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Do Nigerian Banks manage earnings?

THE INSURANCE INDUSTRY AND NIGERIAN ECONOMIC DEVELOPMENT

BY

F.O. IYOHA* AND O. RICHARD**

ABSTRACT

Insurance arises from a contract between an insurer and an assured/insured, whereby the former undertakes to provide against a risk on behalf of the latter. The main function of insurance companies is to provide compensation against risk and also to provide long-term capital to government and corporate bodies. These functions are very crucial to the economy. Arising from the above, this study investigates the contribution of insurance companies to the economic development of Nigeria. The data used in the study was obtained from the annual reports and statement of accounts of the Central Bank of Nigeria (CBN). The data was analyzed using the method of Ordinary Least squares (OLS). The main finding of this study is that the insurance industry has not actually contributed much to Real Gross Domestic Product in Nigeria between 1970 and 2002. The study suggests that the government should provide the enabling environment for the industry to thrive, to carryout enlightenment campaigns and to increase the capital base of the operators in the industry.

BACKGROUND TO THE STUDY

The role of firms in the insurance industry as a player in the Nigerian financial market has been growing through their investment activities and increase in the coverage of a wide range of business and household risks. These roles facilitate economic and financial activities and growth. In addition, amidst the drive to raise profitability, they have become increasingly active intermediaries in a wide range of financial services in the country especially since the birth of the fourth republic in 1999.

The industry now witnesses rapid expansion of branch networks and activities that have given rise to a high demand for skilled and competent manpower. Besides the rising profile of expenditure and activities, the industry is also growing in terms of market capitalization. According to Bisi (2004), the market capitalization of the insurance sub-sector of the economy, as at June 2004, stood at thirty billion Naira as against the sum of seventeen billion a decade ago. The increased capitalization was made possible by the entry of some commercial banks into the market following the introduction of universal banking in 2001. The signing into law of the Insurance Act in May 2003 has also strengthened the industry. For instance, on commencement of the application of the Act, the capital base in the industry has moved from a minimum of ninety million Naira to three hundred and fifty million Naira for composite insurance and re-insurance companies, two hundred million for general insurance business, while life insurance companies require a minimum of one hundred and fifty million Naira as paid up capital.

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Insurance companies being specialized institutions in the financial system are set up to provide compensation against different kinds of risks in the public and private sectors of the economy. In addition, they are also expected to be a source of supply of funds to a variety of financial and non-financial organizations. In the light of the numerous functions of the industry, this study seeks to assess the evidence in respect of their contributions to the growth of Real Gross Domestic Product in Nigeria.

THE PROBLEM

The economic environment in which companies operate in Nigeria has been very competitive and volatile. This has affected the performance and growth of many firms within the economy. The insurance industry in Nigeria is not an exception. The industry is expected to provide compensation against risk, which may be suffered due to death, loss of property and casualty. It is also expected to be a source of long-term finance for development. However, it has not been clear as to what extent the industry has met these obligations.

OBJECTIVE, SCOPE AND RELEVANCE OF THE STUDY.

The objective of this study is to examine the contribution of the insurance industry to the economic development of Nigeria as measured by the Real Gross Domestic Product. The study covers the period 1970 to 2002. The study is thought to be relevant because it would provide reference materials for policy makers, analysts, as well as researchers and all those that are interested in seeing that the industry grows and matures.

METHODOLOGY

The paper employs a non-survey method of data collection for analysis. The main sources of data for this study are: the Central Bank of Nigeria (CBN)'s Statistical Bulletin; Central Bank of Nigeria's Economic and Financial Review (various issues) and the annual financial reports of some selected insurance companies. The actual data collected were the nominal income of the insurance companies and the Gross Domestic Product of the country for the study period. The nominal income and the GDP were converted to real terms to eliminate the effect of inflation. A model was developed, and using the statistical method of Ordinary Least Square (OLS), the data was analyzed.

LITERATURE REVIEW.

