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Repositioning the Nigerian Insurance Industry for Sustainable Development: Risk Management Perspective

Joshua S. Adeyele[1]* Muhammad N. Maiturare[2]

1. Actuarial Science and Insurance Department, Joseph Ayo Babalola University, Ikeji-Arakeji, Nigeria
2. Department of Business Administration, Ahmadu Bello University, Zaria, Nigeria

* E-mail of the corresponding author: crownsolomon@yahoo.com

Abstract

For decades, risk management in emerging economics like Nigeria has relied on a reactive approach to risk financing which has become increasingly unsustainable due to a number of factors. The recent developments in global financial markets have raised serious questions about the management and oversight of the financial services industries, at both the micro level for individual entities and at the macro level for the system as a whole. This study emphasizes the need for involvement of insurance professionals in risk models that needs to be developed into a practice area where risk managers within the industry could be able to learn from established methods of risks modelling. It also revealed that repositioning insurance industry involves products innovation and creating awareness programmes about those products among the prospective customers. When these policies are sought for by individuals and businesses, economic waste resulting from random event will be minimized. This paper also revealed that insurance industry can be strengthened to reduce or manage individual and business for sustainable development. Various measures that insurance industry can use to promote financial stability, mobilize savings, facilitate trade and commerce, and complement government security programs are also covered in the study.

Keywords: Modernising Insurance Sector, Sustainable Development, Product Innovation, Individual risks, Business risks

1. Background of the Study

For decades, risk management in emerging economies like Nigeria has relied on a reactive approach to risk financing which has become increasingly unsustainable due to a number of factors. Arnold (2008) revealed that vulnerability is increasing as emerging economies grow and accumulate more assets as well as the increase in hazard exposure which point to a continuing trend of increasing losses due to natural disasters. Government in Nigeria has not truly lend its effort towards the development of proactive approach to coverage of these natural disasters. Where hazard coverage exists, it is usually limited to major industrial and commercial properties, and some wealthier households. The demand for risk transfer instruments in emerging markets is often constrained (Arnold, 2008) by market gaps, weak regulatory frameworks, lacking data on disaster risk, a lack of a culture of risk financing, and the reluctance of large reinsurance market players to invest in the development of small risk markets. The recent developments in global financial markets have raised serious questions about the management and oversight of the financial services industries, at both the “micro” level for individual entities and at the “macro” level for the system as a whole (International Actuarial Association, 2009).

This incident has necessitated many big organizations to put in place sound risk management as a means of protecting business investments. Sound risk management includes both physical and financial risk control. This study focuses on insurable business risk exposures and individual risk exposures that threaten the economy as a system, and discusses various insurance products available to manage them. Insurance institutions as medium for managing risk have numbers of policies that can be used to protect against serious financial reversals that result from random events intruding on the plans of individuals or business plans. It should be noted that insurance industry which helps us prevent disaster do not just does so, it also helps us to put into practice what is known as sustainable development. Development is sustainable when people can make a good living and be healthy and happy without damaging the environment or other people in long run. The sustainable development can only be realised if the condition for buying insurance products give the insured persons the incentives to reduce or eliminate the possible loss exposures through physical risk control. This of course will reduce the moral hazard on the part of insured.

In this regard, actuarial models can be developed for insurance companies as a guide to make an informed decision about the risk exposures. Ingram (2009) reveals that financial firms are usually faced with capital as a major limiting factor and retained risk as a major driver of capital needs. So financial firms must have risk and risk management at the heart of many management decisions. For non-financial firms, risk will influence need for cash or access to cash and availability of cash and capital, but there may be other much more important limiting factors. In the recent times, more and more firms have leveraged themselves thereby creating a situation where risk and the resulting volatility in cash flow needs are now of very high importance. But there are other firms, such as the large well established technology firms that are awash in cash and have plenty of capital but have very different key limiting factors that push risk management to a lower level on the priority list which means that risk controlling is the only type of risk management that will be undertaken.

It has been observed that many big businesses in Nigeria that would have contributed positively to the economy well being of Nigeria are struggling to survive or no longer in operation due to lack of sound risk management in place. The effect of this is abandonment of capital projects such as building, bridges and road constructions at cooperate and various level of government in the country. The simple reason is that most contractors or the decision making body of the organisations involved do not embark on appropriate risk management techniques or models. There are insurance policies to handle these challenges but it is rather unfortunate, they are not been patronised. One of the reason for these is due to low awareness programmes on availability of insurance products to hedge against these fortuitous circumstances.

