

Chapter 18.1

The impact of the organisational structure

Outline

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

■ Problem and model assumptions

■ Possible organisational forms

■ Optimal organisational form

■ Summary

Flat organisation

- ▶ Investment banks typically have a flat organisational structure
- ▶ Oversight by senior managers on advice given to clients is minimal
- ▶ Senior managers might lack the specialist knowledge, but have experience

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
- ▶ The ideas of higher ranked staff have priority in being put forward

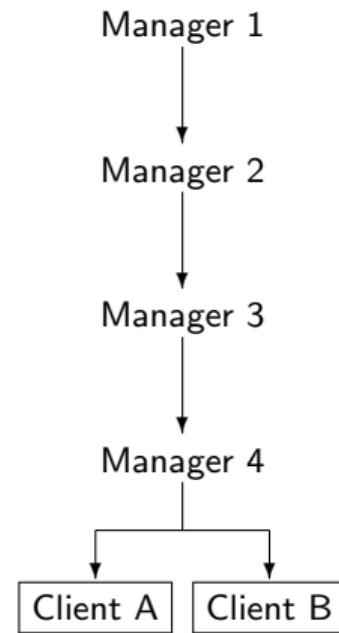
■ Problem and model assumptions

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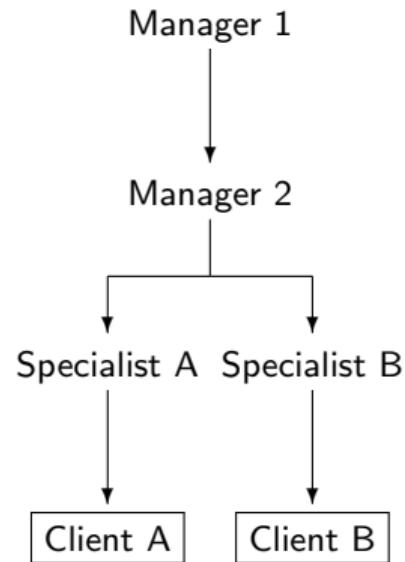
Hierarchical structure



Investment bank profits in hierarchical structures

- ▶ None of the four managers have an idea that is accepted Managers have an idea that is accepted by one of the both clients and generates the surplus from both
- ▶ or it has an idea for one client, but not the other, generating surplus from one client
- ▶ $\Pi_H = 2 \left(1 - (1 - \pi_M)^4\right)^2 V_M + 2 \left(1 - (1 - \pi_M)^4\right) (1 - \pi_M)^4 V_M$
- ▶ If no manager has an acceptable idea, no surplus is generated

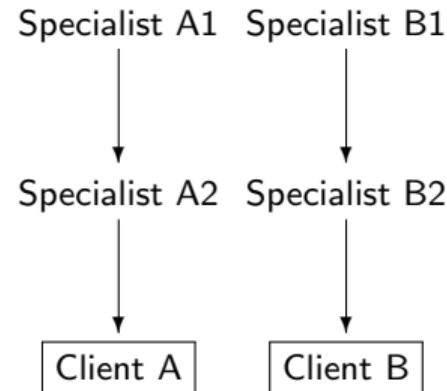
Flat structure



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 and generate surplus
- ▶ or no managers have ideas that are accepted, but the specialists might have and generate surplus
- ▶
$$\begin{aligned}\Pi_F = & 2 \left(1 - (1 - \pi_M)^2\right)^2 V_M \\ & + 2 \left(1 - (1 - \pi_M)^2\right) (1 - \pi_M)^2 (V_M + \pi_S V_S) \\ & + 2(1 - \pi_M)^4 \pi_S V_S\end{aligned}$$
- ▶ If neither managers nor specialists have ideas accepted, no surplus is generated

Independent units



Investment bank profits with independent units

- ▶ Specialists might have ideas accepted and generate surplus for each of the clients
- ▶ $\Pi_I = 2 \left(1 - (1 - \pi_S)^2\right) V_S$
- ▶ If neither of the two specialists for each client have an idea accepted, no surplus is generated