Concept of Insurance

Insurance arises from a contract between an insurer and an assured whereby the former undertakes to provide against a risk on behalf of the assured. The insurer undertakes such risks at a price called 'a premium.' When an assured pays such premium to the insurer, he purchases a security for the future. According to Adesanya and Oloyede (1972), the subject matter of insurance varies considerably from life insurance to anything capable of being insured, like real and personal property. There is also educational and industrial insurance.

Generally, there are two types of insurance companies in Nigeria: Life insurance and non-life. The non-life companies comprise property and casualty firms. The principal event, which life insurance companies insure against, is death. Upon the death of a policy holder, a life insurance company agrees to make either a lump sum payment or a series of payments to the beneficiary of the policy. In contrast, property and casualty insurance companies insure against a wide variety of occurrences like automobile and home insurance.

From the foregoing, it can be seen that Insurance companies are financial intermediaries. According to Fabozzi, *et al* (1997), the insurance companies function as 'risk bearers'. In this capacity, they provide compensation against different kinds of risks associated with the conduct of business.

The Insurance market in Nigeria

The insurance market in Nigeria is highly regulated. This is as a result of the volatile nature of the industry. It is an industry in which the concept of 'utmost good faith' is practiced and seen to be practiced. There are various laws regulating the industry in Nigeria. These include:

(a). The Insurance Act 2003;
(b). The National Insurance Commission Act 1997;
(c). The Motor Vehicle (Third Party) Insurance Act; (2003)
(d). The Banks and Other Financial Institution Act (1991)
(e). The Companies and Allied Matters Act, 1990.

Role of the insurance industry

The role of the insurance industry in economic development of any nation is pivotal. This is because economic development focuses attention upon the development and use of resources to increase supply and improve the distribution of economic goods (Hiliard, 1969).

As noted by Madura (2001), the insurance industry plays a vital and pivotal role in financial markets as well as in economic development by supplying funds to a variety of financial and non-financial organizations as well as government agencies. The Nigerian capital market would not be complete without a mention of the insurance industry. The reason is the pivotal role of banking and insurance in the economy. Banking provides the safe custody and organizes the means of exchanges. These exchanges involve risks. Insurance provides against these risks by spreading the losses of the unfortunate few over many.

Vane and Thompson (1993) indicate that insurance companies are involved in the management of pension funds. In this regard, they accept premiums now in return for the promise to pay a pension at a latter date.

The business of insurance in Nigeria has witnessed substantial growth in the recent past. The industry now occupies a unique position in the socio-economic development of the country. The growth of the industry is evidenced in the increase in premium income of over 10 billion Naira in the last decade, and the large number of insurance companies that are quoted on the Nigerian stock exchange (Bisi, 2004)

This growth came about partly as a result of the promulgation by the Federal Government of two decrees in 1997 aimed at strengthening the industry. The National Insurance Commission (NAICOM) was established to replace the National Insurance Supervisory Board (NISB) through NAICOM Degree No. 1 of 1997. The NAICOM is mandated to ensure the effective administration, supervision, regulation, and control of insurance businesses in Nigeria, conferring regulatory and supervisory power over insurance companies.

As a result of the inadequacies of the industry prior to 1997, and the changes brought about by Decree No. 1, the Insurance Decree No. 2 of 1997 was promulgated to replace the Insurance Decree No. 58 of 1991. The new Decree classified insurance business into life and general insurance and further sub-divided life insurance into two categories for purposes of registration, capitalization and operation. There is also the 2003 Insurance Act. The major issues addressed by the decrees or acts are highlighted below:

(a) The 1997 decree No.2 increased the minimum paid up capital from N5 million to N20 million for each of the life and general insurance business. However, where the general insurance business includes:
   (i) Oil and gas insurance
   (ii) Credit insurance, bonds and suretyship
   (iii) Contractors' all risk and engineering risk
   (iv) Marine and aviation, other than goods-in-transit business by road, water, air and rail, an additional paid-up capital of not less than N80 million was required. In the case of re-insurance businesses, a minimum capital of N150 million was required.

