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See table of contents

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Article abstract

Dans des marchés toujours plus difficiles à pénétrer, la gestion des réseaux de distribution d'assurance devient un enjeu prépondérant dans l'accès aux consommateurs. Parler de gestion de réseau de distribution suppose le plus souvent d'adopter une perspective marketing. Le professeur B. Venard décrit cette gestion dans le cas de l'assurance de dommages d'un point de vue organisationnel.

The Management of an Externalized Distribution Network :

The Case of Non-life Insurance in France

by

Bertrand Venard*

Dans des marchés toujours plus difficiles à pénétrer, la gestion des réseaux de distribution d'assurance devient un enjeu prépondérant dans l'accès aux consommateurs. Parler de gestion de réseau de distribution suppose le plus souvent d'adopter une perspective marketing. Le professeur B. Venard décrit cette gestion dans le cas de l'assurance de dommages d'un point de vue organisationnel.

Introduction

The rapport between insurance companies and their agents is a relationship which constitutes a fundamental element of insurance company global management.

To analyse this type of relationship, some economic and behaviourist models have been used. At their intersection, some integrators' models have been able to explain performance criteria attainment, taking into account the performance of firms within the network. The most successful of these is certainly that of transaction costs (WILLIAMSON, 1975, 1987, 1990).

The success of his work is based upon many types of economic research such as the theory of the firm (COASE, initiator of the transaction cost principle), the theory of property

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rights (ALCHIAN), of agency (FAMA, JENSEN, MECKLIN) and the principal results of the decision theory (SIMON, CYERT, MARCH).

Williamson considers the economic activity of a business, as a group of transactions. According to him, the aim of the business is to minimize these transaction costs. For that, an arbitration between integration and externalization within the framework of performance constraints is required. Externalization means entrusting the care of transaction organization to an establishment. The notion of uncertainty linked to transaction execution is central to Williamson's model. The author also defines the transaction type by its frequency of occurrence, and its need of specific support.

Historical analysis of insurance distribution in France seems to validate Williamson's theory. In fact, companies' decision criterion seems to have been transaction costs minimization.

Since the 19th Century, French companies have made the hypothesis that some well placed independent intermediaries, were more efficient than those salaried to sell a complex insurance product, who required a relationship of confidence between buyer and seller. Elsewhere, this mode of distribution allowed (and still allows) expense sharing of establishments' points of sale between the intermediary and the company. A local presence was also made necessary due to the condition of the transport network, communication and payment techniques. Moreover, in the extent where the survival of the agent was tied to his successful adaptation in the local market, the companies could rely upon a good return of local market information towards the head offices. Finally the use of local entrepreneurs could means that companies could take advantage of their commercial dynamism.

On the other hand, companies made the hypothesis that the costs linked to the transaction management between themselves and their agents were inferior to their profits of externalized management of agent-client transaction.

Admitting that firms have made the correct choice, at a given moment, it nevertheless seems necessary to them that the externalized transaction is maintained at a satisfactory level of quality and cost.

In fact a certain number of questions occur:

- How these companies are sure of their well founded decision?
- What problems are encountered in their distribution management?
- In particular, since the insurance market is profoundly transformed, how to ensure that the initial bet still pays?

To respond to this question, we have studied the case of a business that we will call Topaze to preserve its anonymity. This company is one of the 20 French insurance companies, which distributes its products by a network of exclusive agents. In order to not draw some too contingent conclusions on behalf of Topaze, we have analysed the company-agent relationship in ten other French insurance companies, (but more superficially) holding interviews with some of their officials (90 interviews in total). Our report makes the remark that valid conclusions for Topaze were equally applied to other companies.

Firstly, we will show how Williamson's transaction decomposes itself into two sub-transactions in insurance: the company agent sub-transaction and the agent-client sub-transaction.

Secondly, we will study what are the profitability parameters of an insurance company. This will bring to the fore the principal indicators which are used in distribution management.

Thirdly, we will show how these indicators are measured and controlled by insurance companies. In particular, we will show that the companies are satisfied by an approximate measure of the first sub-transaction management cost.

a) A Transaction can Hide two Others

Williamson's basic unit analysis is the transaction. In insurance, the exchange is made at two levels: that of the distributor and that of the consumer (cf Diagram 1).

The first transaction consists of ensuring successful agent recruitment, establishing a good working relationship between them, and their control.

The second transaction corresponds to client selection, elaboration of the insurance offer, and the complete follow-up relationship.

