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Current Practices and Challenges in Implementing Operational Risk Management in the Nigerian Insurance Industry

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ABSTRACT

The concept of operational risk management has helped financial institutions around the world in creating value and enhancing organisational performance. The focus in Nigerian Insurance industry is towards the establishment of a risk-based regulatory framework and the implementation of operational risk management strategy. The objective of this study is to highlight the practice and challenges of operational risk management in the Nigerian Insurance industry. Questionnaire survey research of managers from insurance companies was utilised. Our findings confirm that insurance companies in Nigeria have adopted a formal practice of operational risk management to a certain degree. The study also identified areas of challenges for the insurance companies which if properly addressed can enhance organisational competitive advantage. The study is beneficial to regulatory bodies, insurance companies and academia with a view to stimulate further research.

Keywords: operational risk management, risk management, insurance companies, insurance regulation

1.0 INTRODUCTION

The concept of operational risk management has helped financial institutions around the world in creating value and enhancing organisational performance. Operational risk management is critical to any organisation, especially with the increased reliance on data and technology. Operational risk has become a pertinent issue in the management of financial organisations because of the swift and unanticipated burst of financial issues that have caused meaningful operational losses to organisations. Operational losses are typically of high-frequency, low-severity variety, but there is always the possibility of catastrophic losses, hence operational risk must be considered. The insurance industry, like all other financial institutions, is moving towards a greater appreciation of the risks facing individual companies and the industry. This may impact on how the insurance industry manages its risks (Acharrya, 2012).

The concept of operational risk first caught widespread attention during the Barings Bank bankruptcy in 1995. It exposed the financial industry to a new risk which was neither

credit nor market risk but with the potential of having as much effect as credit and market risk (Cummins, Lewis & Wei, 2006). The implications of failing to properly manage operational risks go beyond obvious financial losses, such as legal penalties or damage to the company's reputation among shareholders and consumers (Torre-Enciso & Barros, 2013).

The eventual aim of the operational risk management function is to embed a risk culture which synchronises the goals of key decision makers and external stakeholders and provides the framework, infrastructure, tools, and methodology to allow key decision makers to manage operational risk as part of their overall portfolio of risks, in conformity with cost-benefit analysis, within the risk tolerance standards of stakeholders (Fadun & Oye, 2020).

The Nigerian insurance industry has had its fair share of operational risk management failures. To mitigate against these failures, risk regulatory requirements in-line with Solvency II were introduced. These include raising the minimum capital requirements, effecting a separate charge for operational risk, and introducing operational risk management into the management function of Insurance companies. These new regulations will need to be harmonised in-line with organisational goals and objectives. Also, there will be a requirement to document the process of establishing the framework for operational risk management process to determine its success or failure.

There is limited research in the challenges of operational risk management in the Nigerian financial environment thus this study applies the principles directing operational risk management practices in understanding the challenges of operational risk management strategy. The study explores the challenges encountered in operational risk management in the Nigerian insurance industry.

2.0 OBJECTIVE OF THE STUDY

The main objective of the study is to investigate the current practices of operational risk management in the Nigerian insurance industry and ascertain the challenges involved in its implementation.

i. to what extent has operational risk management strategy been implemented in the Nigerian Insurance industry?
ii. what are the challenges of operational risk management in the Nigerian Insurance industry?

2.1 Concept of Operational Risk Management

Operational risk is any factor or event that could impact an organisation’s ability to meet its organisational objectives (van Grinsen, 2009). The impact of operational risk can be both financial and non-financial such as:

i. the disruption of services could seriously inconvenience a firm's customers leading to a severe erosion of their loyalty; or
ii. financial insolvency
iii. a litigation could irrevocably damage a firm's reputation and brand even if the legal cost was easily supported by the firm's financial resources (Kilavuka, 2008).

Thus the ability to manage operational risks will put the financial institutions at competitive positions and help them survive better in the business environment (Mago, Hofisi, & Mago, 2013; Nguyen & Dang, 2022).

Operational risk management is expressively for assessing and controlling the business hazards posed by human beings, by recognising and managing these risks, real business dangers ahead are spotted (Chung, 2003). Operational risk management has its own elements, as its main goal is to ensure that there is an effective framework and measurement mechanism in place. The framework has two main needs to satisfy. It should introduce a mechanism where implementing operational risk policies would be possible firm-wide and, at the same time, it should undertake a process of comprehensive data capturing and measuring mechanism to assess the kind of risk exposure the firm is dealing with.