2. Conceptual Framework

The reactive approach to risk management as used in this study suggests that many decision makers do not realize the need to prevent disaster striking until it happened. For instance, until disasters such as fire outbreak destroy properties worth of billions naira, most people (even the risk managers, decision makers) in Nigeria do not take positive steps to control or prevent such disaster. On the other hand, proactive risk has to do with people taking precautions against likely future peril or risk.

The word “risk” used as a noun in this study expresses the possibility of loss or injury. As a verb, the same word denotes the exposing of one’s person or property to loss or injury. Within the common meaning of “risk”, there are thus two distinct elements, the idea of loss or injury and that of uncertainty (Towbrigde, 1989). Knight (1921) in Davis (2002) defines uncertainty as pertaining to future developments that cannot be reduced to objective probabilities. We should not only prepare ourselves to face this uncertainty but should also try to avoid those changes it might bring. Thus risk can be defined as the possibility of an unfortunate occurrence or as the chance of loss, or as the uncertainty as to the occurrence of an economic loss (Isimoya, 2003).

In the economic setting within which actuaries work, loss is usually expressed in monetary terms (Towbridge, 1989). Theft, embezzlement, and adverse court judgements cause loss of wealth, and are direct forms of economic loss. Death, disability, retirement, and unemployment are various forms of income loss. Damage to property impairs the value of that property where value is a measure of the ability of a property to produce a flow of desired goods and services. For short, risk is the probability that hazards are not dangerous, taken separately. But if they come together, they become a risk. Roff (2004) notes that insurance industry commonly uses the words ‘hazard’ and peril in particular ways, with specific meanings and the easiest way to define them is to view hazard in relation to peril: a peril is defined as that which gives rise to a loss while hazard is that which influences the operation of the peril.

3. Business Risk Exposures

Business owners as well as individuals make plans and have expectations about how business goals should be realized. However, experience has shown that plans will not unfold with certainty and sometimes expectations will not be realized (Bowers et al, 1997). Sometimes, plans are frustrated because they are built on unrealistic assumptions. In other situations, fortuitous circumstances interfere. Problems like these must be tackled if business is to perform competitively, and yet respect the interest of its customers and the economy in which it operates. Insurance system (otherwise called risk financing) is one of the ways of tackling these operational issues which financial business is exposed, particularly where there are significant uncertainty in running the business. Risk management is a fundamental activity that seeks to restrict exposure to potential losses or risks (Ingram, 2009). Insurance is a form of risk management that parties use to protect themselves against a loss. Ideally, it involves the equitable transfer of the risk of loss from one entity to another, over a set period of time, in exchange for a reasonable fee. In insurance companies, the major risk management activities included underwriting of credit risk, authority limits and exposure limits for each of those areas. Below are some of the business risk exposures that risk manager in any organisation should take into cognizant when making risk management decision.

3.1 Property loss exposures: It is important for decision maker to be able to identify what property is exposed to loss and potential causes of loss. This involves identification of what property is exposed to loss and potential causes of loss. The firm must, also, consider how property should be valued for the purpose of making risk management decision. Indirect losses also can arise from damage to property that will be repaired or replaced. For example, if a fire shutdown a plant for eight months, the firm will not only incur the cost of replacing the damaged property, it will also the profit from not being able to produce. In addition, some operating expenses might continue despite the shutdown (e.g. salaries for certain managers and employees and advertising expenses). These exposures are sometime called business interruption exposures. Firms also may suffer losses after they resume operations if previous customers that have switched to other suppliers do not return. In the event that long-term loss of customers would occurs and/or shutdown temporarily would impose large costs on customers or suppliers, it might be optimal for the firm to keep operating following a loss by arrangement for the immediate use of alternative facilities at high operating costs. The resulting exposure to higher cost is known as the extra expense exposure.

3.2 *Liability losses:* firms face potential legal liability losses as a result of relationship with many parties, including suppliers, customers, employees, shareholders, and member of the public. The settlements, judgements, and legal costs associated with liability suits can impose substantial losses on firms. Lawsuits also may harm firms by damaging their reputation, and they may require expenditure to minimize the costs of this damage.