With the commencement of the 2003 Insurance Act, any insurer intending to commence or continue to carry on insurance business in Nigeria is expected to deposit the equivalent of 50% of the paid up share capital with the Central Bank of Nigeria. The minimum amounts required under this Act are as indicated above. In the case of existing companies, an equivalent of 10% of the minimum paid up capital shall be deposited with the Central Bank. This, no doubt, is a confidence booster for the public who have generally been skeptical about the patronage of insurance businesses and their services.

(b) In furtherance of the desire to strengthen the financial position of the insurance companies, the 1997 decree No.2 mandated the establishment and maintenance of technical reserves in respect of each class of insurance in addition to solvency margin.

(c) Under the two decrees (1997) cited above, an advance insurance policy document which gives evidence to the contract of insurance shall be delivered to the insured not later than 30 days after payment of the first premium.

Problems of the industry

In-spite of the growing prospects of the insurance industry in Nigeria, there are still problems militating against the realization of its full potentials. For instance, the level of awareness of insurance business in Nigeria is still very low. This is, however, not peculiar to Nigeria. It is a worldwide phenomenon. In 1975, there was a survey carried out in the United Kingdom to ascertain the level of awareness of insurance business among the populace. It was discovered that only 23 percentage of policy holders actually knew what they were carrying about as insurance policy or cover (Omirin 2004). Apart from the lack of awareness among the populace, there are other problems which include: high level poverty, low capital base of the operators in the industry, perceived unwillingness to pay legitimate claims, and low level of enforcement and compliance with insurance laws.

DATA ANALYSIS

This section formally examines the contribution of the insurance industry to the economic development of Nigeria. In doing this, we specify the following model:

$$RYIC = \beta_0 + \beta_1 RGDP + \beta_2 RYIC_{-1} \text{..............................} (1)$$

Where:

RYIC = *aggregate real income of insurance companies.*

RGDP = *real gross domestic product*

β_0, β_1 and β_2 are constants and

-1= lagged real income of insurance companies.

For the purpose of estimating equation (1) above, the Ordinary Least Squares estimation techniques is adopted. The data used for this regression are presented in Table 2 while the result of estimates of equation (1) are shown in table 1.

Table 1. Estimates of Regression Equation (2)

Dependent Variable: RYC
Method: Ordinary Least Squares
Sample(adjusted): 1971 2002
Included observations: 32 after adjusting endpoints

Variable	Coefficien	Std. Error	t-Statistic	Prob.
C	19.74604	134.2788	0.147053	0.8841
RGDP	0.002744	0.001658	1.654395	0.1088
RYC(-1)	0.579223	0.132219	4.380792	0.0001

R-squared	0.563196	Mean dependent var	610.1448
Adjusted R-squared	0.533072	S.D. dependent var	225.0380
S.E. of regression	153.7733	Akaike info criterion	12.99790
Sum squared resid	685741.0	Schwarz criterion	13.13531
Log likelihood	-204.9663	F-statistic	18.69567
Durbin-Watson stat	1.686443	Prob(F-statistic)	0.000006

From tables 1 and 2, it can be observed that a positive relationship exists between the aggregate real income of companies in the industry and the level of real gross domestic product. This is evident from the coefficient of correlation (R- squared) of 0.583. The regression results also indicate that though a positive relationship exists between the level of real gross domestic product and real income of these companies, this relationship is insignificant. This means that since 1970, the contribution of insurance companies to the level of RGDP has been insignificant.

Table 2: *Nominal and Real Income of Insurance Companies and Gross Domestic Product (=N=m) 1970-20002*