An insurance characteristic is the inclusion of insurance service production in the intermediary-client transaction.

Production consists of client selection, the elaboration of the product/price pairings offered to the consumers, and some follow-up contract tasks. It is noteworthy that the "producer" in insurance is the person who one calls the "seller" in other industries.

In addition to production, the second transaction corresponds to the follow-up under the form of claim rulings.

The follow-up is split into two parts. On the one hand, it corresponds to the change of contract characteristics in function of risk evolution. This can be the change of insured capital in a fire insurance contract. This follow-up is thus an act of production.

On the other hand, the follow-up can be the ruling of claims. It is that which one names contracts application, as opposed to contracts production.

Diagram 1

Insurance Company

1st Transaction

Recruitment of intermediaries

Establishing the relationship

Control

Intermediaries

2nd Transaction

Contract production:

• Client Selection

• Establishing the relationship

• Attend to the evolution of contracts characteristics in the workings of risk evolution

Contract application:

• Attend to in case of risk occurrence, or at the end of the contract

Clients

To understand the distribution management of insurance agents, we will aim to analyse two sub-transactions: those which link the company to the agent. The existence of these two subtransactions imply some management difficulties for insurance companies. In particular, an insurance company must try to ensure the coherent placing of his objectives in these two subtransactions.

In fact, the insurer externalizes his distribution by his agents, and by them saves the responsibility of business actions. Notably, he must assume the costs of carrying out the exchange between poorly selected distributor clients, and as a result some amounts of superior claims regulations on premium income. His point of sale is not profitable for the company, but can be from his point of view. In other words, the agent client transaction can be advantageous for the agent at the detriment of the efficiency of the company-agent transaction.

b) Profitability at the Company Level

The insurance product must be carried out with an objective of increasing its entire revenue whilst reducing transaction costs.

This can be expressed in the following manner in the insurance framework:

Diagram 2

Expenses		**Revenues**
Claim Payments		Premiums
+	<	+
Working expenses		Financial Investment
inc. acquisition expenses		

This inequality can be preserved by acting upon its composition factors:

- the minimization of the claims/premium ratio: the selection of good risks;
- the maximisation of revenue and investments: the recovery speed of premiums and the quality of investments;
- the minimization of working expenses: improvement of productivity.

These three poles of profitability do not have the same probability of achievement. Furthermore, these three poles have different delays of modification.

The minimization of the claim to premium ratio and the maximisation of revenue and investments are objectives which depend on uncertain external factors, of which the evolution can be very rapid. In fact, some external variables (those which the insurer has little control over), condition his profitability. These variables can include: the evolution of the average cost of motor compensation, the increase of insurance claims, the augmentation of thefts, the evolution of the investment value,... One of the ways of limiting uncertainty concerning claims payments is recourse to the mutuality principle, and also of reinsurance (the principle behind this is to insure risks which surpass a certain level endurable, by another type of insurer (the reinsurer), paying premiums for that).

On the other hand, the minimization of expenses is an objective which in principle can be attained with more certainty. This is because these action variables are internal, and the factors which determine the functioning expenses have a smaller variability.

What are the actions put into operation by the insurer to ensure profit maintenance?

The quality of subscribed risks: the claim to premium ratio

The minimization of the claim to premium ratio is certainly the most characteristic objective of insurance companies.

Concerning the risk, three strategies can be adopted (ACKERMAN, 1928, 1948) (KESSLER, 1990) (LOUBERGE, 1981) (VENARD, 1992):

- the reduction of risk occurrence probability (by prevention, training): self-protection;
- the reduction of loss increases (taking rapid account of claims so that they don't worsen,...): self-insurance;
- usage of insurance against uncertainty.

There are three noticeable levels of action corresponding to insurance utilization:

- selection (at the moment of subscription from the renewal of the contract);

- definition of the insurer's obligations;
- definition of the insured's obligation.

Let us take the case of risk selection, and try to understand the intermediary's role in this field. The selection criteria of risks are defined by the insurer. The insurer defines the intervention circumstances to which the intermediary may participate in client selection on the company's behalf.

In the second case, the intermediary is confined to respect the orders of his company. If these powers are exceeded, the selection is operated by members of the company, most often by salaried inspectors in charge of managing the agents. The selection is operated, not only upstream of subscriptions, but also downstream. Insurance companies have some charged services of monitoring, and sometimes terminate risks which are judged non profitable. The agents' autonomy margin is thus very slight for selecting certain high risks.

