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Managing Insurance Business—A Peek into the Future

By Rotimi Okpaise

These are indeed both interesting and challenging times for Nigeria's Insurance Industry.

From being almost comatose a few years back, the insurance sector is fast expanding its risk base and has become a 'beautiful bride' to both local and foreign investors. The FSDH Insurance Index has risen by 24 percent already in 2008! This article discusses likely new expectations from management in view of the wider ownership—as they say—there is no free lunch!

This article is broadly developed from the practices of Life and Health Assurance but equally applies to Non-Life Insurance business.

OUR RECENT PAST

In 2004, the Central Bank of Nigeria instructed banks to re-capitalise by the end of 2005 to a minimum of N25billion (about USD20million). It seemed a tough requirement at the time and, eventually 25 banks emerged. Today no fewer than six (6) of these banks have paid-up capital in excess of N500billion!! This increased capitalisation has significantly transformed the level of economic activity in Nigeria—including the new ***active*** participation (ownership) of banks in the insurance sector.

In 2006, new capitalisation rules were also introduced in the insurance industry—N2billion for Life and N3billion for Non-Life business, this was from a base of N150million and N250million respectively. 49 companies met this requirement through business consolidations and a much wider equity ownership.

GDP per capital in Nigeria increased from USD 800 (2006) to USD1,300 (2007). The increase in the All Share Index was 38 percent in 2006 and 75 percent in 2007.

However, Life, Health and Household insurance premiums accounted for less than 0.3 percent of our GDP in 2006/7. It thus seems that there are significant opportunities to deepen insurance penetration if acceptable products can be designed and appropriate marketing programmes embarked upon—new capital will help finance these development needs.

A PEEK INTO THE FUTURE

Business growth and wider ownership structures will likely lead to (management) reporting challenges in the future. Quality people and adequate information systems need to be acquired to administer, manage and report on the increased business volumes. Shareholders will require more frequent and accurate information on the business trend and their **worth**. Hence operating ratios, the calculation of technical reserves and declared underwriting profits will be under more scrutiny than hitherto.

We illustrate below issues we believe management will in future, need to communicate in details to **stakeholders**—shareholders, investment analysts, rating agencies, and the regulator. We believe potential and current shareholders will wish to be appraised—as in other industries—of how the business 'adds up' and what efforts are being put in place to ensure value/worth is not eroded. Put another way, insurers will have to demonstrate how they manage risk!

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RISK MANAGEMENT

In our view, risk management will be a major contributor to the successful future of the insurance sector. Management will need to constantly review the adequacy of the premium rates, underwriting policies and Know Your Client (KYC) enquiries, reassurance programmes, investment policy, operating systems, processes, people etc.

We believe stakeholders will require companies to establish risk management principles—to identify the sources of business risk and install processes that will mitigate the risks jeopardising business objectives and Shareholders worth.

We give below some examples of risk and mitigating actions.

TYPE OF RISK	EXAMPLE	SOME MITIGATING ACTIONS
Market Risk	An adverse change in asset market values without a corresponding change in liability values.	Have a formal asset distribution policy, define sectorial distribution, and stock selection criteria. Match assets to liability profile.
Interest Risk	A change in the discount rate adopted in calculating liability values without matching changes in asset values.	Prudent Reserving Approaches
Insurance Risk	- An increase in mortality experience (e.g. group life). - An increase in life expectancy (annuity business). - Increase/decrease policy lapses etc.	Anticipate potential changes through prudent reserving
Operational Risk	- Inadequate premiums - ICT failures - Failure to reassure - Inadequate staff	- Review Rates - Document ICT processes, external backup sites, maintenance, etc. - Review administrative processes - Train staff, review recruiting and remuneration policies
Credit Risk	- Failure of reassurer - Failure of debtors (debt security/large broker/agent)	Have operational and financial criteria for choosing reassurers and debt securities
Liquidity Risk	- Failure to meet obligations due to cash flow strains or having illiquid assets.	- Asset liability matching - Secure adequate banking arrangements etc.

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EMBEDDED VALUE

The change in **end year reserves** directly impacts the declared underwriting profits and by implication the overall business profits, dividends and shareholders worth.

We anticipate that reserve calculation methods and their adequacy will in future need to be justified to stakeholders. The calculation methods will have to be scientific, independent of management and be in line with best global practice.

As in other territories we perceive stakeholders will require Shareholders Worth to be expressed as the **Embedded Value (EV)**, which essentially is

(A) The Adjusted Net Asset Value (NAV)—balance sheet NAV if assets and liabilities are expressed at their fair values

Plus

(B) The estimated future profits to shareholders from the business currently in force.

Typically, the EV will exceed the normally reported NAV.

Companies are beginning to privately calculate their EVs in Nigeria and we expect that as insurance market analysts and financial consultants get increasingly involved in the insurance sector, demands for companies published EVs will increase—as is happening in Asia, Australia, Europe and the Americas.

ECONOMIC CAPITAL

We foresee businesses/managers in the near future enquiring of the amount of **Capital** actually needed to be dedicated to insurance business—to reflect the projected business mix and growth over a review period (typically one year). This capital, called the **Economic Capital**, will reflect the entity's risk appetite and will, for instance, differ for identical companies with different reassurance programs.

In Nigeria, where capital requirements are presently high in comparison to technical liabilities the concept of economic capital will immediately be useful for the investment management of the Shareholders Funds. A relatively risk free approach could be adopted for the investment of the economic capital whilst a more risky approach may be adopted for the balance of funds, reflecting the degree of the enterprise's risk adverseness.

CONCLUSIONS

We anticipate 2009 to herald significant changes in the insurance sector.

We see….

- Management making significant investments in operating systems and people
- Active new product development efforts
- More educative and aggressive marketing efforts
- Significant business expansions occurring in 2009
- A relative influx of foreign potential core investors
- Improved financial reporting, especially a shift to EV reporting
- Increased regulatory alertness/requirements. The current "rules based" approach to capitalisation and reserves may yield to a "principles based" approach.

We estimate that 2010 will be the year of the 'big bang' with Life, health and household insurance premium incomes exceeding one percent GDP and at least three insurance companies recognised as being leaders in Nigeria's financial services sector.

For the insurance sector these are indeed interesting times!! ☐