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Alternative Risk Transfer and Its Implication on Business Operations in Nigeria

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Abstract

This paper investigated the alternative risk transfer (ART) and its implication on business operations in Nigeria. ART is not one product, but rather a pattern of doing business; ART is *the use of techniques other than traditional insurance and reinsurance to provide risk bearing entities with coverage or protection. Most of these techniques permit investors in the capital markets to take a more direct role in providing insurance and reinsurance protection, and as such the broad field of ART is said to be bringing about a convergence of insurance and financial markets. This requires the existence of prudent management through the application of some alternative insurance transfer mechanisms like risk, retention, research, diversification, and hedging. This process can be achieved through various methods of physical risk management: staff training, safety equipments, and so on. The researcher employed qualitatively review in this work. The study showed that alternative risk transfer is beneficial to individuals, corporate organizations as it presents risk managers with more opportunities to hedge risks in new and innovative ways, and to be less dependent on insurance cover. This study in conclusion puts forth that, alternative risk transfer enable companies to select the most appropriate risk finance and acquire contingent capital at economic cost. It recommended among others that, organizations should establish a strong structure and finance risk management unit with qualified staff to manage organizational risk and provide expert advice in risk management.*

Keywords: Insurance, Fund, Transfer, Risk-Management, Mechanism

1. Introduction

The need to minimize the occurrence of losses in finance, health, social, industry and so on, explains man's passion for survival. Over time man has resolved to learn and acquire both formal and informal knowledge on risk management in order to reduce the chances of loss as risks appear uncertain to human existence. Irrespective of these knowledge and survival instinct man keeps sustaining losses capable of turning a financial pillar to a financial learner, a healthy economy to an unhealthy one, an employed person to unemployed one, an active agent to one who is inactive and a growing business organization to a redundant business organization. Natural disasters, health epidemics, terrorism, political events and climate change were the five top listed risks in real estate in 2017. Traditional insurance provides solutions for some of these risks. However, in specific cases insurance capacity available may be limited or not available at all, especially for non-damage business interruption events. Risk transfer instruments such as insurance and contracts are not new, but it is expected to play a bigger role in the face of mega-impact risk events like climate change, political unrest, terrorism, and cyber attacks (Louis, 2011).

In the past, few considered hedging against such risks. Insurance rarely provides perfect compensation for losses. The issue of alternative risk management grew out of a series of insurance capacity crises in the 1970s through 1990s that drove purchasers of traditional coverage to seek more robust ways to buy protection for their assets. Changes in the insurance industry have lifted up renewed interest in Alternative Risk Transfer (ART) as a method of protecting assets using the alternative insurance market. ART products are increasingly being used to provide capacity (size, profile or uncertain nature) that cannot easily be transferred to the conventional market reinsurers, to even out position statement fluctuations and to exploit the opportunities provided by the convergence of the reinsurance and capital markets. ART is attractive to clients with long-term, top-management commitment to property loss prevention; a willingness to share the risk; and a serious focus on loss control.

This study's objective is to espouse alternative risk transfer mechanism and highlight its implication on business operations in Nigeria. This work employed a qualitative and conceptual method of study. Here related literature was reviewed to established concepts, opinions, methods and findings that have existed on the subject of discussion and then draw a solid position on the objective of the study. Specifically, the paper is sub-divided into four. First, was the introduction, followed by the conceptual review as section two; the third section examined the challenges of alternative risk transfer to business operations in Nigeria and evaluating the implication of alternative risk transfer; lastly, the fourth section was conclusion and recommendations.

2. Conceptual review

The concept of alternative risk transfer (ART) does not have a precise definition. ART is not one product, but rather a pattern of doing business which has two generally accepted segments- risk transfer through alternative risk carriers and risk transfer through alternative products (Swiss Re 2003). One reason for this is that the range of risk products that can reasonably be defined as ART has expanded over time as product innovation continues. Most organizations see ART as a use of alternative techniques to achieve the same hedging and transfer of risk away from a risk bearing entity as with traditional insurance or reinsurance. Alternative risk transfer enables companies to transfer risks to another party or to the capital market by way of converting these risks into tradable securities with long term maturation. Alternative Risk Transfer allows Organizations to purchase coverage and transfer risks through insurance pools and more conveniently securitizing underwriting proceeds. Securitizing underwriting proceeds here entails making the capital market to take more direct role in providing insurance and reinsurance services by hedging insurance risks against long term tradable securities (De-Mey, 2007). This practice broad field of ART is said to be bringing about a convergence of insurance services and financial markets.

