

IMPERATIVES OF CAPITAL IN INSURANCE OPERATIONS

On issues bordering on practical management, I am always fascinated by Peter Drucker's wits. In one of his classical works, *Innovation and Entrepreneurship*, Drucker emphasized the need for business managers to have financial foresight and thereby established the fact that in any venture, growth needs more cash and more capital. The best way to finance growth is to consistently plow profit back into the business. A drawback to this method is the need for the manager to wait until the end of the year to realize the profit and the cash element to be plowed into the business. However, in the course of the year, investment decisions would have to be made to enhance the competitiveness of the business hence the manager cannot wait for the uncertain profit that should accrue at the end of the year to grow his business. This is the classical situation that often demands for continuous injection of capital into the business either by way of rights issue, fresh equity or debt.

The Nigerian government's desire to grow the nation's economy and create more opportunities for the future of

the nation led to its launching of the National Economic Empowerment Development Strategy (NEEDS). This wonderful and well thought out package has as one of its enabling ingredients, the strengthening of the country's financial system. The CBN Governor and the Minister for Finance have been key actors in the implementation of this laudable program of the Government and with the introduction of new capital requirements in the banking sector and lately the insurance sector, the financial services sector will never remain the same again.

Taking cognizance of the fact that the insurance industry just concluded a process of recapitalization of various companies in February 2004, industry analysts and operators alike engaged in varying degrees of debate on the justification for another call for increase in share capital of insurance companies notwithstanding the fact that the banking industry had been mandated to shore up its capital base. Government's decision to increase the share capital of insurance companies to levels ranging from ₦2 billion to ₦10

billion has put paid to these arguments. As various owners of insurance companies have embarked on different strategies to comply with the new directives from Government, it becomes pertinent at this juncture to attempt to really understand the concerns of some genuine participants in the insurance industry on the Government's latest move.

FINANCIAL CAPITAL OR UNDERWRITING CAPACITY

The International Association of Insurance Supervisors (IAIS) is the world acclaimed umbrella association of insurance regulators. The body which was established in 1994 currently represents insurance regulators and supervisors in some 180 jurisdictions around the world. Amongst other functions, IAIS issues global insurance principles, standards and guidance papers on insurance business. In its Principles No. 5 issued in January 2002 on Capital Adequacy and Solvency, IAIS strictly advocated the principle of adequate technical provisions as the cornerstone of a sound capital adequacy and solvency regime in insurance business. This approach

underlines the position of advocates of risk-based capital in determining the adequacy or otherwise of the existing levels of capital in the insurance industry.

In measuring the risk exposure of insurance business in order to determine appropriate capital requirement, there are common and popular methods. Viable measures of risk supported by actuarial literature include Probability of Ruin, Variance or Standard Deviation of Surplus, Expected Policyholder Deficit and Expected Default Loss Rate on Surplus. After selecting a standard of risk measure, capital adequacy assessment is determined on Economic, Generally Accepted Accounting Principles (GAAP) or Statutory basis. To date, neither the National Insurance Commission (NAICOM) nor the Finance Ministry has been able to confirm the basis on which the new prescribed capital requirements for insurance was arrived at notwithstanding the fact that insurance is a highly technical business and of international nature.

Financial capital is of essence in any viable business but the peculiar nature of insurance business situates capital more

in the context of underwriting capacity. Aptly defined, underwriting capacity is the combination of the retention of an insurance company and the treaty or facultative cover that a reinsurance company provides to support the insurance company. Both the retention and the reinsurance cover are afforded from the underlying capital of the relating insurance and reinsurance companies.

As a rule of thumb, an insurance company limits its retention on any given risk to a rate of between 3 and 5 percent of its shareholders' fund depending on its business strategy as to safety of its balance sheet or aggressive growth of market share. For example, an insurance company with shareholders fund in the region of ₦500 million will fix its retention on any standard risk at ₦15 million per risk at a conservative rate of 3% of its net assets or shareholders fund. Assuming that a reinsurance company granted such an insurance company a 20 line surplus treaty cover, then the insurance company would have a total cover of ₦300 million from the reinsurers. This scenario provides the insurance company with an

underwriting capacity of ₦315 million. Though, a typical policyholder is not usually aware of this arrangement but in practice this is the bulwark of insurance operation.

According to the last research report issued by Augusto & Co. on the insurance industry in Nigeria, the total shareholders fund of the insurance companies polled came to about ₦19 billion based on year 2002 accounts of the companies in the industry. Using the same illustration highlighted earlier to determine the underwriting capacity of the local insurance industry, we can safely assume that the industry should ideally possess a retention of ₦570 million and also assuming that the local market as a group would secure access to a reinsurance surplus treaty arrangement of 20 lines, the collection of the insurance companies would have a total cover of ₦11.4 billion from reinsurers. Consequently, the total underwriting capacity for any single risk should be ₦11.9 billion for the local market. In dollar terms, this should translate to an underwriting capacity of US\$88.66 million using an exchange rate of ₦135.00

to the dollar. This available capacity, for all intent and purposes, is reasonable and sufficient to provide the fulcrum for the growth and development of the insurance industry in Nigeria by stemming the incidence of capital flight.