The question which therefore needs to be asked is what are the criteria which legitimate the intermediation in a risk appreciation role?

The first criterion is the possibility of information access. The collection facility depends on the type of information involved. In general, quantitative information is easily collected. A counter example is that of data which is seen as confidential (revenues, heritage,...). Qualitative information often necessitates an experienced man of "confidence."

The second criterion is the necessity of risk visit. In certain cases, the visits are not prescribed, and afterwards the intermediation does not assign itself for that. For example, at the companies studied, no risk visit is carried out for principal risks concerning particulars such as, motor, household (the most common), illness. In other cases verification becomes imperative. Thus, shopkeepers can have a risk sufficiently complex to necessitate a collection of information, which can only sometimes be obtained. An example of this, are certain businesses, which must have some particular protection against theft. This is strongly identified with industrial risks.

These two targets differentiate themselves by the premium revenue/verification costs ratio. The cost of verification of a risk by the company itself justifies whether the resulting premium is important. In a contrasting case, the cost of verification means that it is preferable to externalize the confidence evaluation to agents, notably for their professional targets. In a firm such as Topaze, this type of arbitration is achieved by calculating the daily cost of an inspector (employee of the company in charge of the risk inspection), compared to case by case at premium expectations which are linked to a potential client.

Production amelioration and investment maximisation follow specific actions on the part of insurers.

Actions concerning productivity

The improvement of productivity has as its aim the reduction of relative administrative group costs to insurance operations by the produced unit. To reach this objective, many strategies can be put into practice.

The first possibility is to increase the volume of activity if there are some economies of scale. Secondly, one can also decide to reduce the acquisition cost of contracts. Thirdly, the cost itself can be reduced (notably commissions). In principle, this is not possible for a placed exclusive agent without his agreement, and means waiting for a new recruit to renegotiate commissioning. The fourth alternative is to transform the products by the creation of multi-risk contracts (such as multi-risk dwelling, or groups of contracts: "motor plus dwelling plus health insurance"), or of a longer duration. Fifthly, one can look to optimize the workings of insurance companies and their networks (for example, acquisition of information by network intermediaries).

To look for productivity gains requires a knowledge of costs. Williamson suggests that the firm knows perfectly well its transaction costs, and simultaneously its costs and those of its partners. This knowledge is necessary for mutual concessions between different forms of organization. In the dozen studied insurance companies, lack of precision was evident.

Thus, the complete cost of distribution for the insurer includes:

- the remuneration of intermediaries covering;
    - structure expenses: the infrastructure (the point of sale, the vehicle,...), tools (data processing, telephone,...);
    - administration expenses of the management of contracts, claims and accounts;
    - commercial expenses: sales, promotions, advertising, after-sales, claim rulings;
    - intermediary profits;
- the costs of organized support logistics by the company;
- the costs of organized control logistics by the company.

The cost of support logistics are also caused by the recruitment of intermediaries, their training, advertising, achievement of commercial companies,...

Control costs come principally from a system of itinerant inspection (on average an inspector for 8 or 9 point of sales at Topaze), and of a surveillance system by salaried sedentaries.

The diversity of these costs create a real difficulty in determining the complete cost of distribution. In fact, a certain number of costs can not be entirely charged to distribution. For example, global training expenses correspond simultaneously with company training of agents and personnel. The keys of cost sharing do not exist in the studied enterprises. These keys are elsewhere difficult to achieve.

This results in an approximate evaluation of distribution costs. The complete cost is evaluated by two ratios:

- management expenses in percentage of premiums;
- commission in percentage of premiums.

Management expenses exceed largely the framework of distribution, whereas commissions are only a part of distribution expenses.

Moreover, differences between the two parties are quite important, however real the lack of precision. For non-life activity, management expenses represent 34% premiums and 19% commission (Topaze data in 1990).

Thus, one can observe that the company-agent relationship management is made with a strong indecision on the real cost of network functioning. This implies, amongst others, that a company does not ask itself constantly about the relevancy of its distribution mode in function of the transaction cost.

