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Research Paper

Financial Risk Management Approaches in the Manufacturing Industry

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ABSTRACT:- Approaching financial risks such as market, credit, and operational uncertainties, in a professional manner is becoming increasingly important. Market swings, interest rate volatility, loan defaults, falsified data in company reports, and fraud have not only led to serious financial losses but also tarnished reputations of some firms in the past few years. A holistic approach to financial risk management enables a company to have a high level of awareness of as well as uniformly assess, professionally managed and suitably control all of its financial risks. This study is set out to explore the effective and efficient approaches in which the manufacturing industries applies in their financial risk management. It was observed that; appropriate financial risk management impacts the industrial development positively; industrialist seeks for alternative approaches for handling risk due to lack of confidence on insurance industry, insurance transfer as a means of transferring risk is of benefit to the industrialists etc. on the basis of the findings, the author recommend that; policies should be developed to regulate the fraudulent practices in insurance industry, no exemption should be placed on any geographical location rather insurance cover should be made to accommodate every geographical area among others.

Keywords:- Financial risk, risk management, insurance, risk transfer, firms, risk, financial transfer.

I. INTRODUCTION

It is becoming increasingly important to monitor and manage all types of qualitative as well as financial risks. (Nail, 1986). Any firm in an industry can decide to invest in whatever project that it feels committed to and the quantum of investment will be determined by the type of investment that the firm has in mind. The amount of capital to be investment is of primary importance to the firm. If the project is large, then the capital outlay is expected to be large.

However, financial risk management is defined by Charles (2004) as the practice of economic value in a firm by using financial instruments to manage exposure to risk, particularly credit risk and market risk. It requires identifying its sources, measuring it, and plans to address them.

Financial risk management can be qualitative and quantitative. As a specialization of risk management, financial risk management focuses on when and how to hedge using financial instruments to manage costly exposures to risk (James, 2003).

Financial theory (i.e, financial economics) prescribes that a firm should take on a project when it increases shareholder value (Van, 2004). Finance theory also shows that firm managers cannot create value for shareholders, also called its investors, by taking on projects that shareholders could do for themselves at the same cost. When applied to financial risk management, this implies that firm mangers should not hedge risks that investors can hedge for themselves at the same cost. This motion was captured by hedging irrelevance proposition. In a perfect market, the firm cannot create value by hedging a risk when the price of bearing that risk within the firm is the same as the price of bearing it outside of the firm. In practice, financial markets are not likely to be perfect markets. (Van, 2004).

This suggests that firm managers likely have many opportunities to create value for shareholders using financial risk management; the trick is to determine which risks are cheaper for the firm to manage than the shareholders. A general rule of thumb, however, is that market risks that result in unique risks for the firm are the best candidates for financial risk management (Crockford, 1986).

Nonetheless, the concepts of financial risk management change dramatically in the international realm. Multinational corporations are faced with many different obstacles in overcoming these challenges (Van D. et al, 2004).

There has been some research on the risks firms must consider when operating in many countries, such as the three kinds of foreign exchange exposure for various future time horizons; transactions exposure, accounting exposure, and economic exposure.

II. HISTORICAL DEVELOPMENT OF INSURANCE BUSINESS IN NIGERIA

Modern insurance business was introduced in Nigeria by the British trading companies in 1879. It was introduced primarily to benefit the European traders who traded on the West Coast of Africa. These traders brought finished goods to Nigeria and on exchange took away raw materials, such as cocoa, groundnuts, tin, coals, palm kernels, cashew nuts and so on, for which they required some forms of insurance against peril of the sea and other fortuitous events. In order to fulfill this need, British insurance firms sent their agents to Nigeria to issue over notes to these traders while the actual policy documents were prepared by the parent companies in England. These only agencies were established in Nigeria and the very few Nigeria that were employed in these agencies knew little or nothing about insurance practice as they were not exposed to the practice of insurance in anyway (Nwite, 2004).

Before the introduction of modern insurance business in Nigeria, there existed and (still exists) forms of insurance that helped society to spread the risks within it, thereby reducing the burden of individuals and their dependants. These insurance could be called traditional social insurance schemes. They include the ESUSU/AJO contribution, age grades, extended family structure, social clubs, kinsmanship and other various form of communal contributions, which were paid to various forms of communal clasher (Agu, 1999) this insurance can be described as brothers keeper" fraternities.

Modern insurance business in Nigeria has exceeded the initial selfish orientation to include other areas of risk exposures. Nigerians now have considerable equity involvement in both local and international traders. Thus, with increasing urbanization, industrialization, science and technology, Nigerian were (and still) positively business as better substitutes for the crude or traditional social insurance business. There have been positive developments in the Nigeria insurance industry in 1921, a full-fledged insurance company was established, in Nigeria, National Insurance Corporation (NICON) and Reinsurance Corporation were established in 1969 and 1977 respectively. There are also progressive enhancement and establishment of various insurance associations and training facilities as well as regulations and supervisions. Infact, by 1977, there were a dynamic supervision/regular (National Insurance Commission) 136 registered insurers, 5 professional reinsurer, 480 registered insurance brokers and numerous registered insurance agents operating in Nigeria insurance market as well as 30 loss adjusting companies (Okonkwo, 2004).