If the usual shibboleth of multinational companies for improved local market capacity by insurers is subjected to empirical test in the light of the illustration contained in this article, it would be obvious that the Nigerian insurance market is actually not bereft of capacity. The real issue borders on selective determination of local capacity by the multinationals in spite of the quantum of underwriting capacity available to prosecute bearing of risks emanating from the nation's economic terrain. The challenge, then, becomes that of the NAICOM in assuring the multinationals of the safety of accepting the entire underwriting capacity available in the Nigerian market since licenses would not have been issued to the local insurance operators to continue in business if NAICOM doubts the health of their underwriting capacity.

THE MYTH OF OIL & GAS

According to global reports, historically, energy insurance has not been really profitable in the recent past. Since 1996, insurers playing in the energy market recorded underwriting losses consecutively through to year 2002 before falling back to profit in 2003. Though the premiums generated in this line of business is usually huge in dollar terms, so also, the claims that flow from the line of business are usually of large magnitude.

Since one of the major reasons adduced by Government for upping the capital levels of insurance companies is to encourage the market to take more of the risks arising from the oil and gas sector, it is expected that by the time we have, let us say, about 20 insurance companies possessing capital base of =N=3 billion each, the underwriting capacity of the local market would have increased tremendously. Whether the players would be willing to stake their entire capital on underwriting risks in the oil and gas sector is another matter entirely given the fact that economic activities exists in other sectors that may be more profitable

and requiring attention of insurance companies' capital.

Another major concern for operators in the light of the perceived unduly excessive capital requirement imposed on insurance companies is the challenge of being able to generate sufficient returns to justify such high level of capital injection into the business. This is predicated on the fact that increasing capital without any change in business activity or the investment asset mix will actually decrease most of the companies' profitability. No matter the number of companies that will eventually emerge under the new mega arrangement, the current market premium size which is far below =N=100 billion may not be sufficient to generate the kind of return on investment that will whet the appetite of the typical Nigerian investor knowing full well that insurance claims will continue to rise in line with inflation.

CASE FOR REINSURERS

The capital requirement of =N=10 billion prescribed for Reinsurers has been described as too high and unnecessary by virtually all stakeholders in the insurance industry. Aside

the fact that the argument earlier advanced in respect of insurance companies equally hold true for reinsurers, this level of capital is totally out of context with the provision contained in the IAIS Principles No. 6 issued in October 2002. Reinsurers in Nigeria, except Africa Reinsurance Corporation, operate basically within the Nigerian market with very little or no physical presence in other markets on the continent.

For example, as economically advanced as the South African market is with enormous business activity commanding market premium size in the billion dollar range, the minimum capital requirement for Reinsurers operating in that market is R10 million which is equivalent to US\$1.5 million. The paid-up capital of a reinsurance company in South Africa is much less than the current minimum capital of =N=350 million of that of a Nigerian reinsurance company which is now been increased again. The nature of reinsurance business is such that allows for cross-border operation without specific compliance with legal requirement of different jurisdictions. What this means is that a South African or

Kenyan reinsurance company can come to Nigeria and provide reinsurance support service to Nigerian insurance companies based on the level of capital prescribed in their own country. The question then is why are we compelling the Nigerian players to capitalize to such a level that can reduce the existing number from the few 4 to 1 whereas other reinsurers are allowed to operate in the same market without such an onerous demand. Rather, it would have been more equitable if the Nigerian reinsurers were to jerk up their capital from the current =N=350 million to just =N=5 billion instead of =N=10 billion assuming a genuine desire for achievement of compliance with Government's new thinking.

Conclusion

Responding to the new directive from Government with a sense of patriotism, the Nigerian Insurers Association (NIA) has enjoined its

members to embrace the call for recapitalization in good faith. There is no doubt that the new development poses challenges to the insurance industry but these are surmountable. I expect my colleagues in the insurance industry to warm up to the task ahead once the bank's reform and consolidation process officially comes to an end by December 31, 2005. Consequently, come January 2006 there would be a flurry of activities in the insurance industry that will usher in emergence of new companies on the floor of the Nigerian Stock Exchange (NSE) with attendant issuance of Initial Public Offerings (IPOs) as well as new public offers from companies already listed on the floor. Just as we have witnessed in the case of banks, we will also witness combination of different group of companies jostling for recognition under mergers and acquisition schemes. This, indeed, is an interesting time for the insurance industry.

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