3.3 *Human resources*: losses in firm value due to worker injuries, disabilities, death, retirement, and turnover can be grouped into two categories. First, as a result of contractual commitments and compulsory benefits, firm often compensate employee (or their beneficiaries) for injuries, disabilities, etc. Second, worker injuries, disabilities, death, retirement, and turnover can cause indirect losses when production interrupted and employees cannot be replaced with zero cost with other employees of the same quality.

3.4 *Losses from external economic forces*: the financial category of losses arise from factors that are outside the firm. Losses can arise because of changes in the price of inputs and outputs. For example, an important supplier or purchaser can go bankrupt, thus increasing costs or decreasing revenues.

4. Individual Risk Exposures

People are exposed to many types of risks that may result in a reduction in their income or wealth due to death of breadwinner, unemployment, accidental injury, sickness or disability (Ransom, 2003). One method of identifying individual/family exposures to risk is to analyze the sources and uses of funds in the present and planned for the future. Potential events that cause decreases in the availability of funds or increases in uses of funds represent risk exposures. Because both physical and financial assets represent potential future sources of funds, potential losses in asset values also represent exposures. Just as business risk management consultants can aid in the identification of business risk, individual/family financial planners can help identify and then manage personal risks. The risk of a drop in earning prior to retirement due to external economic factors is also an important risk facing households. Some public support in the form of compulsory social insurance and unemployment insurance programme which is often available in advanced countries is not available in Nigeria. Also, one of the most important sources of risk for most individuals and families is from medical expenses. Another major sources of expense risk is from personal liability exposures. Individuals can be sued and held liable for damages inflicted on others. The main source of personal liability arise from driving an automobile and owning property with potential hazards. These risks are typically managed by using loss control and purchasing liability insurance

Retirement often implies a large drop in earnings. To continue to pay living expenses during retirement, an individual needs to have saved substantial funds prior to retirement and / or rely on public programmes, such as social security. The risk associated with pre-retirement saving and thus the risk of not having sufficient on how the assets are invested. The choice of assets, (e.g., between stocks, bonds, and real estate) is an important risk management division for all individual and households. Even after someone has retired with substantial assets, the person faces the risk of living so long all savings are depleted before death. This longevity risk can be managed using annuities. However, annuity products can only function well if insurance sector is modernized.

5. **Modernizing the Insurance Sector**

The insurance industry is expected to play an important role in annuity components of the new pension systems and is in fact likely to be one of the main beneficiaries of pension reform. Adeyele (2011) argues that insurance as a subsystem of economy is crucial to sustainable development of a nation. However, in most developing countries the insurance sector has suffered from major structural problems. A generally repressive regulatory framework which impedes competition, innovation and efficiency. Both premiums and new products are subject to vetting and control by regulatory agencies that are staffed with bureaucrats rather than experienced professionals (James and Vitta, 1999). Koroma (2009) reported in Adeyele (2011) reveals that the statistics on developing countries' economies and standards of living paint pictures of poor domestic revenue effort, under-capitalization, and inappropriate policy design and implementation as well as ineffective and inefficient utilization of off resources. This results to underperforming economies, acute poverty, and perilous social and political systems (Adeyele, 2011).

Because of the imposition of tight controls and the absence of reliable data, insurance companies in most developing countries have not developed the technical expertize for pricing risks and setting reserves, while their financial management is inadequate (James and Vitta, 1999). Data on loss experience are not collected in any systematic way and life tables are not properly constructed. Thus, to develop and modernize the insurance sector in Nigeria, radical reforms still need be undertaken. These may include restructuring, recapitalizing and consolidating a fragmented sector, opening the local market to foreign institutions or to joint ventures with multinational insurance groups, modernizing insurance regulation, enhancing the transparency of insurance policies and annuity contracts, and creating an effective insurance regulatory authority.

Although Nigeria has reformed its insurance sectors. There is still need for insurance regulation to abandon its preoccupation with premium and product controls and prescribed investments and to rely on solvency monitoring and prudent investment policies for ensuring the soundness of individual companies and the protection of policyholders and annuitants.

