Ownership Structure and Monopolization: An Analysis of Publicly and Privately Owned Life Insurance Firms

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Table of Contents

Abstract

Life insurance companies can be publicly or privately owned, but what advantages are there to each structure and why? Through intensive literature research, it is clear that there are distinct differences in the management theories, goals, and purposes of the two ownership structures. Further, the evidence suggests that each structure holds certain advantages over the other. The potential for monopolization of one of these structures is examined, but due to the numerous tradeoffs in the two structures, it is unlikely this would occur. The literature shows that there is a need for more research on the subject of ownership structure since a very slim body of knowledge exists and the subject is very speculative.

Introduction

It is intuitive that there is a difference between publicly and privately owned firms. It is also clear that there must be advantages to each type of structure. If this were not the case, one structure would hold too many advantages to make the other competitive, thus driving them from the market (Jensen & Meckling, 1976). So what advantages does each type hold, and how can they both stay competitive in the market? This question is important since a greater body of research that gives better familiarity with these advantages, and disadvantages, will allow for better understanding of these firms and a larger knowledge base to make business decisions as the head of one of these companies.

Background

The structure of ownership is not a topic that has garnered a lot of scholarly attention. With that in mind, it is easy to see that further research is necessary to gain more insights about these important differences between privately and publicly owned firms (Perry & Rainey, 1988). Privately owned firms are owned by a group of investors or a sole proprietor. These firms are called "mutual" firms and do not have stock that is publicly traded in theory. This means that the firm does not have to base financial decisions on how it will affect stock, but what will be best for policyholders in the long-term. A publicly owned firm, however, has stock that is traded on an exchange, so ownership changes hands frequently. The goals for a public firm are typically more focused on the short-term gains of the stockholder. Whether a firm is working for the stockholders or the policyholders can play a large role in the decision-making process. This will be discussed in greater depth.

Research on privately versus publicly owned firms has accelerated in recent years (Rainey & Bozeman, 2000). This includes a new body of literature about special topics on private versus public firms in recent years. This is an essential topic for competing businesses and scholars alike. Why has one ownership structure not monopolized the market? Is there potential for monopolization in the future? What would the corporate culture look like if there was not a competition between these structures? These are just some of the questions that will be answered in a few sections.

Summary of Findings

The following table (Figure 1) summarizes advantages and disadvantages of privately versus publicly owned firms for various related issues found in this study. Each of the topics listed will be explained further.

	Privately Owned	**Publicly Owned**
Separation of Ownership and Control	Advantage	Disadvantage
Agency Costs	Large Advantage	Large Disadvantage
Stability of Credit	Large Advantage	Large Disadvantage
Average Credit Rating	Large Advantage	Large Disadvantage
Investment Risk	Advantage	Disadvantage
Firm Size (Average)	Advantage	Disadvantage
Dispersion of Ownership	Advantage	Disadvantage
Regulation	Small Advantage	Small Disadvantage
Administrative Intensity	Advantage	Disadvantage
Efficiency	Similar	Similar
Percent of Market	Large Disadvantage	Large Advantage
Raising Capital	Large Disadvantage	Large Advantage
Benefit to Investors	Large Disadvantage	Large Advantage

Figure 1: Advantages and Disadvantages of Privately Versus Publicly Held Firms

Review of the Firm

There has been much speculation about the nature and tendencies of the firm. Because of this, there is a robust body of research and speculation on the firm. Goals, purposes, and management theories are all part of this research. Jensen and Meckling define a firm as "a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals … are brought into equilibrium within a framework of contractual relations" (Jensen & Meckling, 1976). Because of this, a firm behaves like a market and uses a complex set of contracting relationships to delineate the rights of the parties involved.

In their article, "The Theory of the Firm," Jensen and Meckling assert that firms are able to be successful despite the agency costs inherent in the corporate form (Jensen & Meckling, 1976). An agency cost is the cost that is associated with the separation of ownership and control, stockholders and managers, and the interests of the two parties. These agency costs are much more common in a publicly owned and traded corporation since there is far more separation of control. This then, is a disadvantage for a publicly held firm. Yet, investors will still invest their money in firms despite these agency costs. This is a testament to how solid a model the public firm is, as these costs can be enormous.