Alternative risk transfer covers includes; risk securitization through catastrophe bonds, insurance-linked securities and reinsurance sidecars, trading of risk through industry loss warranties and weather derivative contracts and transforming capital market risks into reinsurance through transformer vehicles. They consider other techniques like captive insurance companies, life insurance linked securitization, longevity risk transfer and other alternative risk financing techniques sometimes (Lawrence, 2007).

According to Oluoma (2006), non- insurance transfer and the insurance transfer are two principal ways of transferring risks. Non-insurance transfer (e.g. subcontracting of some hazardous activities) serves the purpose of transferring some or whole of liability for loss or damage of property to another person or unit/agency. Examples could be seen in contract awards to contractors or sub contractor, hedging contracts, bailment and lease contracts, creating a trust for estate management, bank, and so on. The alternative risk transfer market is broken into two primary segments: risk transfer through alternative products and risk transfer through alternative carriers.

Alternative Risk Transfer Channels

Transferring risk to alternative carriers entails funding organizations, such as captive insurers or pools, which are willing to take on some of the insurer's risk for a fee. Generally, alternative risk transfer (ART) emphasizes capital preservation over operating performance and place greater weight on business retention over market share. Ryan, Davis and Irwin (2017) categorize ART vehicles into the following broad groupings:

The most common form of alternative risk transfer is known as captive or self insurance. This is a type of alternative risk transfer policy established by organizations to cover their own risk and do not insure the risk of insuring public. Hence they have access to reinsurance market and enjoy tax haven. Self-insurance is the largest portion of the alternative carrier market available for companies under state insurance commission regulation as it allows the company (adjust the amount of risk that they have on their portfolio) to reduce costs and streamline the claims process. Risk retention groups and captive insurance tends to be more popular with large corporations. A captive is an insurance company that insures the risks of its owner, affiliated businesses or a group of companies. It issues policies, collects premiums and pays claims — just like a traditional insurance company. What fundamentally distinguishes a captive and makes it alternative to commercial insurance is the form of ownership and who keeps the insurance company profit. **S**ingle-parent captives are owned by one company or group (the parent). Pure captives are single parent captives that accept only the risks of the owner (or owner-affiliates). Not all single-parent captives are pure captives; in some instances, a single-parent captive can accept business from third parties. Group captives offer insurance to several or many unrelated policyholder owners and can take many forms. Some group captives dedicate themselves to a particular industry, while others choose to write in a limited geographic area, such as a single state. Group captives are the ART vehicle that most resembles a commercial insurer and have similar rating dynamics.

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Risk Retention Groups (RRGs) are designed to provide liability insurance for a consortium with similar business interests. Under this arrangement, an RRG is subject only to the regulatory authority of its domicile state, even if it is a multistate insurer. This is mostly practiced in the United States and has not gained much recognition in Nigeria.

Self-Insurance Funds is type of ART instruments can write selected coverage only for policyholder owners doing business in that particular area. These funds differ from commercial insurers primarily in two ways: they are subject to; joint and several liabilities for any claims and governed under a specific charter whereby the surplus is composed wholly of subscribers' savings accounts. "Joint and several liabilities" stipulates that all of the subscribers' savings accounts and all of the policyholder owners' assets can be used to satisfy any claims.

Protected Cell Companies (PCCs) is a highly complex and flexible structure that can be used in a variety of ways by multiple users and sponsors; it can hold any number or combination of insurance and financial operations, transactions, or instruments. Again, this has not gained wide popularity in Africa and Nigeria due to its complex nature.

