

# Financial Consolidation and Financial Performance of Insurance Companies in Nigeria

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*Abstract:* - The research investigated the effect financial consolidation has on the performance of Nigerian insurance firms covering the period 2011 to 2022 utilizing the feasible generalized least squares (FGLS) on selected five insurance organizations. Key variables used in the analysis included financial consolidation measured by merger and acquisition (M&A), Herfindahl-Hirschman index (HHI), and concentration underwriting capacity (CUC), while performance was captured by equity return (ROE). Findings revealed that M&A and HHI both positively and significantly affect ROE. However, CUC had positively insignificant effect on ROE. The study then recommended that policymakers and industry stakeholders should focus on improving financial consolidation to support economic growth and improve firm-level performance.

*Key-Words:* - Insurance Company, Financial Consolidation, Return on Equity, Merger and Acquisition, Herfindahl-Hirschman index, Concentration Underwriting Capacity, Feasible Generalized Least Squares.

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## 1 Introduction

The insurance firm is of significant importance due to its role in risk management, economic stability, and social welfare. It gives room for people to transfer any burden or potential losses to them, reducing their exposure to various risks. By pooling risks and sharing losses, insurance promotes economic stability and confidence in investment activities, [1]. Hence, investors, policymakers, and individuals closely monitor their productivity to improve risk management strategies, ensure economic stability, and enhance overall performance. Despite this, it has been observed that the Nigerian insurance firms' performance has been low; impediments have been created due to low efficiency, as reflected in a decline in return on investment, plus contracting net profit margin, [2]. These collectively indicated a decline in both consolidation and institutional efficiency within the industry, impacting its overall performance.

Globally, research attention has been drawn to insurance firms due to their substantial impact on various aspects of the economy, as well as their significance for individuals and businesses alike, [3]. Insurance companies provide individuals and businesses with a mechanism to manage and mitigate risks. By purchasing insurance policies, individuals transfer the burden to such insurance organizations, which helps provide financial security in case of unforeseen events, [4]. However, there have been several challenges and trends in the insurance industry that have influenced its performance and operations. Customers' expectations have evolved with the rise of digital experiences in other industries. They now demand personalized, convenient, and seamless insurance services. Insurers are investing in digital platforms and mobile apps to provide self-service options, simplify claims processes, and enhance customer experiences, [5].

The distinction between advanced and emerging markets is evident in their respective performance, with the latter surpassing the former. In the first half of 2022, the United States experienced a lower annual real GDP growth rate of 2% compared to the euro area's 4%, [6]. Despite the adversities presented by the conflict in Ukraine and the energy crisis, the euro area showed resilience and sustained positive real economic growth for the year 2022. According to [7], India has shown exceptional performance within the context of major developing countries, with a noteworthy real GDP growth rate of 7%. This growth rate surpasses that of China (3%) and Brazil (3%). The primary factor contributing to this accomplishment may be attributed to the release of pent-up domestic demand after the reopening phase after the COVID-19 pandemic. China saw limited growth (3%) as a result of stringent measures implemented to combat the COVID-19 pandemic while Russia's GDP declined by 3% owing to the imposition of sanctions and other economic consequences stemming from the conflict in Ukraine, [8].

The 2020 pandemic effect on global insurance markets was milder than initially expected. While the global economy shrank by 3.3%, direct insurance premiums saw a smaller decline of 2.1%. This led to a slight uptick in the global insurance penetration rate, which increased from 7.2% in 2019 to 7.4% in 2020, [9]. In Africa, a similar trend emerged, with insurance premiums growing at a slower pace than the GDP in 2020, decreasing by 2.9% while the economy contracted by 2.1%. This decline had the effect of reducing Africa's insurance entrance from 2.78% in 2019 to 2.6% in 2020. Notably, Africa's reinsurance market continued to perform relatively well, surpassing primary insurance markets, primarily due to its competitive reinsurance capacity, as highlighted by [10].

