specialists generate.
- We have thus established that flatter structures with less or no management involvement is optimal for investment banks where the specialist knowledge is important to generate advice that is seen by the client to be relevant and be accepted. In cases where specialist knowledge is not that important the involvement of managers generates more ideas and even if they are less good than those of specialists, their larger number might increase the revenue of investment banks.

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- ▶ If managers generate less surplus than specialists, **flatter structures** are favoured even more

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- Problem and model assumptions
- Possible organisational forms
- Optimal organisational form
- **Summary**

- We can now derive some conclusions from this model about the optimal organisational structure of investment banks.

Benefits of flatter structures

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- Flat hierarchical structures emerge from these model for a wide range of parameter constellation, suggesting they are relevant in many cases.
- ▶ Having a hierarchical structure implies that many levels of management will be involved in important decisions and thus advice to client might improve through the input of multiple managers, making this structure optimal.
- ▶ Given the lack of specialist knowledge by managers, such as not being fully aware of the specific circumstances of their clients, might generate advice that is inferior to that of specialists who have a better knowledge about their client.
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 - If specialists generate higher surplus than managers, flatter structures are generally preferred,
 - as in this case their ideas will more often prevail and generate high revenue for the investment bank.
- Clients approach investment banks often with very specific problems and providing advice would need a detailed knowledge not only of this problem, but also of the client overall, and any potential solutions. Managers with their responsibility for many clients will often lack this specialist knowledge. Therefore, investment banks have a flat structure or often even operate as independent teams with very limited oversight by managers.

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Different knowledge bases

→ Specialists and managers might differ in the type of knowledge they have.

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 - Analysts and team leader in investment banks will have a good and detailed knowledge about their clients, the environment they operate in and the potential solutions that can be offered.
 - In contrast to this managers will have a more general knowledge and have experience of what worked in the past. Managers might also have the benefit of knowledge about advice given to other clients, which staff might not be aware of, and that might be applicable in other cases, too. These two knowledge areas can complement each other.
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 - Also, specialist understand the client well and will be able to tailor advice close to their needs, making their advice easily accepted.
 - However, while the advice specialists give might be beneficial for their client, it might not be optimal for the investment bank. It might be more profitable for the investment bank to fall back on solutions previously used rather than develop new solutions as this might increase costs, while benefitting clients only marginally. Managers are much more likely to be aware of such concern and be willing to take them into consideration.
 - ▶
 - The important part is that advice needs to be accepted, that is the client must feel that the investment bank has provided good advice, otherwise the client will not return for future advice and the reputation of the investment bank may suffer.
 - This importance of having the advice accepted overall favours a flatter organisational structure to increase client satisfaction.
- We have thus been able to show that a flat hierarchical structure allows investment banks to provide clients with the specialist advice they require and managerial oversight will often lead to less optimal solutions being suggested to clients.

Different knowledge bases

- ▶ Staff in investment bank have **high levels of knowledge**

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Different knowledge bases

- ▶ Staff in investment bank have high levels of knowledge, managers might have more **general knowledge**

- Specialists and managers might differ in the type of knowledge they have.
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 - Analysts and team leader in investment banks will have a good and detailed knowledge about their clients, the environment they operate in and the potential solutions that can be offered.
 - In contrast to this managers will have a more general knowledge and have experience of what worked in the past. Managers might also have the benefit of knowledge about advice given to other clients, which staff might not be aware of, and that might be applicable in other cases, too. These two knowledge areas can complement each other.
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Different knowledge bases

- ▶ Staff in investment bank have high levels of knowledge, managers might have more general knowledge
- ▶ Specialists might be offering advice that is **easier accepted** by clients

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- ▶ Staff in investment bank have high levels of knowledge, managers might have more general knowledge
- ▶ Specialists might be offering advice that is easier accepted by clients, but managers have more knowledge how to **extract surplus** for the investment bank

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