The management of operational risks requires a focus on human factors, effective risk communication up and down the organisation, and capabilities that collectively build organizational resilience.

This starts with understanding how and why things can "go wrong," what underlying risk factors cause upsets, and an appropriate focus on risks at all functional levels of the organisation (Ossetton & Heuts, 2016).

Ultimately, the goal of operational risk management is to manage the volatility of results generated by problems associated with business-threatening events (Hemrit & Ben Arab, 2012).

The management of operational risk is a necessary activity for insurers, which presents ample opportunities for development and a large field of study on conceptual and practical issues due to the particularity and complexity involved in these types of risk (Barros & Torre-Enciso, 2012). By managing operational risks, an insurance company aims to increase share values and overall protection on operational and reputational risk whilst maintaining minimal operational losses (Radu & Olteanu, 2008). Also, the effectiveness of operational risk management and availability of operational capacity can ensure the frequency of costly losses reduce in an organisation (Cornwell, Bilson, Gepp, Stern & Vanstone, 2023).

3.0 THEORETICAL FRAMEWORK

An operational risk event is connected to human behaviour (Anglin & Gao, 2016). The report of Bryce *et al.,* (2016) show that the effectiveness of Solvency II is based around the reliance upon people for effective decision making; the importance of good training for

empowerment of staff; the importance of Board level engagement; as well as an individual's own world view and perceptions influenced by the adoption of an organisational risk culture. Acharyya (2012) thus identifies the importance of subjective factors such as individual actions, organisational culture, individual's emotions, understanding, response to risky situations, and so on in operational risk management.

Subjective risk theory deals with the qualitative aspect of risk. It addresses the social dimensions of risks and investigates peoples' behaviour and is highly dependent on the dynamics of the community context within which it arises (Wynne, 2006). For this study, subjective risk theory relates to the subjective assessments in evaluating the challenges of operational risk management.

3.1 Principles of Operational Risk Management Regulation and Implementation

Solvency II is a fundamental and wide-ranging review of the current insurance directives. Solvency II is based on three guiding pillars that intend to offer better risk measurement and management in market, credit, operational, insurance, and liquidity risks.

The pillars focus on minimum capital requirements, risk measurement and management, and information disclosure respectively.

i. Pillar 1 focuses on quantitative requirements such as valuing assets, liabilities, and capital.

ii. Pillar 2 focuses on supervisory activities which provide qualitative review through the supervisory process including a focus upon the company's internal risk management processes. Pillar 3 addresses supervisory reporting and public disclosure of financial and other information by insurance companies (O'Donovan, 2014).

Under Solvency II, insurance companies are expected to maintain a specific minimum capital requirement for operational risk, to undergo supervisory tests of their risk management practices and to publish their strategies and processes for managing operational risk, the structure and organisation of the area, their risk mitigation policies, and the techniques to estimate it.

Consequently, insurance companies must develop a structured operational risk management process that is consistent with their overall risk management system and must consider their respective risk bearing capacity when making business decisions (Prokof & Pfeifer 2013).

3.2 Challenges of Operational Risk Management Practice

According to Fraser & Simkins (2016), there are several challenges encountered in the enterprise risk management. They include misconceptions, implementation challenges, corporate governance, and external challenges. Dornberger *et al*. (2014) also posits that these challenges stem from the composition of the system, suitable metrics, the human

factor, and the complexity of the operating environment. Though, there are international best practices determined to manage operational risk by COSO, organisations should adapt to their system and determine their best practice in line with the recommendations (Dornberger *et al*, 2014). Prokop & Pfeifer (2013) in their study of German insurance companies identified a lack of transparency as well as IT security as key challenges of operational risk management. Van Grinsen (2009) attributes the challenges faced by insurance companies to inadequate data, supporting techniques, tools, and governance in operational risk management. All the above studies support that responding effectively to these challenges ensure competitive advantage for organizations.

4.0 METHODOLOGY

This study is a cross-sectional research. The survey was conducted through the administration of a structured questionnaire to the respondents. The questionnaire was pretested specifically for question variations, meaning, task difficulty, respondents' interest, attention, flow, and timing. The questionnaire is divided into five sections. All questions are close-ended questions with some giving the respondent multiple options to pick from while the others are based on a Likert scale of one to five.