### 1.1 Research Problem Statement

In 2020, Nigeria experienced a 3.0% contraction in GDP due to declining oil prices and the depreciation of the Nigerian naira against the US dollar. In contrast, Egypt, another oil-exporting African country like Nigeria, achieved a 3.6% growth in 2020, [11]. South Africa, once the largest economy on the continent, ranked third in 2020 and reported an 8.2% GDP decline due to falling prices for metals and minerals and the further depreciation of the South African rand against the US dollar, [12]. The African insurance markets displayed varying premium volumes in 2020. South Africa, the largest insurance market on the continent, still contributing nearly 68% of total premiums, reported a 3.4%

decline in premium volumes when adjusted for inflation as the market contracted, and the rand depreciated considerably. Morocco, the second-largest insurance market in Africa, increased its premiums by 7.3%. However, Nigeria, the continent's fifth-largest market, witnessed the most substantial contraction in 2020, with total premiums decreasing by 14.8%; Kenya's premiums decreased by 2.5% while Egypt exhibited remarkable performance with growth of nearly 9%, adjusted for inflation, [13].

The Nigerian insurance industry faces a myriad of real-time challenges that warrant a comprehensive study of the effect of consolidation components on the performance of insurance organizations within the nation. The Nigerian insurance industry's market share in the gross domestic product (GDP) has experienced a noticeable decline. The year 2020 witnessed the sector contributing 0.5% of the nation's GDP, a figure that has since dwindled to 0.4% by 2023, [14]. The trimming down displayed the problems of sectoral development.

Inadequate adherence to regulatory standards poses operational and reputational risks. Claims processing inefficiencies result in delayed and inaccurate claim settlements, further denting customer trust and satisfaction, [15]. Effective risk management remains a challenge for the insurance industry, potentially leading to unanticipated losses and financial instability, [16].

## 2 Theoretical Framework of Agency Theory

The assumptions of agency theory underpin the understanding of the relationship between principals (shareholders) and agents (management), [17]. The theory assumes that individuals, whether shareholders or management, act in their self-interest, [18]. Shareholders seek to maximize their wealth, while managers aim to achieve their objectives, such as job security, power, and financial rewards. However, this conflict of interest always leads to the ultimate goal of profit maximization, [19]. The theory argued that managers charged with running corporations will need to do everything possible to boost the performance of the company and satisfy their principal, [20], hence the need for the separation of the office of the chief executive officer (agent) and that of the chairman of the board (principal), [21]. The theory believed equity holders will have their investments better secured and would want better performance when separate individuals

hold both positions. The separation of the two offices provides a monitoring device for the equity owners and this boosts performance, [22].

The theory assumes that agents and principals have different objectives and goals. For example, shareholders primarily seek to maximize shareholder value and returns, while managers may have alternative goals, such as job security or empire-building, [23]. These divergent goals would boost profitability but can lead to agency problems. Agency theory suggests that the relationship between shareholders and management is not without costs. These agency costs can include monitoring costs (such as financial audits and oversight), bonding costs (like performance bonds), and residual loss (losses incurred due to agency problems), [24]. In the context of insurance companies, the effectiveness of agency theory is contingent on understanding and addressing these assumptions to ensure that shareholders and management's interests are aligned, ultimately impacting company performance, [25].

One weakness of the theory was that agency theory postulated that there would be some disagreements and suspicion between two parties, [26]. This threat arises due to variances in incentives. Principals (shareholders) believe that agents (directors) will act in their selfish interest because they have different preferences, [27]. Agency cost is the cost that is sacrificed by equity owners, to ensure that the agents (executives) work in the best interest of their principals. It is a means by which the principal ensures that their investment is protected from exploitation by agents, charged with running the corporation, [28].

In the context of insurance companies, the effectiveness of Agency Theory is contingent on understanding and addressing these assumptions to ensure that shareholders and management's interests are aligned, ultimately impacting company performance, [29].

## 2.1 Empirical Framework

[1], the study indicated that the consolidation dimension had an important and favorable effect on performance.

[2], revealed that the consolidation dimension had a negative but significant effect on the after-tax profit of insurance firms.

[4], stated that the consolidation dimension had a positive influence on insurance firm performance.

Furthermore, [13], showed that consolidation dimension had a significant influence on the before-tax profit of insurance firms.

[5], collaboratively opined that the consolidation dimension had a negative but beneficial influence on the net income margin of insurance firms.

[8], indicated that mergers and acquisitions have a positive impact on the profitability of insurance firms in Spain. M&A activities are associated with improvements in return on assets (ROA) and return on equity (ROE), indicating enhanced profitability after the occurrence of M&A transactions.

[30], examined whether or not Mergers and acquisitions, affect Corporate Financial Performance of financial technology inclined quoted insurance companies in Nigeria using multiple regression analysis. Results of the research showed a positive impact of M&A on the financial performance of quoted insurance firms in Nigeria. The study failed to explore potential challenges or limitations associated with consolidation in the Nigerian insurance industry.

