



Mergers And Acquisition Of Financial Institutions In Nigeria: A Case Study Of Insurance Company

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ABSTRACT

The new racialization directive by National Insurance Commission (NICOM) were aimed to strengthening the capital base of Nigerian Insurance Companies. The new risk based supervision model (RBSM) ultimately revolutionize the operations of the entire Industry for efficient and effective performance of the Nigerian Insurance Industry. The new requirements will engender business stabilization which will outlaw the prevailing situation where every insurance company underwrites all manners of risks even when financially unfit for them. One of the measure put in place to achieve this are Mergers and acquisitions. Bigger companies were encouraged to buy smaller ones while the smaller ones put up themselves for acquisition. This article presents the methods, process and the technicalities involved in Mergers and acquisitions in the Nigeria Insurance Industry.

Keywords: Mergers, Acquisition, Insurance, Actuarial valuations and Management.

INTRODUCTION

Merger implies 'take over', amalgamation', 'transfer of business' from person or group of persons to another. The term is usually used interchangeably by different authors, hence the need to clarify what each denote. As defined by ISA (2007), Merger is the amalgamation of the undertakings or any part of the undertakings or interest of two or more companies and or more corporate bodies. The word Merger may also connote a situation when or more companies agreed to come together as one company. This entails the maintenance of a single fund for the new unit or separate funds for each of the original companies. While Acquisition means the takeover by one Company of sufficient shares in another Company to give the acquiring Company control of such Company. Meanwhile, amalgamation is used also as 'Merger' or takeover' and specifically applied when the insurance funds of the two companies are fused into one fund. However, it is not uncommon to see substantial element of the management of the companies will continue to be involved in the management of the new single unit. Following the economic reforms especially financial and non-financial sector reforms, mergers of the same size is inevitable in any given economy particularly developing countries. The name of the new unit usually reflects the component part of the merging companies and the shareholding evenly distributed between the original bodies of shareholders.

Furthermore, a "takeover" occur when a bigger company takes over the ownership and management control of the smaller company. The taking-over company usually hold substantial unit of the shareholding structure of at least 75% of the shares of the new company while the smaller company holds 25% shares as agreed between the parties. In most case, it is only the name of the taking over company that will be reflected on the name the company. For

example, in some few years ago, Sovereign Trust Insurance took over Confidence Insurance Company and the Sovereign Trust Insurance was retained for the two merged companies.

In “transfer of business”, the insurance company transfers a portion or the whole of its risk to another large and more successful insurance company whilst transferring a corresponding proportion of its funds to the receiving company. Consequently, the receiving company will issue to the insured its own policies to replace the transferred policies in respect of the risk transferred. A transfer of business differs from a Merger, take over or amalgamation in the sense that under the former only the assets corresponding to the transferred risks need be carried over to the receiving company while the remaining assets of the transferring company will remain with the company.

Mergers and acquisitions in the Insurance Industry are reform strategies employed in the Insurance Sector in order to achieve improved financial efficiency, operational performance and expansion of business. Mergers and acquisitions have become a global tool to achieve economies of scale and higher productivity.

They are the current issues confronting the Nigerian Insurance with the mounting pressure on them to meet the capital adequacy stipulations of the National Insurance Commission (NICOM). Insurance Companies are beginning to embrace Mergers and acquisitions as the best survival options due to the challenges in raising funds in the capital market. Mergers and favourable regulation, the number of domestic and cross border Merger acquisition have increased significantly (Hitt, *et al.*, 2005). Essentially, the increase in the numbers of insurance companies within the last three decades has enlarged the market considerably. The increased size of the market should be an added advantage to the insurance industry and the so called ‘Mushroom companies’ should merge and be transformed into more viable units. This action would encourage pooling of human and financial resources to ensure better performance and stability of the industry. Hitherto, the Federal and State Governments own controlling shares of the Nigeria’s insurance Industry. They have now divested and sold their controlling shares to individuals and private companies.

In acquiring the controlling stake in the companies, Government opted for the long established and successful expatriate companies. Government patronages understandably were directed at these companies which led to a deep gulf between the larger companies owned jointly by government and foreign interest and the smaller indigenous companies.

Furthermore, the reinsurance treaty arrangement is bound to be favorable to the bigger organizations because of their foreign connections since the treaties were placed abroad. The low capital requirement for the establishment of insurance companies inhibits insurance business in Nigeria. Banking institutions which obtain deposit and with well calculated and defined financial risks were, required to have a very high capital base. Whereas, insurance companies which take higher financial risks were allowed to operate smaller capital requirements. Ogunlana (1986) argued that the capital requirement for establishing an insurance company should be higher than the one required for setting up a bank. Once the capital requirements of insurance companies are reviewed to the acceptable level, smaller companies will be encouraged to Merge or bigger companies will take over smaller ones through outright purchase. There is certainly a case to be made for larger and stronger companies rather than a fragmented market.