The sampling frame was drawn from the list of registered Insurance companies. Respondents engaged in the survey are the employees of Insurance companies who are directly or indirectly associated with risk management such as senior managers, especially operational risk management as well as head of business units.

This study utilises stratified random probablity sampling. This technique was utilised to ensure the presence of key subgroups (business type and ownership structure) within the sample (Saunders et al, 2015; Ekinci, 2015).

A total of 400 participants were selected from 20 insurance companies chosen for the survey from a total of 7,036 employees.

For analysis, descriptive statistics and inferential analysis were used in this study. The initial stage of descriptive statistics included calculating frequencies, and percentages, and means to investigate the individual set of variables.

5.0 RESULTS

Table 1: Operational Risk Management Strategy

Variables	Response Label	N	%
Regulatory capital set aside for operational risk			
	< 10m	58	16.6
	N11m – N25m	91	26.0
	N26m – N50m	106	30.3
	N51m – N75m	62	17.7
	> N76m	33	9.4

Variables	Response Label	N	%
Operational risk evaluation methods			
	Scenario analysis/Stress testing	283	80.9
	Factor based on volume measures	261	74.6
	Stochastic modelling	229	65.4
	Firm-developed model	234	66.9
	Others	130	37.1
Operational risk quantification			
	Single loss estimate	63	18.0
	Model based on scenarios	85	24.3
	Loss data analysis	65	18.6
	Hybrid model	119	34.0
	Others	18	5.1
Operational risk aggregation with total capital requirements?			
	VaR/CoVar	57	16.3
	Gaussian copula	66	18.9
	Sum	86	24.6
	T-copula	118	33.7
	Others	23	6.6
Means of regulatory capital calculation for operational risk management			
	Basic indicator approach	60	17.1
	Standardized approach	105	30.0
	Advanced measurement approach	58	16.6
	No structured method of measurement	127	36.3
Responsibility for operational risk management implementation			
	CEO	26	7.4
	CFO	60	17.1
	Other Member of Board	58	16.6
	Head of Risk Management	110	31.4
	Business Unit Head	30	8.6
	Head of Audit	66	18.9

Table 1: Operational Risk Management Strategy

The study was able to assess the practice of operational risk management in insurance companies in Nigeria. The respondents acknowledged the potential severity of operational risks and appreciated that the regulatory requirements will serve to increase its profile. Over half (57.4%) of the companies surveyed had set aside more than N26m to manage operational risk. Operational risk capital is one of the requirements of solvency II for insurance companies. This current research did not look at the adequacy of the funds in respect to actual operational risk losses.

Scenario analysis/stress testing was the favoured mode of risk evaluation method, using a hybrid model, that is one specifically designed to suit the companies' operations for operational risk quantification.

This reflects in the methods used to calculate the regulatory capital to manage operational risk. More of the respondents agreed they had no structured method of measurement for the regulatory capital.

This suggests that the allowance for operational risk in the standard formula is not truly risk based. In this case, the capital calculated does not reflect the true cost of operational risk within the organisation. It would therefore appear that further consideration is needed regarding the standard formula for the calculation of operational-risk capital.

The study also indicates that the ORM function is embedded in the individual lines of business. This means that individual business units report on their own operational risk, most probably on an aggregated basis within the unit. Ideally, an embedded and centralised approach is recommended. In addition, operational risk management strategy laid majorly with the head of risk management and head of business units.

Table 2: The extent of operational risk management implementation in your organization

Questionnaire Items	Scale Level					Mean
	1	2	3	4	5	
To what degree does your organisation manage operational risk?	5.7	6.3	22	30	36	3.84
To what degree does your organisation think sound operational risk management practices are important?	0	0.3	26	31	43	4.1686
To what degree does operational risk management systems capture interrelations between risks?	6.6	11	23	33	25	3.5943
To what degree is the effectiveness of your organisation's operational risk management practices?	7.7	8.3	29	21	34	3.6571
To what degree is the appropriateness of data based modelling in your organisation?	8	13	31	23	26	3.4543
To what degree does your organisation record operational risk data?	6.9	12	32	26	23	3.4686
To what degree does your organisation comply with legal and regulatory requirements?	5.1	7.1	32	24	32	3.7057
To what degree does your organisation comply with corporate guidelines and policies?	2.3	4.9	31	32	31	3.8343
To what degree is the quality of operational risk management process?	11	18	25	24	22	3.2829
To what degree is the relevance of data used in operational risk management process?	3.4	7.1	14	40	36	3.9743
To what degree is the efficiency of the operational risk management process?	6.9	12	35	23	23	3.44