[31], study findings indicated that mergers and acquisitions (M & A) have a positive impact on the financial performance of Nigerian banks.

[32], the study found out that the consolidation dimension had a positive and significant influence on the asset returns of major insurance firms.

[33], study reveals that mergers and acquisitions have a positive effect on the financial performance of agricultural companies.

## 3 Methodology

This research utilized five insurance firms quoted on the Nigerian capital market and included Axamansard Insurance Plc, Custodian and Allied Plc, Great Nigeria Insurance Plc, Law Union, and Rock Ins. Plc, and Veritas Kapital Assurance Plc.

Secondary panel data was used for the study and covered twelve (12) years which lags between 2011 and 2022 for the five selected Nigerian insurance firms, during which the insurance sector in Nigeria experienced significant consolidation. The data will be collected from the Nigerian Insurance Commission (NIC) and the Nigeria Exchange Group (NGX) databases. The sourced data would be estimated using the panel data regression.

### 3.1 Model Specification

The study model was adapted and modified from the study of [34] and its explicit form was:

$$ROE_{it} = \beta_0 + \beta_1 MA_{it} + \beta_2 HHI_{it} + \beta_3 CUC_{it} + \varepsilon_{it}$$

Where:

The dependent variable was equity return (ROE)

The proxies for financial consolidation are:

Merger and acquisition (M&A)  
 Herfindahl-Hirschman index (HHI)  
 Concentration underwriting capacity (CUC),  
 $\beta_0$  is the intercept for model 3.1  
 $\beta_1$  to  $\beta_3$  are the parameters estimating each independent variable  
 $\varepsilon_i$  captures the error term;  $i$  represents the individual insurance companies and  $t$  denotes years

## 4 Data Analyses and Interpretation

### 4.1 Panel Unit Root Test

It was utilized to test for the data stationarity, [35], [36]. The unit root utilized was the Levin, Lin, and Chu (LLC). In the unit root results in Table 1, it can be seen that all variables were level stationary.

Table 1. Panel Stationary Test

Variable	LLC	
	I(0)	I(1)
ROE	-3.4349***	-2.2544**
MA	-4.8226***	2.9989
HHI	-4.9256***	-3.2456 **
CUC	-5.3157***	-3.5308**

NB: \*\* Significant at 5%; \*\*\* Significant at 1%.

### 4.2 Hypothesis Testing

Pesaran CSD test showed F-statistic = -1.017 and prob = 0.309 > 0.05 dictating the evidence of cross-sectional independence among the independent variables. On the choice of estimation between OLS and FEM, the testparm had F-statistic = 8.77 and prob = 0.00 < 0.05, indicating preference for Fixed effect model (FEM), while Breusch-Pagan LM test with chi-square = 0.00 and prob = 1.000 > 0.05 favored random effect model (REM) as the preferred estimator. Also, the Hausman test result was used to decide between FEM and REM has chi-square = 7.84 and prob = 0.049 < 0.05, indicating a preference for FEM as the appropriate estimator. However, the Modified Wald Test for Heteroskedasticity shows chi-square was 36.40 with 0.000 probability value signaling heteroscedasticity. Also, the Woodridge Test for Autocorrelation shows an F-statistic of 0.281 and prob. of 0.045 < 0.05 indicating serial correlation or autocorrelation.

Sequel to the stated diagnostic test results, the Feasible Generalised Least Squares (FGLS) is considered appropriate for interpretation and hypothesis testing to achieve objective one because it can simultaneously handle heteroscedasticity and serial correlation issues present in the model.