Insurance products that are available on the ART market includes such options as contingent capital, derivatives, and insurance-linked securities which are closely associated with debt and bond issues, as they involve issuing a bond. Securitization covers bundling the risk of one or more companies together, and then marketing those risks to investors who are interested in gaining exposure to a particular risk class. Key market participants of alternative risk transfer are Investment banks, Insurers, Reinsurers directly and through their capital market~~s~~ subsidiaries, broker~~s~~, consultants.

Risk Control Mechanism

Nwite (2004), risk control are actions that reduce the expected cost of loss in terms the frequency of losses and/or the severity (size) of losses that occur. It involves reduces the level of risk activity, and increasing precautions against loss for activities that are undertaken.

Risk control involves avoiding the event that could generate loss. It is an extreme method of handling risk. It is foregoing the activity associated with the risk. For instance, a traveler may decide to avoid flying because of fear of plane crash. A firm may decide not to own computer or computerize its operation because of past experience of financial loss due to computer-related fraud.

There are instances in personal risk management and organizational risk management where certain risks are unavoidable primarily because some desired objectives will be achieved. However, some retention may be due to ignorance or that the costs of such losses are minimal. Where the retained risk has minimal cost effect, there are actions that primarily influence the severity of losses that do occur.

Example of risk reduction is installation of safety equipment such as cameras, heat or smoke-activated sprinkler system and so on.

Organization can control its organizational risk by engaging in research. The objective of every research is to address an identified problem and come up with research solution to the problem. Risk **d**iversification is another risk control measure by organization. Risk diversification may be through portfolio diversification where organizations invest in different subsidiaries. Companies can hedge their risk and companies with the same peril exposure can contribute into a common fund, out of the fund, the unfortunate is made fortunate or predicting the combined chance of loss. Thus, predictable loss is then shared proportionately by all the units in the combination.

Financial Risk Management

This can also be referred to as loss or risk financing. It implies methods used to obtain funds to pay for or offset losses that occur. There are three broad methods of financing risk management outside insurance. Risk retention is one method whereby a business owner retains the obligation to pay for part or all the losses accruing to the organization. Risk retention often is called ‘self insurance. Organisations uses of financial derivatives to hedge their risk such as forwards, futures, options, and swaps extensively to manage various types of risk, most notably price risk. These contracts can be used to hedge risk or offset losses that can occur from changes in interest rates, commodity prices, foreign exchange rates, and the likes. Risk can be financed and transferred through contracts**.** This allows businesses to transfer risk to another party (third party). Like insurance contracts and derivatives, the use of these contracts also is pervasive in risk management.

Methods of Physical Risk Management

Nwite (2013) highlighted that organizing staff training and seminars, provision and instalment of physical devices (that can be used to reduce or prevent the probability (ies) and/or severities of many types of risk), enlightening people about the risk inherent by indicating with danger signs or posters in all the risk producing danger points in the environment (such as control switches, transformers and so on) will drastically reduce risk occurrence.

Risk controls are those preventive and protective strategies designed to reduce losses. In other words, it is the application of physical preventive and protective strategies in risk management. Physical risk management method is a strategic tool for risk reduction and control. The approach equips staff with new updates of the likelihood of risk occurrence and quarantees reinforcement through training.

Hung, (2006) citing Oksana in a work titled the limits to market-based risk transfer in the financial system and the implications for the management of systemic long-term financial risks discusses why these markets remain “incomplete.” It also explores a range of options by which policymakers may encourage the development of these markets as part of governments' role as a risk manager. The study reviewed the structural influences on market behavior and explores why risk transfer activity is absent or to date ineffective in the context of these risks. Key influences discussed in that study include regulatory frameworks, rating agency treatment, tax and accounting policies, market structure, and the availability of data and risk modeling capabilities; the authorities' ability to influence market behavior and risk management practices, in particular through regulatory influences which may encourage greater innovation in alternative risk transfer markets similar to the Basel principles for banks. The study concluded that government policies may help to improve the measurement of risks; need to act as risk manager by taking a long-term and proactive approach to the management and possible sharing of such risks across sectors.