Another significant characteristic of the firm is that it can also use resources that can be more efficiently ascertained by the conventional search through the general market and thus promote competition (Alchian & Demsetz 1972). This is significant because it provides more evidence to suggest that the firm does behave like an efficient market itself to find an equilibrium with competition. Finally, Coase states that the purpose of a firm is to forecast and operate through the price mechanism by the making of new contracts. Furthermore, management merely reacts to price changes and rearranges the production factors that they can control (Coase, 1988). Therefore, management cannot control all aspects of the firm, but will use the factors that they can control in order to react to price changes and stay competitive in the industry. The goal is essentially to remain competitive no matter what happens in the market. This is true for all types of ownership. Conclusively, the firm is a very essential, yet broad topic in scholarly research that includes many different theories and added complexities. Even though it is such a broad topic, this knowledge about the firm is a platform on which to base the effects of public and private ownership on firms.

Review of Ownership Structure

The first thing to note about ownership structure is that on average, private companies will have a higher credit rating than their public counterparts (see figure 2).

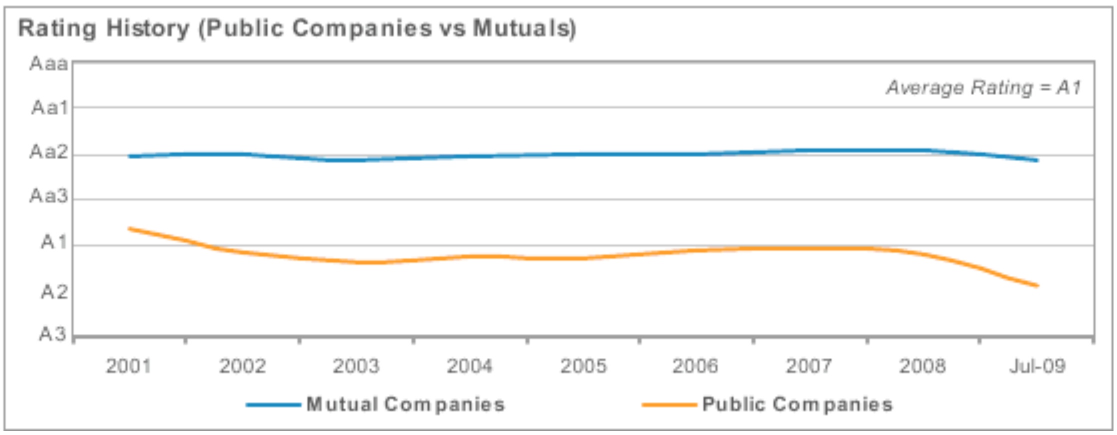

Figure 2 (Fliegelman, 2009): History of Moody Ratings for Private and Public Firms

Note that the figure from Moody's average credit ratings in 2009 of life insurers shows that large private firms have held a higher average credit rating with little variation, even with the recession that began in 2008. With the stock companies, there was significantly more fluctuation of average credit rating consistent with the business cycle. This may likely be due to a public firm's dependence on capital markets, which fluctuate over time. So when the economy is booming, public corporations will have more capital and get higher credit ratings. Conversely, when the economy is in a downturn, the public firms will see adverse effects in their credit ratings.

Another interesting note is that the average ratings for stock companies were always lower than those of the private companies, even during expansion. So why is this? The answer may be that stock companies tend to be more risky than mutual companies (Lamm-Tennant, 1993). Public firms tend to take on more risk because of their potential for greater reward and expanding shareholder wealth. Making riskier investments is more common for stock companies who are seeking higher returns. An example of this is AIG. AIG is a publicly held company that took on subprime mortgage investments. This was a risky strategy that caused a financial crisis for the company and a downgrade in their credit rating from AAA in 2004 to A1 in 2009 (Fliegelman, 2009). Investments like these are far less likely to be made by privately held companies, which explain their higher overall rating due to less risk.