■ Problem and model assumptions

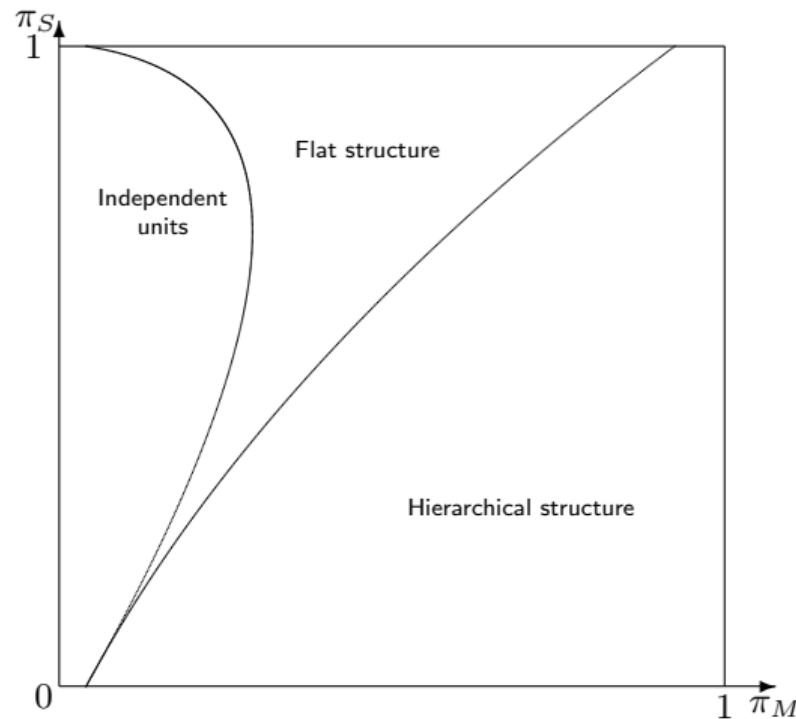
■ Possible organisational forms

■ Optimal organisational form

■ Summary

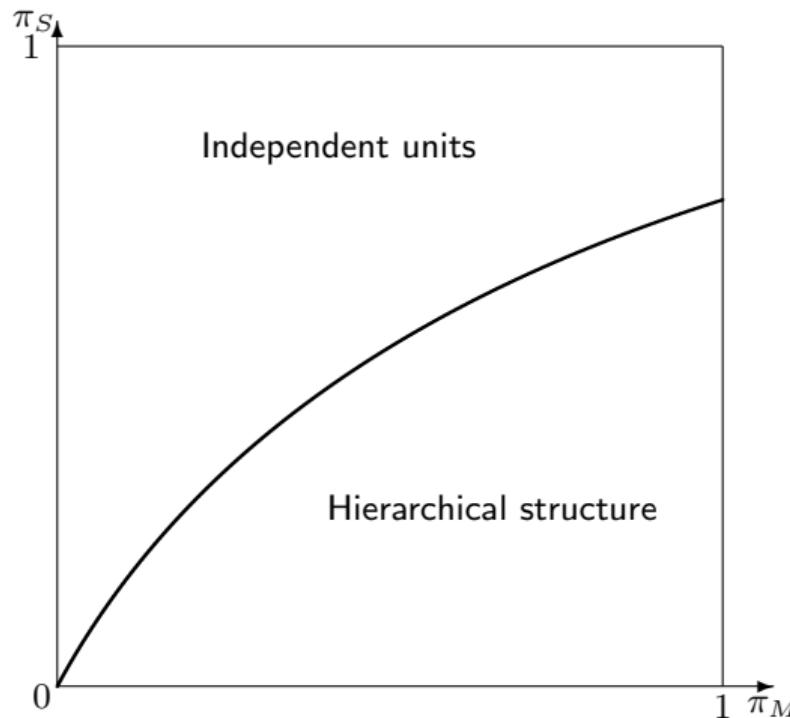
Comparison of profits to investment banks

- ▶ Comparing investment bank profits, we obtain that
- ▶ $\Pi_H > \Pi_F$ if $\frac{V_M}{V_S} > \frac{\pi_S}{1-(1-\pi_M)^2}$
- ▶ $\Pi_H > \Pi_I$ if $\frac{V_M}{V_S} > \frac{1-(1-\pi_S)^2}{1-(1-\pi_M)^4}$
- ▶ $\Pi_F > \Pi_I$ if $\frac{V_M}{V_S} > \frac{1-\pi_S(1-\pi_M)^2-(1-\pi_S)^2}{1-(1-\pi_M)^2}$
- ▶ If $\frac{V_M}{V_S} < 1$, then $\Pi_F < \Pi_I$ and the flat structure is never optimal

Managers providing higher surplus than specialists ($V_M > V_S$)

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

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

Specialist involvement is preferred

- ▶ If managers generate less surplus than specialists, flatter structures are favoured even more
- ▶ A flat structure is not optimal as the management involvement is not generating enough surplus
- ▶ Structures are either hierarchical or independent

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Benefits of flatter structures

- ▶ Hierarchical structures benefit from the input of many layers of management
- ▶ This ability to generate many ideas needs to be weighed against the potentially lower surplus these ideas generate
- ▶ If specialists generate more surplus, flatter structures are preferred as then the ideas of specialists prevail

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, but managers have more knowledge how to extract surplus for the investment bank
- ▶ The requirement to have advice accepted, favours flatter structures, as found in most investment banks



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