Journal of International Management 16 (2010) 275–287

Contents lists available at ScienceDirect

Journal of International Management

Fox School of Business
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Distribution system choice in a service industry: An analysis of international insurance firms operating in the United States

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ARTICLE INFO

Article history:
Received 7 December 2006
Received in revised form 16 June 2009
Accepted 18 June 2009
Available online 8 July 2010

Keywords:
Distribution system choice
Insurance industry
Direct writing
Independent agents

ABSTRACT

Service firms play an increasingly important role in the global economy. However, the internationalization strategies of such firms, and especially their distribution system choices, have been underexplored in the international management literature. One specific service industry that has internationalized rapidly in recent years is the insurance industry. This paper examines the determinants and performance implications of the choice by international insurance firms between two rival distribution systems: direct writing and independent sales agents. Drawing on the transaction cost theory-based literature on resource commitment, control, and risk, we develop hypotheses on the determinants of the choice between these two distribution systems and on the performance implications of this choice for insurance firms. Analyzing a sample of 168 distribution entries into the United States by insurance firms from six foreign countries over the 1992–2000 period, we find that cultural distance has a U-shaped effect on the probability of direct writing, and that an insurer's intangible assets have a positive effect on this probability. We also find that the direct writing system performs better in terms of profitability, but that the independent agency system performs better in terms of market share growth.

1. Introduction

The choice of foreign entry mode is one of the most important strategic decisions that internationalizing firms have to make, and is therefore one of the core research topics in international management research (Werner, 2002). Many studies have examined the entry mode choices of manufacturing firms (for reviews, see Datta et al., 2002; Slangen and Hennart, 2007). Yet, services play an increasingly important role in the US and global economy, and have in fact become more important than goods. For instance, "services produced by private industry accounted for 67.8% of US gross domestic product (GDP) in 2006, with real estate and financial services such as banking, insurance, and investment on top" (US Department of State, 2007: 7). Production of goods, on the other hand, accounted for only 19.8% of US GDP in 2006. Moreover, services differ from goods in several important ways. For instance, while goods are tangible and can be stored, services are often intangible and must be produced and consumed simultaneously (Capar and Kotabe, 2003; Contractor et al., 2003). Despite the economic importance and unique nature of services, relatively few studies have examined the entry mode choices of service firms. These studies have often examined services in general, lumping expansions by firms operating in a variety of service industries (e.g., Agarwal and Ramaswami, 1992; Erramilli, 1991; Domke-Damonte, 2000; Erramilli and Rao, 1990, 1993; Fladmoe-Lindquist and Jacque, 1995). Only a few studies examined the entry mode choices by firms operating in one and the same service industry. Agarwal and Ramaswami (1992) examined the

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1075-4253/$ – see front matter © 2010 Published by Elsevier Inc.
doi:10.1016/j.intman.2010.06.006

determinants of the choice between licensing, joint ventures, and wholly-owned subsidiaries by US equipment leasing firms, while Erramilli (1996) examined the determinants of the choice by US and European advertising agencies between majority and minority ownership of foreign subsidiaries. Brouthers (1995) and Brouthers et al. (1996) examined the determinants of the choice by US computer software firms between servicing foreign markets through wholly-owned subsidiaries, joint ventures, or contractual arrangements (i.e., licensing or franchising). Contractor and Kundu (1998) and Erramilli et al. (2002), finally, examined the determinants of the choice between wholly-owned subsidiaries, joint ventures, management contracts, and franchising in the international hotel sector.