6. Insurance Products for Hedging Individual and Business Risk Exposures

From a societal perspective, the key question is how risky activities and risk management by individuals and businesses can best be arranged to minimize the total cost of risk for society. Minimizing the total cost of risk for society produces an efficient level of risk. By buying insurance products to protect against uncertainty is part of risk management. Consequently, repositioning insurance industry involves innovativeness in product designs, creating awareness programmes about the existing products among the prospective customers. When these products are sought for by individuals and businesses, economic waste resulting from random event will be minimized. There will be need for government to create more incentives in form of tax reduction for those who patronize insurance business. Also, it has been noted that a poverty stricken individuals in Nigeria will likely find it difficult to pay for damages inflicted on the third party. In this respect, some of insurance policies such as public liability, professional liability, product liability etc discussed below should be made to work in Nigeria as in developed countries. By so doing development can be sustained through the operation of insurance system.

6.1 *Fire and special peril insurance*: The basic intention of this policy is to provide compensation to the insured person or firm in the event of damage to the property insured (i.e. buildings, stock and other content) (Ransom, 2003). It is not possible, in commercial world, to issue a policy that will provide compensation regardless of how the damage occurs. The insurance company have to know which perils they are insuring against, although it is more common to add specified perils to fire policy so that the cover is built up to meet the insured's requirements, rather than pre-packaged as with household types of policies. These perils are: storm, tempest or flood; burst pipes; earthquake; aircraft; riot, civil commotion; malicious damage; escape of water; explosion and impact.

6.2 *Theft insurance:* Theft policy have the same aim as the standard fire insurance policy, in that they intend to provide compensation to the insured in the event of loss of the property insured. Damage to the building, provided the insured is responsible for the cost of repair, occurring during theft or attempted theft is covered; however, there is usually a limit applicable to this item (Ransom, 2003). While damage to property caused by fire was one of the earlier obvious causes of loss, other people stealing it, or damaging property while trying to steal it followed close behind, and so theft insurance developed in response to this need (Roff, 2004). Whereas fire policies rarely distinguish between different types of stock depending upon its attractiveness to thieves. Specific items and sums insured will apply to stock depending on its attractiveness to the thieves.

6.3 *All risks insurance:* Uncertainty of loss is not restricted to events brought about by fire and special perils, nor is it limited to events occurring on or about the insured's premises (Ransom, 2003). This realization led to the development of a wider form of cover known as all risks which includes personal effects, business all risks, good in transit, contractors' all risks, and money insurance. The term 'all risks' policy covers 'accidental loss or destruction of or damage to the property insured. Therefore, all loss or destruction of or damage to the property insured is recoverable provided that it has occurred accidentally so far as the insured is concerned, and provided that the cause is not specifically excluded from the policy.

6.4 *Money insurance:* Money insurance is an important class of insurance in view of the many street robberies that take place nowadays (Ransom, 2003). The policy provides compensation to the insured in the events of money being stolen either from their business premises, their own home, or while it is being carried to or from the bank. This cover is extremely important for the person running a medium sized business since large sums of money are drawn from banks to meet wages and these can often be the target for hold-ups. One important addition to this cover is often the provision of some compensation to employees who may be insured or have clothing damaged during robbery.

6.5 *Business interruption insurance:* This cover has two dimensions – the maximum amount that needs to be insured and the maximum time period that the interruption will affect the business. Both of these are specified in the policy. The indemnity period (time period) is chosen by the insured and is defined by Ransom (2003) as:

The period beginning with the occurrence and ending not later than the maximum indemnity period thereafter, during which time the business is affected by the interruption occasioned by the damage. The maximum indemnity period for which compensation is payable is often twelve months, but may be much longer depending upon the type of business, specialist machinery, types of customer and so on.

6.6 *Employer liability insurance:* When an employer is held legally liable to pay damages to an insured employee or to the representatives of someone fatally injured, they can claim against their employers' liability policy which will provide them with exactly the same amount that they themselves had to pay out. The policy will also pay certain expenses such as lawyer's fees or doctor's charges where an injured person has been medically examined. The intention is to ensure that the employer does not suffer financially, but is compensated for any money they may have to pay in respect of a claim. The policy is restricted to damages payable in respect of injury and does not apply where property of an employee is damaged.