Table 4.0-4: Operational Risk Management Implementation

(1- to no degree; 2 – to a lesser degree; 3 – to an average degree; 4 – to a major degree; 5 – totally)

Table 2 addresses the efficiency of operational risk management in insurance companies.

Respondents agree that their organisations know the importance of sound operational risk management practices (M = 4.17); understand the importance of data in managing operational risk (M = 3.97) and comply with the organisation's corporate guidelines and policies when managing risk (M = 3.83).

Table 3: Challenges for operational risk management

Questionnaire Items	Scale Level					Mean
	1	2	3	4	5	
Increases in regulation	.6	.3	12.3	38.0	48.9	4.3429
Increase in reputational risk		7.1	31.4	21.1	40.3	3.9457
Inability to retain key staff	13.4	15.7	24.3	24.6	22.0	3.2600
Increases in errors from people/failure of systems	6.0	8.0	18.9	29.4	37.7	3.8486
Increase in fraud activities	11.7	14.9	16.3	24.3	32.9	3.5171
Inability to retain clients	.3	4.9	24.9	31.1	38.9	4.0343
Increase of legal risk	9.7	12.3	18.9	31.7	27.4	3.5486
Increase in public scrutiny	9.7	12.3	20.6	25.1	32.3	3.5800
Inability to manage going business concerns	8.6	12.6	28.9	24.9	25.1	3.4543

Table 4.0-7: Operational Risk Management Challenges

(1 – not important; 2 - slightly important; 3 – somewhat important; 4 – important; 5 – very important

Table 7 presents the results for the challenges of operational risk management in the insurance industry. The inability to attract and retain key staff (M = 3.26) is the least challenge encountered in operational risk management in the insurance industry in Nigeria. The main challenges are increases in regulation (M = 4.34); inability to retain clients (M = 4.03); increase in reputational risk (M = 3.95) and increases in errors from people/ failure of systems (3.85).

6.0 FINDINGS AND DISCUSSION

Though regulation is one of the main drivers of the implementation of ORM, it is also identified as a major challenge in operational risk management practice from the findings of the study. Though, regulatory agencies attempt to protect the financial industry by enacting laws, regulations, and guidelines for operations, in Nigeria, the insurance regulatory framework is not as effective as that of the banking industry. Government policies are set in line with Solvency II requirements which often are not reflective of the realities of the Nigerian business environment (Oko-osi, 2019).

Another main challenge is the inability to retain clients. The Nigerian insurance industry is characterised by low penetration due to low income and diverse culture (Mojekwu & Yusuf, 2009), thus loss of clients will impact on insurance companies. Increase in reputational risk was also identified as a challenge of ORM in the insurance industry. However contrary to other studies such as Fraser & Simkins (2016); Dornberger *et al.* (2104), inability to attract and retain key staff was the least challenge identified in this study.

The findings of the research confirmed the fact that insurance companies in Nigeria to a certain degree have adopted a formal definition of operational risk which serves as a platform for a detailed operational risk management framework. This research therefore concludes that this practice should change as the development of structured approach to operational risk management matures. A final implication of this study is that it identified areas of future challenges for the insurance companies by which may be the sources of operational risk, and if properly addressed can help the organization better manage and monitor its operational risk management profile and enhance competitive advantage.

7.0 CONCLUSION

The benefits of implementing a formal and detailed operational risk management strategy are expected to enhance operational risk management practice and add value to insurance companies.

Understanding the challenges provides improvement in the control of operational risk exposures and the alignment of control measures to the risk appetite, which will consequently enable the achievement of calculated decisions, on operational risk mitigation and management strategies.

The findings have major implications to the financial sectors and regulatory agencies in Nigeria. Operational risk management practices must be fully implemented and reflective in the overall performance of insurance companies to align with international best practices.

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