Investment Maximisation

Investment maximisation has become very important in insurance companies, in the respect where their profits come more and more from investments than from risk subscriptions (AARONOVITCH, SAMSON, 1985). The principle is that companies collect premiums before paying out claims. In this duration between collection and pay out, they can make this money fructify. Investment maximisation is much less so dependent upon distribution politics, but much more upon the speed of recovering its premiums. The quicker the company recovers its insurance premiums, the quicker it can invest its premiums, and obtain financial benefits. It is thus of primary importance to watch the regularity of money entries. The speed of recovery is measured by the ratio between those it has collected and those which must be.

c) The Profitability at the Agent Level

The agent manages his business based upon different indicators, which can be summarize by the following table:

Diagram 3

Expenses		**Revenues**
Structural Expenses		Volume of Commissions
+	<	+
Management Expenses		Annexed Incomes

428 The principal concern of the agent is to maximise his revenue in order to increase the volume of his commission.

In the first instance, the agent aims to negotiate, with his company, the most elevated possible commissions. His action is limited where this negotiation intervenes, whereas the agent finds himself in a position of weakness from the signing of an intermediation contract, which stipulates rates of commissioning. Following that his action will transit by his union representatives who negotiate new product commissions with the company.

In the second instance, the agent can modify his production in such a way as to maximise his revenues.

The agent in order to achieve this will play upon:

- the increase of turnover and thus:
    - the increase in the number of new contracts and of the number of contracts by the client (politics of the complete client),
    - the increase in the average duration of the client's contract, and thus the stabilization of the agent/client relationship,
- the orientation of production towards better commissioned risks.

As declared one agent: "*I am motivated by the direct relationship between my work and my salary: the more I work the more money I earn,*" or "*I produce few home contracts* *because the volume of revenue is too small in comparison with the great efforts required to accomplish it."*

His second objective is, in principle, to increase his productivity by controlling his structure and management charges.

He can try to attain a critical size corresponding to the redemption of agency structure charges. The agent can also organize his activity in order to minimize his costs. He may undertake computerisation, and the simplification of his management.

On the one hand, our interviews with agents have shown us that this amelioration objective is not a priority for them in comparison with the obligation of their business development.

On the other hand, we have remarked that in the field of management organization, the agent has quite a large margin of liberty. His only constraint is to respect his rights and powers face to face with his company. The result is that from one agency to another, different modes of management are found. Thus from an agents' meeting, we have been able to note that each has his own organization concerning the treatment of receipts, and that they have never had the opportunity to compare their colleagues' solutions and so to take advantage of possible innovations.

The behaviour of the agent is guided by finding a revenue level which he considers satisfactory in level and in stability. Taking hold of company objectives, this search is made under the constraint of a claims on premiums ratio and sales measuring the speed of the financial flux of agents towards company satisfaction.

d) Objective Divergences Between the Company and Its Agents

In so far as the firm delegates an intermediary to carry out a certain number of tasks, it is plausible to think that there is an influence of one upon the other at the profitability level, that is to say an interpenetration of profitability factors.

On the one hand, the insurance sales person has an impact on its company's profitability, in so far as he is paid to verify and accept risks (or claims). Moreover, he is guarantor of the flux speed of premiums. His action of vigilance on risks and the flux of premiums conditions the profitability of the company.

On the other hand, the company has an influence on the distributor. The firm influences the dual financial obligation of work/remuneration. This financial obligation depends to a large part upon the efficiency of management tools put at the disposition of the intermediary by the company.

One could think that this interdependence implies solidarity between the insurer and its interdependent distributors. Nevertheless, these could appear as an ideal mechanism, experiencing some perverse effects.

The agent is divided between the need to increase his turnover, and the need to watch his portfolio, two objectives which are difficult to reconcile, if not impossible.

A perverse effect follows from a link between the turnover of the intermediary and his commission. In fact, at first the intermediary has an interest to subscribe bad risks which are characterized by considerable claims, in order to increase his remuneration. For example, one can say that bad drivers are good clients for the agent, because they generate large commission. There thus exists a floating danger in the quality of the distributor.

A good portfolio necessitates to be restrictive as concerns the acceptance of risks and to not be afraid to refuse bad risks. These two actions suggest that the intermediary should voluntarily limit the progress of his turnover. Their influence on the evolution of his claim to premium ratio is uncertain. The intermediary, however, has some difficulties in reaching these actions by himself.

e) The Share of Productivity Gains: a Non-cooperative Game

A productivity gain for the company at the level of the intermediary secures itself:

- either by reducing the task transfer cost of the intermediaries;
- or by increasing the volume of tasks carried out by them to constant remuneration.

The regime of remuneration, based on commission on contracts, is fixed for each agent in his contract for an undetermined duration. A derogatory regime can be fixed by contractual annexes to the agreement.