To the best of our knowledge, studies of the entry mode choices made by firms operating in one specific type of service industry–financial services–are so far lacking. In this paper we fill this gap in the entry mode literature by examining the entry mode choices of firms operating in a financial service industry, i.e. the insurance industry. Specifically, we examine the choice between two distribution systems that insurance firms may use to sell insurances abroad: the direct writing system and the independent agency system. The independent agency system represents a low-control entry mode under which insurance firms close non-exclusive contracts with independent business owners who sell the products of several insurance firms. These business owners control the customer list, meaning that the insurance firm cannot replace the agent or contact clients directly without the agent's permission. The direct writing system, on the other hand, represents a high-control entry mode under which insurance firms sell their products through employed sales agents and/or through exclusive agents. Under this arrangement, the insurance firm retains the ownership of the customer list (Kim et al., 1996; Berger et al., 1997; Regan, 1997; Seog, 1999; Regan and Tennyson, 2000; Cummins and Doherty, 2006).

An important challenge that international insurance firms face is to maximize their performance in their overseas markets by serving these markets through the right distribution system. This study aims to gain insight into the way in which insurance firms choose between independent agent and direct writing distribution systems, and into how this choice affects their performance in the foreign market entered. Specifically, this study sets out to explore the main determinants of the choice by international insurance firms between selling their products in the US through independent agents or through direct writing. Moreover, it examines the *ex post* performance consequences of this choice for the performance of the insurance firms in the US. By doing so, we aim to improve our understanding of the strategic decision making of managers of internationally-operating insurance firms, and of the comparative performance of rival distribution systems commonly employed in the insurance industry.

Our decision to study the insurance industry is motivated by several factors. First, the insurance industry has experienced a large volume of foreign direct investment (FDI) in recent years, mainly due to new technological advancements and governmental liberalization policies, which have created many opportunities for insurance firms to become active in foreign markets. Moreover, the insurance industry is one of the largest service industries in the US (US Department of State, 2007). Second, an insurance policy involves the payment of a premium over a long period of time in order to generate a specific type of benefit for the policyholder in the future. As a result, policyholders are likely to have long-term relationships with their insurance firms, and are likely to have a special interest in the performance of their insurer. Together with the lack of international management research on insurance firms and their entry mode choices, these specific characteristics make the insurance industry an interesting service industry to study.

To examine the determinants and performance implications of the choice by insurance firms between direct writing and independent agents, we draw on two distinct bodies of research: the transaction cost theory-based literature on the level of resource commitment, control, and risk associated with foreign entry modes (Anderson and Gatignon, 1986; Hill et al., 1990) and the literature on insurance distribution systems. We combine these two streams of literature to develop and test a set of hypotheses on (i) the determinants of the choice between independent agent and direct writing distribution systems, and (ii) the implications of this choice for the performance of the insurance firms in the US.

Our study makes at least two contributions to the international management literature. First, while several studies in the risk management and insurance literature have examined the distribution systems used by insurance firms (Kim et al., 1996; Regan, 1997; Regan and Tzeng, 1999; Seog, 1999), we are the first to study distribution system choices made by such firms from an international management perspective. Second, we are the first to identify the main strategic determinants of the choice between using independent agents and direct writing, and to simultaneously explore the performance implications of this choice for the focal insurance firm. Hence, our study is both descriptive, identifying what drives insurance firms to choose a specific distribution system, and normative, identifying whether specific distribution systems contribute more to firm performance than others.

2. Literature review

It is generally accepted in the foreign entry mode literature that there is a tradeoff between the resources committed to an entry mode and the level of control associated with the entry mode, with control referring to a firm's ability to influence systems, methods, and decisions in a foreign market (Agarwal and Ramaswami, 1992; Anderson and Gatignon, 1986). Control has an important impact on firms operating in foreign markets and serves as a way of obtaining a higher return, since without sufficient control a firm may have a hard time coordinating its actions and implementing its production or marketing strategies (Anderson and Gatignon, 1986; Dong et al., 2008). Control entails a high level of resource commitment, including high overhead, and increases a firm's exposure to potential losses due to fluctuations in exchange rates when operating in foreign markets (Davidson, 1982; Anderson and Gatignon, 1986).

> "Control, then, is the focus of the entry mode literature because it is the single most important determinant of both risk and return. High-control modes can increase return and risk. Low-control modes (e.g., licenses and other contractual