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Small Talk Newsletter

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Bigger Is Not Always Better

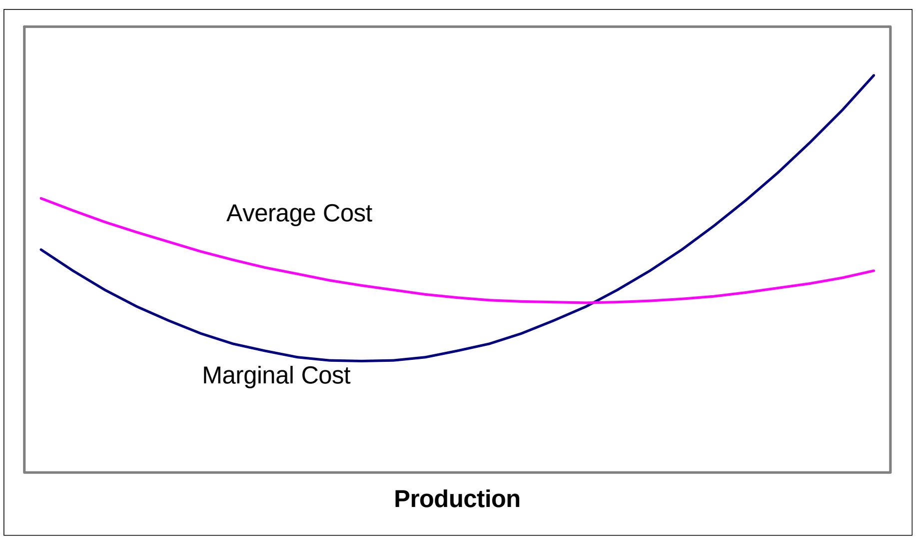
by Grant Hemphill

One of the more memorable experiences of my year as chairperson was a debate which I moderated at the Spring 1996 SOA meeting in Orlando. The topic was “For and Against Industry Consolidation.” Scott Cipinko (of the National Association of Life Companies) and Tom Dlouhy argued against consolidation while Mel Young and Mike Sproule argued for it. The debated resolution was: “The public would be well served by extensive consolidation of the industry.” We polled the audience before and after in order to see if we had swayed opinions. The shock to me was that a large majority of the audience favored consolidation (before and after the debate). At Smaller Insurance Company Section function, I had expected otherwise.

No winner was declared that day, but the session was very lively and entertaining. Perhaps Mel Young and Mike Sproule were more persuasive, since Tom Dlouhy has gone from small company work to find success at consolidation.

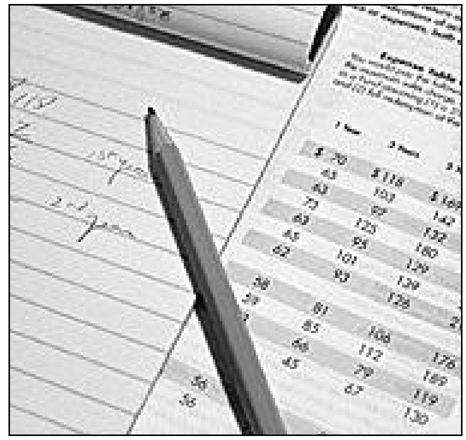
The conventional wisdom that there are economies of scale was mentioned but not questioned. Bigger companies will achieve lower unit costs. All companies must achieve critical mass. Critical mass is getting larger. Consolidating companies will lower costs. Centralizing operations in a larger unit will lower costs. (However, the centralized operation may be less responsive to marketplace needs.) This view is well expressed in Henry Mintzberg’s *The Structuring of Organizations*, Prentice-Hall, 1979.

It is hard to find business people who will disagree with that conventional wisdom. Even in the face of contrary data (and there is much), they will not consider the possibility that the theory is wrong. “Management just failed to make the necessary tough decisions after the merger.”



Economists do not agree that bigger is cheaper. They view the above arguments as sociological rather than economic. Every microeconomic text has a chart similar to the one on this page.

Economists really believe this. Marginal costs first decline with increasing units and then they increase with increasing units. I have asked many business people about the above marginal cost curve and they think it must apply to



industries other than their own. In their industry, they think the curve must continue downward with increasing scale. Some of the texts suggest why the curve turns upward. Perhaps some production variable begins to be strained. Eventually, necessary resources are limited.

A better explanation is found in Oliver Williamson’s *Markets and Hierarchies: Analysis and Antitrust Implications*, Free Press, 1975. Williamson believes in the power of free market economics. It drives out inefficiency. Spending decisions that are exposed to market economics will be efficient. Spending decisions that are isolated from market economics tend to become inefficient. How does this isolation happen? A government bureaucrat provides the extreme example. He has almost no idea what expense the public is willing to pay for the function he performs. But the distant, centralized, corporate employee is in a similar situation. She can only try to do her job “better.” Each becomes a budget maximizer, sincerely trying to do a better job and needing a larger budget to improve service.

In Williamson’s words, “The organization of the large enterprise along the lines of the (product or market divisions, or small companies) favors goal pursuit and least-cost behavior more nearly associated with the neoclassical profit maximization hypothesis than does the [functionally centralized] organizational alternative.”

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Bigger Is Not Always Better

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Two examples will illustrate.

I once worked for a small life subsidiary of a distant, giant manufacturer. Fortunately, we were usually quite autonomous. But, I remember the day when corporate engineering showed up with the parking lot signage. The signs were beautiful and very substantial. They were built to the same standards and quality as those used at the corporate palace. Economies of scale certainly applied because we could never have purchased such opulent signs for the expense that was allocated to us. But in our small town, there was no need for any signs.

Competitive term is sold with inexpensive advertising. However, I have known more than one company that used an expensive, glossy, multicolor, multipage term brochure because corporate standards suggested one for each product. Again, the cost was lower due to centralized economies of scale but too high because the expense was out of touch with the market.

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There is one counter argument to the idea that centralizing functions isolates them from market economics. In theory, a very good communication, cost allocation, and budget system could restore market pressure to remote expenses. Williamson says that the cost of such a system quickly exceeds the savings it can produce as organizational complexity increases.

I think the future is good for small, focused insurance companies because we have marketing, service and expense advantages that come from being in touch with our consumers.

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Bank Insurance Regulation—An Update

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Definition of insurance

THE ACLI WAS involved in negotiating this. Both bills are the same. It defines insurance with reference to the federal tax code.

Insurance underwriting

THIS IS A MAJOR issue. Both bills stipulate that insurance can only be written by holding company subsidiaries. The Senate bill, however, allows an exception for small banks (for banks, it is less than $1 billion of consolidated total assets). Will the Treasury or the Fed have jurisdiction over this? This may be a deal-breaker. Obviously, the insurance industry wants to maintain control over the underwriting. The only hope of smaller companies that might get involved in providing products for this market is to make sure the insurance industry has this control.

Other Issues

THESE BASIC ISSUES involve clarifying the roles of the banks and insurance companies and who will regulate them. Insurance has generally been regulated by the states, and large banks have generally been regulated by federal law.

There are many aspects of federal law that do not apply to insurance companies. The Democrats are trying to include various issues in this regulation. Some of these are: downstream commercial investments, the control of takeovers of recently demutualized insurers, the application of the Community Redevelopment Act (CRA), application of domestic violence, and the privacy of medical and financial information.

According to Allen Caskie, much of the compromising will be partisan with Democrats trying to insert these provisions, and the Republicans trying to keep them out and focusing on the bank—insurance issues. We should all be watching how this turns out. If nothing has been finalized by the time you received this issue, you should contact your state representative with your views.

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