6.7 *Public liability insurance:* member of a public may suffer injury or damage to their property due to the activities of someone else, and public liability insurance have been designed to provide compensation for those who may have to pay damages and legal costs for such injuries, or for the damage to property. Ransom (2003) notes that it is useful to think of a public liability policy as being an 'open' policy as opposed to a 'specific' policy. An employers' liability policy is a specific policy in that it relates to injury to employee; likewise, products liability and professional indemnity policies are specific, the former relating to defective product and the latter covering professional negligence. *The public liability policy is an 'open' policy in that, instead of the scope of cover being specified by insured perils, it is defined by the exclusion of specific perils.* Public liability insurance is designed to compensate an insured in respect of claims for legal liability from members of the public or companies who may suffer due to their negligence or that of their employees. Cover is provided for damages as well as costs and expenses incurred in the event of a claim for injury or for damage to property. Particular types of policy are available for each type of risk.

6.7.1 Business risk policy – every business organisation is exposed to the risk of incurring legal liability due to its operations. The public may be in contact with the firm in its offices or the firm may be on the premises of others, in the street or on various sites. The policy will indemnify the insured for liabilities thus incurred.

6.7.2 Product liability – an exception on most business public liability policies is liability arising out of goods sold. This is a very onerous liability and one that insurers prefer to deal with separately. If a person is injured by any product that they purchase (foodstuffs for example) and they can show that the seller, or in some cases the manufacturer, was to blame they could succeed in a claim for damages.

6.7.3 Professional liability – another exception on the basic public liability is liability arising out of professional negligence. This covers professional people's liability for injury, damage or financial loss to clients or the public as a result of breach of professional duty, or negligent acts, errors or omissions in their professional capacity. An example might be an insurance broker giving advice on insurance coverage to a client on fire insurance for their factory, getting the business from the client and then simply forgetting to place that cover. If the factory burns down, the broker has cearly been negligent, the client has suffered loss as a result of this and the broker would be liable to pay damages. Professional indemnity cover is intended to provide insurance against the possibility of having to pay these damages (which in this case could be the value of the fire loss costs).

7. Conclusion

This study examined a variety of possible policies for alleviating potential economic losses, including hedging mechanisms against possible losses arising from business and individual risk exposures, and other non-formal forms of insurance to hedge against risk. It also revealed that financial risk management offered by insurance companies will enhance good physical risk control due to the conditions and terms of contracts imposed on the insured by the insurer. It will also reduce moral hazard of the insured if well designed.

Managing risk is almost never the responsibility of a lone individual within a business enterprise. The varied nature of risk types and impacts typically demands that many people work collaboratively (American Academy of Actuaries, 2009) to identify, understand, quantify, and manage risk. Similarly, developing a framework for managing the numerous and diverse financial risks a business faces usually requires the varied perspectives of all the professionals within or consulting with the business who play a significant role in the risk management process. Risk is an intrinsic part of doing business in all areas of businesses, as firms must be willing to take on a fair amount of risk in order to provide the most value to shareholders. Management must decide whether to use insurance or captive insurance to deal with the identified risks whichever is economical.

In order to make insurance industry viable to national development, government at the centre should strengthen the industry to reduced or managed individual and business risks for sustainable development in Nigeria. If we are careful about how we treat the environment and if we are aware of our weaknesses and vulnerabilities to existing hazards, then we can take measures to make sure that hazards do not turn into disasters. Risk modelling can also be used in areas regarding financial risk. This has worked successfully for some big firms. However, the current financial crisis is a convincing evidence that, although risk models are useful tools, risk management is much more than just models. Risk models must be embedded in appropriate risk governance and entity-wide risk culture. This includes a clearly defined and communicated risk appetite for the entity, clear roles and responsibilities for risk and corresponding limits on risk taking, complemented with stress and scenario testing. The modelling assumptions and their results need to be transparent, understood and regularly debated by management and regulators (International Actuarial Association, 2009).

Conclusively, the governing body of a insurance industry has the ultimate responsibility and accountability for performance of the industry and should function in an oversight capacity. The governing body should approve overall business strategies and risk management and control policies of insurance companies, and perform independent evaluations to ensure compliance and continuing suitability of established strategies and policies. It can be seen that insurance not only facilitates economic transactions through risk transfer and indemnification but is also promote financial intermediation. By this means, insurance industry can be used to promote financial stability, mobilize savings, facilitate trade and commerce, and complement government security programs.

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