The first consideration of a sale or Merger is the value to be placed on the company or companies. The determination of the value is quite complicated and more so for a company

transacting life insurance business. There are internationally accepted methods of valuing an Insurance Company and in particular its life business which varies from company to company. The detailed technicalities of the valuation of insurance companies are usually handled by Actuaries and this paper present an overview and the principles involved and their adaptation to the Nigeria Market.

FACTORS INFLUENCING MERGERS AND ACQUISITIONS

- a. Legislation: Following the enactment of new legislation affecting the operations of Insurance Company or the introduction of new economic policies by government, the proprietors may become unwilling or unable to continue in the business. They will be compelled to seek a buyer. In Nigeria, following the upward review of the minimum capital base of insurance companies, companies were made to merge and in some cases taken over by bigger companies.
- b. Following the withdrawal of the licensees of insurance by the regulatory authorities due to a breach of the compliance requirements, the life insurance element of the business maybe transferred to another company. This is to protect the interest of the policy holders who do not wish to surrender their policies.
- c. Government intervention. In developing economies, the government may take proactive step to protect their economy by compelling foreign companies to part with substantial parts or whole of their shares to indigenes. This was carried out in Nigeria under the indigenization programs of the federal government.
- d. Investment purposes. A potential investor either an individual or institutional investor may take up a proportion or the whole of the shares of the insurance companies purely as an investment.
- e. Business Expansion. An insurance company may wish to diversify into another area or line of business which the acquired company is in noted for but the purchaser is not active. The Company will be able to take advantage of the expanded agency network for marketing purposes and the benefit of new executive talents. This, a convenient way for an over capitalized company to gain additional premium income thereby ensuring effective use of capital.

DETERMINATION OF THE VALUE OF AN INSURANCE COMPANY

The basic assumptions that must be considered in examining the actuarial and other reports prepared by the technical experts as itemized below.

- (a) The annual rates of growth of new business (both life and non-life) in future.
- (b) Expected rate of interest accruable to the purchaser for investing his fund in the purchase of the company shares.
- (c) Future rate of interest expected to be earned on life insurance fund which will be built up from both the existing and new business.
- (d) Assumptions made on the tax expected to be paid in future by the company being valued for purchase.
- (e) Future tax assumption on purchase.

The important consideration in a sale or Merger is the value to be placed on the company or companies and the determination is not straight forward because of the technicalities involved. Although, there are internationally acceptable methods recognized for valuation of an insurance company in particular life business and the determination varies from company to company thereby accommodating legitimate differences in opinion. The basic factor influencing any purchase transaction is the interplay of forces of supply and demand. Although, the technical experts will come with their reports, the existence of a potential purchaser and a

seller will play significant role in the determination of the final price of the company. Another factor that will come into play is the bargaining skills of the buyer and seller but this will be diminished if sale is occasioned by political decision of Government.

The net asset value was previously accorded a lot of weight in the calculation of the value of a company which simply is the total assets of the company minus total liabilities not attributable to shareholders. This is arithmetically equal to the ordinary share capital plus any reserves built up over the years. Hence, this is obtained by adding the balance sheet value of the ordinary shares to the reserves and the resulting amount divided by the total number of shares. A determination will be made to include or exclude "Good will" item in the assessment of the value of the company.

The usage of net asset values in the evaluation of a company's share has diminished recently with greater attention paid to future profits expected to be generated for shareholders of the company. Hence, the value of a company's share is determined by estimating the future profits which will be discounted at compound interest to the date of purchase.

In insurance, the features of the business are not different from any other trading company and one could put a value on the business by considering its record or dividend record. An average of 10 years' record may be considered to allow for distortions due to variable claims.

Another refinement to this approach is to value separately the shareholder's assets and exclude the effect of interest earnings from those assets when determining the earnings from the insurance business. The usual method of the valuation of insurance company's shares here is the discounted value of future shareholders' profits. A composite company, that is a company transacting both life and non-life business should be valued separately since non-life business is short term business and life business is a long term business. In respect of the life business, the future profits expected to accrue from the contracts already in force at the purchase date are valued separately from those future new business in order to ensure that the contributions of future new business to profit to be identified.