The literature on ownership structure deals with other relevant topics that can aid in the understanding of ownership structure. Demsetz and Lehn point out three determinants of ownership structure: value-maximizing size, control potential and systematic regulation (Demsetz & Lehn, 1985). First, the structure of corporate ownership varies systematically in ways that are consistent with value maximization. The larger a firm is, the larger the firm's capital resources ought to be as well. This gives a greater value to each portion of the firm's parts, which should diffuse ownership (Demsetz & Lehn, 1985). Since the ownership would be spread over more parts of the firm, it could cause the firm to specialize in bearing specific risk types within the company. (De Alessi, 1973). This would mean that each part of the company will have a specific task and risk associated with that task. Instead of having fewer divisions in the firm and having greater total risk to each part, specialization will occur with diffusion of ownership and risks will become associated with that division of the firm. Specialization in what parts of the company bears what risks is an advantage to the rational owner as it will have a tendency to maximize the potential for each sector of the firm. Another advantage is that a diffuse ownership will likely keep the costs of capital lower, which could help make more profits. Because of this, it would seem proper that both a publicly owned or privately owned corporation would attempt to seek this advantage by increasing their size but keeping sectors diffused to specialize and maximize potential. However, a privately owned firm has the edge with this ownership structure determinant because it is privately owned and can therefore diffuse ownership as seen fit by policyholders and managers, not as the stockholders see fit. In a study by Adams and Hossain, it was observed that privately held firms are generally larger than publicly held firms, and had a more diffuse ownership (Adams & Hossain, 1996).

The second determinant of ownership structure, control potential, is more difficult to measure says Demsetz and Lehn. The authors define control potential as "the wealth gain achievable through more effective monitoring of managerial performance by a firm's owners" (Demsetz & Lehn, 1985). This means that, if there were no agency costs, control potential would have no role in ownership structure. When the ownership of a public firm and the managers have shared goals for the firm, the corporation will do well and the control potential will be minimized, which will increase the firm's value. However, the problem is that all too often the stockholders interests conflict with those of the managers of the firm. These agency costs will be a disadvantage to a public firm. Private firms incur less agency costs, and the ownership has more direct control over the managers of the firm. Exercising too much ownership control may seem to lower the value of the firm though; this is more relevant to a public firm (Demsetz & Lehn, 1985).

The final determinant, regulation, restricts the options of owners. Regulation heavily favors neither a public nor a private firm, but rather has an effect on both. Regulation causes a lot of scrutiny by regulators to replace management if the balance sheet looks too risky (Demsetz & Lehn, 1985). This slightly favors a private firm because the change in management will not have the potential to drop the price of investing in the firm. The management change could cause less interest in investing for a time, but if the price significantly decreases in a publicly owned firm, this is a disadvantage.

Another note on ownership structure differences is administrative intensity. Administrative intensity is defined by Pondy as "the number of managers, professionals, and clerical workers divided by the number of craftsmen, operatives, and laborers employed by the organization" (Pondy, 1969). Pondy's work found that administrative intensity will decrease with organization size and increase with functional complexity as well as the separation of ownership and management (Pondy, 1969). Due to these findings, it is found that a privately owned firm tends to encounter less administrative intensity. Since private firms tend to be larger than public firms (Adams & Hossain, 1996), administrative intensity would be less for a private firm. Also, separation of ownership and management are much greater in a publicly owned firm than a privately owned firm. This being the case, it would cause a higher administrative intensity for public firms compared to private firms yet again. Functional complexity is the only factor that does not favor a public firm. Pondy states that, "if all occupational specialties in an industry are equally populated, then only the number of occupational specialties needs [to] be counted to get a measure of functional complexity" (Pondy, 1969). Therefore, functional complexity shows a bias toward neither a public nor private firm. Overall, that gives private firms a definitive advantage over public firms with respect to administrative intensity.

Also, Greene and Segal found in their study on the profitability and cost efficiency in the life insurance industry that, on average, there is no significant relationship between cost inefficiency and organizational form (Greene & Segal, 2004). This is an interesting note as it gives an advantage to neither public or private firms with respect to cost efficiency. This is because stock companies may be more effective at disciplining managers because of the threat of a takeover, giving a public firm more cost efficiency. But a private firm negates that advantage by effectively eliminating owner-customer conflict because the owners are the policy holders themselves (Greene & Segal, 2004). However, there is a positive correlation with investments and inefficiency and a negative correlation with annuities and inefficiency. This means that the investments business tends to be less cost efficient and annuities business tends to be more cost efficient (Greene & Segal, 2004). This is another interesting side note that does not necessarily give either ownership structure an advantage or disadvantage. The most interesting part of the study was that Grene and Segal found that the life insurance industry was 20% inefficient on average. Anecdotally, managerial behavior and perceptions are highly affected by ownership structures (Lachman, 1985). Lachman points out that higher formalization levels and less flexible internal managerial processes in public firms can cause the managers of public firms to believe that the rewards of their jobs are lower than that of those in the private sector (Lachman, 1985).