Year	Life	Non-life	TYIC	RGDP	CPI	RYIC
1970	6.852	9.968	16.82	54148.90	10.80	155.7407
1971	12.584	15.864	28.448	65707.00	12.50	227.584
1972	13.878	25.585	39.463	69310.60	12.90	305.9147
1973	15.468	30.346	45.814	73763.10	13.60	336.8676
1974	23.592	39.749	63.341	82424.80	15.40	411.3052
1975	29.706	70.685	100.391	79988.50	20.70	484.9807
1976	39.909	104.968	144.877	88854.30	25.60	565.9258
1977	49.685	164.308	213.993	96098.50	29.60	722.9493
1978	64.662	169.368	234.03	89020.90	34.50	678.3478
1979	81.834	155.372	237.206	91190.70	38.50	616.1195
1980	100.915	188.233	289.148	96186.60	42.30	683.565
1981	126.889	240.694	367.583	70395.90	51.20	717.9355
1982	142.613	259.374	401.987	70157.00	55.10	729.559
1983	171.827	228.633	400.46	66389.52	67.90	589.7791
1984	168.083	237.595	405.678	63006.40	94.80	427.9304
1985	181.901	205.086	386.987	68916.30	100.00	386.987
1986	212.783	263.69	476.473	71075.90	105.40	452.0617
1987	219.887	419.958	639.845	70741.40	116.10	551.1154
1988	276.228	506.675	782.903	77752.50	181.20	432.0657
1989	330.294	806.164	1136.458	83495.20	272.70	416.7429
1990	414.068	1048.444	1462.512	90342.10	293.20	498.8104
1991	487.836	1334.237	1822.073	94614.10	330.90	550.6416
1992	732.003	2617.901	3349.904	97431.10	478.40	700.2308
1993	1327.039	5901.257	7228.296	100015.20	751.90	961.3374
1994	2515.92	14671.68	17187.6	101330.00	1180.70	1455.712
1995	2813.021	14587.55	17400.57	103510.00	2040.40	852.8019
1996	2416.892	13150.56	15567.46	107020.00	2661.10	585.0008
1997	3162.381	16519.02	19681.4	110400.00	2863.20	687.3917
1998	3803.334	17846.47	21649.81	112950.00	3149.20	687.47
1999	3814.5	18594.4	22408.9	116400.00	3357.60	667.4083
2000	3832.16	21870.43	25702.59	120640.00	3590.50	715.8499
2001	3956.123	25845.06	29801.18	125351.00	4268.00	698.2469
2002	4077.924	26923.53	31001.46	129830.00	4270.20	725.9955

Note: (i) Life and non-life denote the income of life and non-life insurance companies.
(ii) TYIC = total income of insurance companies
(iii) RGDP = real gross domestic product
(iv) RYIC = aggregate real income of insurance companies.

Source: *Central Bank of Nigeria –Annual Report and Statement of Accounts (various issues)*

To ascertain the authenticity of the above findings, we analyze the various diagnostic statistics such as the Durbin-Watson (D.W) statistic and the adjusted $-R^2$. The adjusted $-R^2$, from table 1 is 0.533. This means that more than 53 percent of the variation in the aggregate real income of insurance companies in Nigeria is explained by changes in the current real level of gross domestic product and past level of real income of insurance companies in Nigeria. The high coefficient of adjusted multiple correlation indicates that the model specified in equation (1) has a good fit.

To test for the existence of serial correlation in the residual of the estimated model we analyze the D.W statistic. From table1, it is = 1.7. The closeness of this statistic to 2.0 means that the regression results is free from the problem of serial correlation. The result obtained showed that this industry has not actually contributed significantly to the level of real gross domestic product between 1970 and 2002. This implies that drastic measures have to be taken to improve the performance of the industry as a whole.

CONCLUSIONS

Insurance is a non-bank financial industry whose main function is to provide compensation against different kinds of risks affecting the industrial and commercial sectors of the economy as well as private individuals. Apart from this, it also plays a vital role in the financial markets as well as for the economic development of a nation by providing cover and assistance to a variety of financial and non-financial corporations and government agencies. The insurance business is however still not well developed in Nigeria.

In the light of the importance of the industry, the study investigated the extent of its contribution to the economic development of Nigeria. The result obtained showed that it has not contributed significantly to the country's real gross domestic product between 1970 and 2002.

RECOMMENDATIONS

The main recommendations from this study are:

(i) Government needs to create an enabling environment for effective functioning of insurance companies in Nigeria.

(ii) A lot of Nigerians need to be sensitized about the importance of insurance services.

(iii) There is the need to further increase the capital base of the insurance companies to match the current increase in the capital base in the banking sector

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