Ogunsola (1984) identified six components in the valuation of a composite insurance company shares and this includes:

- a) The present value of future profits expected to accrue to shareholders from the non- life business alone.
- b) The value of future profits expected to accrue to shareholders from the existing portfolio of life business making use of all the assets and investments held in the life insurance fund but excluding those assets which are outside the life fund.
- c) The value of future profits expected to accrue to shareholders from future new business
- d) The value of tangible physical assets which are not held in any of the insurance funds but which are held in the balance sheet and will now become the property (through the company) of the new shareholders e.g. office furniture, official cars, buildings, e.tc.
- e) The value to be placed on intangible assets (which may not appear on the balance sheet) e.g. the value to the company of a chief executive of exceptional caliber who has a contract to remain with the company for the next five years and who has signified his intention to remain in spite of the change in ownership.
- f) The value that can be placed on other factors about the company known to the purchaser and which are a source of contingent gain or loss to the company. For example, the existing reinsurance arrangements will be investigated to see if they provide adequate protection for the company and if they are not, a reduction may be made to allow for this factor. Another possible source is potential past Liability.

Additional the consideration is past service pension rights of the company staff where the benefits payable under existing pension arrangements are inadequate.

The figures obtained for the various components are added up (or subtracted where negative) to arrive at the computed value of the shareholders' interest in the company.

It is the nature of insurance business to assume liabilities, therefore consideration must be given to disputed claims and pending legal actions. These are not problematic in life insurance contracts since in most cases, the account or the actuarial valuation report should reflect accurately the provision required for outstanding claims. Non-life insurance is rarely straight forward and one need to consider whether the accounts make adequate provisions for these items. There may be other liabilities to consider, including contract of employment with severance conditions. Also there may be accrued pensions liability and adequate provision should be made for this.

LEGAL CONSIDERATIONS

The legal positions vary from country to country but what need to be noted is that the legal requirement of a life office is more stringent than the non-life office. For instance, Mergers, Acquisitions and Takeover in Nigeria apart from the provisions of the Insurance act (2003) are governed by the Investment and Securities Act (ISA 2007), the Securities and Exchange Rules and Regulation (SERR) made pursuant to ISA and the companies and allied matters act (1999). The Nigerian Investment Promotion Commission Act (1995) now allow business to be wholly foreign-owned and guarantees foreign investors the unconditional transfer of the net proceeds of their investments. The process is guided by the Insurance Act (2003) and approval of all the relevant regulatory authorities must be obtained before the process is finalized. The intent and purposes of the legislation is the protection of the policy holders.

Consequently, because of the long and complicated technical and legal process involved in Mergers and Amalgamation Proprietors and Managements of the Companies should explore other cost effective alternatives to achieve their desired objectives. It could take up to two or more years from the date of intent to reach the completion stage. The actuarial, legal, accountancy, surveyors and other expenses can be quite considerable. Two Simpler cost effective avenues may be explored.

- a) This could be achieved by the mere purchase of the shares of one company by the other. In this particular case both companies will retain their separate corporate identities. This option may found preferable since less time expense and legal complications are involved.
- b) The formation of a new holding company whose only assets would be the shares of the two original companies (which will still retain their former identities) and the original shareholders of the companies will now be shareholders of the new holding company. It is also the best option where both companies are composite companies.

CONCLUSION

The purchase of insurance shares, mergers, amalgamation or/and taking over of insurance fund represents an abstractness of certain aspects of modern economic systems for the shares themselves constitute intangible right to future dividends. Hence, the purchaser of insurance shares amounts to buying an intangible associated with a company whose products are intangible. The purchaser may be part of a group of financial institutions connected through a web of shareholdings (intangibles) with the shareholders collecting their profits but whose products are not visible or touchable. The fragmented nature of the insurance market in

Nigeria is influenced by the public's conception of insurance business as highly profitable. Many shareholders' entrepreneurs and State Governments have an inflated idea of owning their own insurance company. Many of the insurance companies formed within two decades cannot justify a value which would pay their shareholders original investment let alone provide a profit. Simply put, in many cases the company have not grown in line with expectations due to the general malaise which tragically has afflicted the whole company. Such companies are ideal target of a takeover if realistic price can be negotiated, if the takeover is by a larger insurance company, the resultant effect is a major savings in expense.

Furthermore, there may be some situations when outright acquisition would be the best option. For instance, a Broker might consider having a stake in an insurance company where he places business. The Broker will be able to add its value to the insurance company by virtue of the expanded future business. The insurance company would naturally expect that the Broker would place higher proportion of its business with it than other potential purchasers. The Merger of Companies or the takeover of smaller Companies may well be a necessary development in order to aid the expansion of the company. It must be noted that the statutory minimum capital for insurance companies in Nigeria is well below the ideal level to establish a company and underwrite large risks. Insurance is an industry principally concerned with carrying risks. The acquisition of smaller Companies or Mergers between small Companies would go a long way towards improving this situation. Even larger companies benefit from increased capital resulting from Mergers. Mergers should also lead to savings in administrative expenses and reinsurance cost. The regulatory authorities should set higher capital requirements for Insurance Companies and Mergers, and Acquisitions would be vehicles of this objectives.

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