In general, the difference between publicly and privately owned corporations may seem insignificant at first, but when analyzed, we find that the differences can be quite substantial; causing business to be conducted in completely different manners for both types of company. There is no evidence that private insurers are less cost efficient than public insurers (Cummins & Zi, 1997). Mutual companies do tend to have higher incurred underwriting losses than do stock companies, but tend to have risk management and long-term sustainability planning that enables them to survive better in a bear market (Maguire, 2009). Mutual life insurance companies are likely to have higher asset specificity; lower incidence of reinsurance and cost of governance than stock life insurance companies as well as tending to be larger in size (Adams & Hossain, 1996). Mutual companies also have decision hierarchies that pass initiatives of the lower agents to the higher level agents, first for ratification, then for monitoring. Stock companies tend to reward agents both for initiating and implementing decisions for ratifying and monitoring the decision management of the other agents (Fama & Jensen, 1983). According to a study by Winklevoss and Zelten, mutual life insurance companies' surplus (for the largest five firms) has consistently exceeded the need for such funds in the past; they have ample margins to cope with all the risks facing them which create the need for a surplus (Winklevoss & Zelten, 1973). Also, publicly traded firms exhibit a greater international presence than privately held firms (Mascarenhas, 1989). As mentioned earlier, stock companies are riskier than mutuals. Stock firms tend to have more lines of business than mutuals but are not significantly less concentrated in more lines of business than mutuals. Stock firms have greater concentrations in geographic areas that have the greatest risk as well, contributing to their overall higher risk (Lamm-Tennant & Starks, 1993). Finally, given that we have public policies that establish regulation and cover for insolvencies, society is often thought to be better off with the continued presence of mutuals. Mutuals tend to write less risky policies. Market contracting costs are also smaller for mutuals, which also have less insolvency. Mutuals also have lower levels of regulation and are less susceptible to moral hazards (Morse). Overall, mutuals appear to have many advantages compared to publicly owned firms. This leads to the question if these advantages are substantial enough to lead to monopolizations of private firms.

Is Monopolization Possible?

Because of the aforementioned reasons, it seems like it would be a better business decision to be a privately owned firm, as they have a number of advantages over a publicly held firm. So if this is the case, why are 90% of U.S. life insurers publicly owned firm (Greene & Segal, 2004)?

The first reason for more public firms than private is that raising capital is much easier in a public firm. With a stock company, you can issue new equity in the form of common stock or preferred stock to raise funds for expansion. With a private company, you do not have the ability to raise money in the form of an IPO like a public firm can. Instead, a private firm must raise money for investment or expansion by attracting private investors to invest in the firm, or they must simply bide their time and choose projects and security investments carefully in order to grow the company over a more extended period of time from within the funds they already have. But this is not feasible for all owners or firms, especially insurers, which is why many will take their firms public. It is far more time consuming to raise money as a sole proprietor or partner, than having a public offering of stock to raise funds quickly and easily. So it seems unlikely that sole proprietors would benefit from a monopolization of the firms as private because they would be forced to raise capital in a more difficult way, causing less expansion in the businesses. In much the same way, a sole proprietor would not be in favor of having only public firms either, as it would eliminate "family businesses" that are a part of their life and an extension of their personality. If all firms were public, a firm would have to always start out with an IPO to raise funds. If this were the case, it would be more difficult to start a small business, but more importantly, the founders of the firm would have the potential of being forced out by the stockholders. Because of this, a business founder would want the option of being a private or public firm, and could switch partway through the life of their career.