Table 2. Regression Result  
 DV: *roe*

Variables	OLS	FEM	REM	FGLS
Constant	-1.7560 (1.7068)	-0.4966 (3.8341)	-1.7560 (1.7068)	-1.9735 (1.4918)
<i>ma</i>	2.7403*** (0.9452)	- 4.1924** *	2.7403* ** (0.9452)	2.5283* ** (0.9596)
<i>hhi</i>	1.1020*** (1.6162)	0.8210 (0.5955)	1.1020* ** (0.1616)	1.0909* ** (0.2071)
<i>cuc</i>	0.0194 (0.1422)	-0.0023 (0.0167)	0.0194 (0.0142)	0.0210 (0.0185)
Observations	60	60	60	60
Numbers of id	5	5	5	5
R-squared	0.6627	0.7320	0.6627	0.8057
Adjusted R-squared	0.6446	0.6960	0.6446	0.7796
F-statistics (prob)	36.67(0.000)	8.77(0.000)	110.02(0.000)	74.34(0.000)
Pesaran CSD Test		F(4,52) : -1.017 Prob : 0.3093		
FE Testparm		F(4,52):7 .90 Prob: 0.000	-	-
Breusch-Pagan LM Test			Chi-bar <sup>2</sup> (01):0.0 0 Prob: 1.00	-
Hausman Test			Chi <sup>2</sup> (3): 7.84 Prob: 0.049	-
Modified Wald test for Heteroskedasticity		Chi <sup>2</sup> (5): 36.40 Prob: 0.000	-	-
Wooldridge test for autocorrelation		F(1, 4): 8.281 Prob:0.045	-	AR (0.364)

Notes: DV: dependent variable, OLS: ordinary least squares, FEM: Fixed effect model, REM: Random effect model, FGLS: feasible generalized least square. Statistics \*\*\* showed significance at 1%.

The estimated FGLS model as indicated.

$$roe_{it} = -1.974 + 2.528ma_{it} + 1.091hhi_{it} + 0.0210cuc_{it} + \varepsilon_{it} \quad (1)$$

From FGLS results presented in Table 1 and captured in estimated model (1), there is evidence that the merger and acquisition have a positive relationship with the return on equity. It means any

increment in the merger and acquisition will cause increase in ROE. Thus, an increase in the merger and acquisition within the insurance companies will lead to a 2.528 percent increment in ROE. Findings revealed further that the merger and acquisition have a vital impact on the ROE of the Nigerian insurance firms.

$$(ma_{it} = 0.192, z - test = 2.66, p < 0,01)$$

This implies that the merger and acquisition were vital in influencing changes in the ROE of the chosen Nigerian insurance firms.

Also, HHI had a positive impact on ROE which means any increment in HHI would cause an increment in ROE.

$$(hhi_{it} = 1.091, z - test = 5.27, p < 0,01)$$

It means the Herfindahl-Hirschman index was vital in affecting changes in the ROE of the chosen Nigerian insurance firms.

Finally, as revealed in Table 2, the concentration of underwriting capacity (CUC) was positive with ROE. It means CUC led to an increment in ROE. Thus, an increase in the concentration of underwriting capacity will lead to a 0.021% increment in return on equity. Further, CUC was insignificant to the ROE of the selected Nigerian insurance firms.

$$(cuc_{it} = 0.021, z - test = 1.13, p > 0,05)$$

Hence, CUC was an insignificant element affecting changes in the ROE of the selected Nigerian insurance firms.

Moreover, adjusted  $R^2$  ( $\bar{R}^2 = 0.7796$ ), which is the evidence of explained variable – return on equity – variations explained by the explanatory variables – merger & acquisition (MA), Herfindahl-Hirschman index (HHI) and concentration of underwriting capacity (CUC) – by 77.96 percent.

The Wald test statistic of 74.34 with a probability figure of 0.000 means merger & acquisition (MA), Herfindahl-Hirschman index (HHI), and concentration of underwriting capacity (CUC) are joint vital elements affecting changes in ROE of the selected Nigerian insurance firms.

#### Decision Rule

To accept or reject the null hypothesis, the Wald Chi-squared probability value was employed and

evaluated at 1 percent significant level. From Table 2, The WaldChi<sup>2</sup> Statistic of 74.34 with a probability value of 0.000 was vital at 5%, meaning the null hypothesis stating that consolidation has no significant effect on the return on equity of insurance companies in Nigeria was not accepted.

## 5 Recommendations

1. The insurance firm should improve the regulatory framework governing insurance companies to ensure that it encourages financial consolidation efforts that lead to efficiency gains while safeguarding against monopolistic practices. This can be achieved through regular reviews and updates of regulations to align with industry best practices.

2. The policymakers should provide financial plus regulatory support to companies willing to consolidate. This can help improve market competitiveness and efficiency.

3. The policymakers should encourage insurance companies to introduce more innovative products and services for customers. This can help improve the concentration underwriting capacity of the insurance firms.

4. The policymakers should make a regulatory framework that would ensure relaxed entry into the insurance company market. This would boost competition in the sector and enhance their performances.

5. Training and seminars should be organized by the government and policy makers for employers and employees in the insurance business on the importance of consolidation and how it can help boost performance of the Nigerian insurance firms.

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