Sibindu (2015) investigated alternative risk transfer methods of Insurance and sought to find out whether Alternative Risk Transfer techniques represent a cost effective way of balancing insurability by analyzing global trends. His findings showed that indeed the ART solutions are a must buy for both corporate and insurance companies, as they result in the organization using them in achieving financial efficiency. His study also demonstrates that there is a paradigm shift in insurance from that of indemnity to that of value enhancement.

3. Alternative Risk Transfer and Its Implication on Business Operations in Nigeria

The scope for risk management practices in financial companies have been expanded to a level where risk embedded in typical financial sector products such as corporate bonds, commercial loans and insurance can be repackaged into financial market securities (Andersen, 2003). With growing convergence of insurance, banking and capital market, Alternate Risk Transfer (ART) is receiving considerable attention as a risk transfer and financing mechanism. Using tools like credit - and insurance - linked securities it shed risks from financial institution's position statement and transfer them via capital markets to institutional investors.

The implication of alternative risk transfer to business operation is one with positive and negative side. It implication is negative when the risk experience is catastrophic in nature. The business environment is exposed to financial risks associated with unexpected events such as a death, an injured employee, a legal suit or a natural disaster. Natural disasters can strike at any time causing a serious financial crisis. Insurance coverage helps companies plan for unforeseen damages caused by both natural and man-made disasters.

However, businesses and economic activities survives and continuity to exist despite environmental and business risk. Alternative risk transfer has significantly and effectively protected business activities and sustained its operation through risk hedging. It serves as an alternative plan where there is no insurance cover against organisational risk. Alternative risk transfer builds risk management principles and disciplines into businesses owners, promotes induce productivity, business strength and expansion of their boundaries and profitability, saving and investing, minimizing economic loss/cost and profit making. It promotes profitability and growth of corporate organizations through economic loss or waste minimization and cost of business operations of the firm. It encourages savings and investment. Alternative risk transfer is beneficial to individuals, corporate organizations and promotes business operation.

Companies with increasing revenues and large position statement through ART can take on more risk which ordinarily would be difficult to find cover for in the conventional insurance market. ART can be used to hedge risks (or accumulations of risks) considered by a company to be intolerable or unacceptable – for example, commodity, exchange rate or weather risks – or to gain a financing cost advantage over its competition, such as utilizing insurance structures that competitors may not have access to. ART can also enable companies to reduce the cost of borrowing (in certain circumstances, insurers' contingent capital may be cheaper than standby lines of credit) and can be used where a lender of capital stipulates some form of insurance coverage – for example, as part of a credit enhancement deal. Risk managers are no longer thinking in terms of insurance products or transactional insurance but about how insurance can be used for financing. ART presents risk managers with more opportunities to hedge risks in new and innovative ways, and to be less dependent on 'classic' insurance.

4. Conclusion and Recommendations

In the world of business, be it finance, insurance, banking, manufacturing, marketing or commerce, individuals and organizations are exposed to a lot of risks such as natural disasters business uncertainty, bankruptcy, fraud, and so on which also affect productivity and business growth. Alternative risk transfer (ART) enable companies to select the most appropriate risk finance and acquire contingent capital at economic cost

Despite challenges which make it difficult for business institutions to actualize its major objective of growing business because of catastrophic risk that could arise in the business environment, alternative risk transfer has enabled institutions to face and manage their business risk in the absence of no or few traditional insurance policies available to them. With growing convergence of insurance, banking and capital market, Alternate Risk Transfer (ART) is receiving considerable attention as a risk transfer and financing mechanism. We therefore recommended that:-

i. Government should use different policy initiatives at its disposal to encourage private sector and market-based solutions to foster more robust financial market.
ii. There is every need to provide an enabling environment (basic amenities and security) that will promote business growth and minimize loss.
iii. Establishment of strong structure and finance risk management research institution that support business risk.

iv. Organizations should be encouraged to train risk managers that will ensure effective and efficient risk and investment management in their system.
v. Organizations and individuals should seek professional advice from prudent risk managers.

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