Firstly, the remuneration does not seem to have real economic justification, because the cost of task transference does not evolve with the extent of these tasks.

In fact, proportionality has the advantage of calculation simplicity, and is often found in other professions. On the other hand, remuneration of each agent is interdependent of the extent of product management, which has been modified under the simplification of contracts, by automation and computerization.

Likewise, this remuneration is not a function of the market potential which is touched by each agent, nor of the state of the local competition. The variation in division characteristics does not imply transformation of the remuneration (in another sector, American Express differentiates the remuneration of its sellers in respect of their customer zone potential).

Secondly, it is difficult to carry out to a readjustment of this remuneration. The legal statute of agents in France does not allow agents to fall below a given rate of commission without their agreement. It is necessary to negotiate with each individual agent in order to change the global commission of the network. The companies, thus, do not secure the right to obtain a level of identical commission for their agents' group. The companies must wait for the appointment of a new agent to reduce the commission rates of products.

Thirdly, the fixing of remuneration, independently of assigned tasks, means that the company can hesitate to make investments in the rationalization of the agent's job, knowing that this will not cause the redefinition of remuneration. This explains why the organization of agencies is left largely to the initiative of agents (another reason is their liberal profession statute). Likewise, the agent will refuse the establishment of a new management mode in exchange for a drop in remuneration.

Fourthly, the action of the company on productivity is thus made at the margin, by task transference towards the agent, without that the real impact of such actions may be evaluated with precision. The company takes the option of transferring a charge of maximum work upon them. Productivity gains are made by reducing the ratio: cost/volume of transactions, by playing on an increase in achieved transactions by the intermediary. This strategy is designed to reduce the profitability of agents.

The example of premium collection reveals the difficulties in reaching an arrangement between the company and its agents. The intermediary intervenes in the premium flux. He is remunerated for the collection that he has achieved, and does not wish to restrict the resulting commission (no more than 3% of the revenue). However, if the company centralizes the collection to take advantage of economies of scale, it will be able to recuperate premiums more quickly and to diminish the global cost of collection.

The problem of the agent is the following:

- on the one hand his charges are to a large extent fixed costs, which means it can exist a certain inertia between an investment and the attainment of the level of turnover allowing him to profit;
- on the other hand, commercial activities aiming to attain this turnover augmentation objective do not have an

immediate impact. Thus, the non-life contracts are only generally renewable once a year, and then, the prospects are not always interested by the insurance products;

- finally, the individual entrepreneurial agent must manage his investments in an autonomous manner, but is limited by the weak financial surface of his business. This factor is even more crucial than the general agent as an "individual person", who has some difficulties mobilizing funds in origin of financial establishments. One thus sees in the studied companies that the most successful agents were those first to computerize, whereas the small agents were the most reluctant as concerns this investment.

Conclusion

From a monograph incorporating a dozen French insurance companies, we have been able to analyse the functioning of the relationship between insurance companies and their agents. Our framework of theoretical analysis is that of Williamson's Transaction Cost Theory. Our conclusions are the following:

(i) the transaction appears as a multiple, decomposing in a number of sub-transactions;

(ii) the profitability parameters of a company and its agents seem opposed on certain points. These can generate quasi structural conflicts (VENARD, 1993);

(iii) the real cost of the transaction is relatively undetermined;

(iv) productivity gains in insurance are difficult to achieve.

Finally, it is apparent that, more than the attained cost level, it is the capacity of firms to minimize these costs which constitutes a competitive advantage.

In fact, French mutual insurance companies (which have opted in a large part for an integrated distribution) have put into work simple politics of cost minimization, easily accepted by their salaries: the standardization of products, a strong selection of risks, computerization of tasks, a more rapid collection of premiums,... These policies are accessible to every kind of company.

In analysing the case of insurance companies which have decided to externalize their distribution, we have caught a glimpse of the difficulties that they have met in order to achieve cost minimization. In fact, traditional firms and agents have been slow to adopt steps of global competitiveness of the company agent system. Each "economic agent" camps on his positions, aided by a rigid statute. A point of essential vigilance must thus incorporate conditions of competitive improvement, in order to minimize costs, whilst respecting the required level of utility by the market. It is in adapting a step of global cost minimization (certain successes include a minimization of 50% of working costs) that traditional companies will be able to save all the legitimacy and efficiency of their distribution by intermediaries.

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