Another reason why the public firm has not been forced out of the market is because of the investor's preference for liquidity. A liquid investment usually has much more value to an investor than a non-liquid investment. Investors can be individuals that do not have much to invest, or major corporations that are throwing a lot of financial weight around in the market. They all seek liquidity. If their investment is performing poorly, they want to get out of it fast and put that money into a stronger investment. This is another significant advantage for the public firm. Public firms are extremely liquid due to the exchanges of common stock both electronically and in physical markets. Investors can get into a firm's ownership, hold stock for a short period of time and reap the benefits of the firm's profits. With a private firm, issuing bonds is the main way to invest. The issue with these bonds is that a private firm needs very large amounts of money from these bonds, which shuts out small investors. The other issue is that they have fixed returns. It is beneficial for the risk-averse to have fixed rates, but in general, this limits returns even in expanding markets. This potential for a higher rate of return is another key advantage for a public firm in the eyes of the investor.

With this in mind, is monopolization of an ownership structure type possible? Yes, monopolization is possible, but extremely unlikely. On one hand, there are many advantages to conducting business from a private perspective, but on the other hand, raising capital and gaining investors are big advantages for public firms. The most likely way to have a monopolization occur would be to have a major economic collapse. If the economy of a nation receded by a large margin for many years, economic pressure could push public firms out of the market. If an economy collapsed in such a fashion, the public firms would be more likely to crash more quickly than the private firms. This can be seen by the recent economic recession and life insurance companies. Public companies that had capital through equity had their stock prices significantly drop, which hurt the business and caused layoffs and smaller profits. One such firm that had its prices drop was The Hartford Life Insurance Company. The drastic price drop resulted in layoffs at The Hartford to avoid bankruptcy. During the same period, mutual life insurers such as New York Life, Northwestern Mutual and MassMutual all had growth and issued dividends to their policy holders. If this recession had been more severe and lasted for much longer, companies in situations like The Hartford would have trouble staying solvent and could potentially shut down. This could also lead to the eventual monopolization of the market by private firms.

The monopolization of a market by private firms could cause major social problems. If all the firms were mutuals, then the small investor would have no where to put his or her money except in a bond, CD, or money market account. The average rate of return for all of these would be lower than for a well diversified stock market portfolio. So investors would be a major loser if monopolization occurred by private firms. The other loser would be the consumer. If all of the public firms left the industry, there would be significantly less firms doing business. Because of this, the supply of goods and services would decrease significantly. If the supply decreases, the prices will go up. So not only will the consumer have less options to choose from, each option would cost more. This is a highly unlikely scenario. Monopolization of ownership structure by private firms would be beneficial to the business owners, but not for the investors or consumers. Expansion would take far more time because it would be harder to raise capital via equity, and the overall economy would slow.

As alluded to before, if the monopolization of public companies occurred, the business would be hurt, as would the economy. The economy would have trouble with the lack of private firms because private firms tend to be the largest. This business would be taken over by public companies, which may not have the capacity to take on as much business. Another key issue to having public companies monopolize the market is that business itself would be hurt. All firms would then have a focus more on the short-term gains and increasing shareholder profits. Furthermore, if a publicly monopolized economy fell into an extended recession, many firms may become bankrupt and supply could sharply decrease, causing extremely inflated prices on goods and services. All in all, investors would gain from monopolization of the organizational structure by public firms, but consumers would again lose, as would business itself.

Conclusion

Throughout our study, we've assessed the status of the firm, reviewed the forms of ownership structure in a corporation, and discussed monopolies in the ownership market. We found that there appears to be significant advantages to doing business and creating profits for the private ownership type. Most advantages were for a private firm, not a public firm, but public firms were still a large percentage of the market, so we looked into what advantages could possibly keep public firms so well-entrenched in the market. We found that the ease of raising capital by way of equity and investor interest were the main reasons that public firms continue to exist. We then explored the possibilities of a monopolized market with respect to ownership structure and found that economic forces made this unlikely. Our study also indicates that a monopolization of ownership structure by either type could potentially be bad for the economy as a whole and cause higher prices for consumers.

A limitation of this study is that it is only based on a literature study, where a combination of previous literature was used to formulate hypotheses tested by thought experiments. A more comprehensive and precise study would include real-world data that was gathered over the course of a few years from a significant group of both private and public firms. As a result, further research on the topic is required to draw additional conclusions.

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