III. THE CONCEPT OF INSURNACE

The definition or meaning of insurance has been analyzed by various scholars, all defined insurance in their own ways. Some were defining insurance as a social device, some as a contract, some as an institution, some as a discipline, some as a pool of risk like the pooling school of thought and the transfer school of thought. The technical school of also defined insurance in their own way. But none of these authors has come up with the definition that will embrace all aspect of insurance. That is the problem we have in defining insurance today. According to the pooling school of thought definition of insurance, insurance is defined as a pool of risk where people that are exposed to the same peril contribute into a pool from which the unfortunate is made fortunate. The transfer school of thought defined insurance as a risk transfer mechanism, whereby the policy holder called the insured contributes into common pool, out of which the unfortunate is made fortunate, on the insured pays a consideration called a premium in view of the risk insured so that if loss occurs, the insurer will put the insured in the same financial position he was prior to the loss (Marcus, 2002)

The technical school defined insurance as process whereby losses are lightened upon many rather than being heavily upon few.

Ivamy (1979) defined insurance as an agreement between two parties, the insured and insurer where by the insured pays a small consideration called premium in view of the risk insured, so that if a loss occur, the insurer will put the insured in the same financial position he/she was prior to the loss (Aneke, 2004).

Nwite (2007) defined insurance as a profession where people are trained to insure the risk exposed to them, corporate bodies, government and the general public and also teach them on ways to manage risks in their environment. Also in another discipline, insurance is defined as an institution that insures the risks of people, managed by an expert, settle claims of loss occurs on any risk insured. Finally, insurance is defined by psychologist as a social device that reduces the suffering of people for those that contributed to the scheme, it provides protection to those who needed such protection by paying some consideration (Berger 1999).

IV. REASONS FOR INSURNACE BUSINESS IN NIGERIA

[1]. Employment: Insurance industry offers employment in all facet of life, statisticians, economists, engineers, accountants, marketers, communicators, this is because all the aspect of the academic are in insurance industry. (Nduka, 2005).

[2]. Encourage savings: Insurance industry encourages savings mostly in life business people buy various types of life assurance policies like whole life assurance, endowment assurance, term assurance, decreasing term, annuity contract etc. this provides savings for the continuity and growth of the nation.

[3]. Insurance industry encourages trade both domestic and international: It is pertinent as this juncture to mention that business transactions are encouraged by insurance policies like fire policy, motor insurance, fidelity guarantee, performance bond, cash in transit, employers liability, insurance group life etc.

[4]. Risk management advisory role: The Nigerian insurance industry teaches individuals, organization how to manage risks exposed to them and advises them on the impact, effective risk management in various fields of endeavour like banking industry, manufacturing industry, logisticians etc.

[5]. Consultancy services: The Nigerian insurance industry also offers some consultancy services on how to plan group pension, individual pension, retirement planning, protective devices in various offices depending on the activities conducted on such offices (Aneke, 2004).

[6]. Encourage movements of goods from one location to the other: No nation can ever be self-independent. They must interact with one another since nature has different natural endowment. For all these, produced goods semi finished and finished goods are made available to the end users by providing various types of insurance policies like motor vehicles, marine and aviation and all these facilitates trade (Nwite, 2004).

[7]. Encourages portfolio management, diversification and management of investment.

V. CONCEPT OF RISK TRANSFER

Risk transfer entails risk handling strategies (Nwite, 2010). Risk transfer according to law dictionary refers to the basic concept of the payment of a premium by someone who is unable to withstand a loss to firm who agrees according to the terms of the policy to cover this loss.

Insurance risk transfer according to Nwite (2006) involves a process whereby an individual or organization transfer the risk they cannot handle to the insurance company by paying a little consideration called premium so that if a loss occurs to the subject matter insured, that the insurance company will out the individual or organization to the position he/she were prior to the loss.

Risks can be transferred either through insurance on non-insurance strategies. A typical example of risk transfer is an insurance policy.

Types of Risk Transfer

There are three basic types of risk transfer. They are:

a. Insurance transfer: According to the transfer school of thought, insurance is a risk transfer mechanism whereby the policy holder herein called the insured contribute into a common pool, out of the pool the unfortunate is made fortunate or the insured pays a consideration called premium in view of the risk insured, so that if a loss occurs the insurer will put the insured in the same post he/they/she was prior to the loss. (Nwite, 2012).
b. Non- insurance transfer: This refers to the transferring the activities that causes the risk like in the contract of building, giving out the electrical wiring.
c. Transferring the loss to a third party: This involve shifting the loss to a third-party by giving for instance a bag to keep for you that you are coming.

VI. FINANCIAL RISK TRANSFER

Irving (1856) in his transfer school of thought opined that “a device for the reduction of uncertainty of one party called the insured, through the transfer of particular views of another party, called the insurer, who offers a restoration at least in part of economic losses suffered by the insured” is known as “insurance”.

Diskson (1985) also referred to insurance as the risk transfer mechanism whereby the individual or the business enterprise can shift some of the uncertainty of life on the shoulders of others. Inturn for a known premium usually a very small amount compared with potential loss, the cost of that loss can be transferred to an insurer.

Therefore, when applied to financial risk transfer, it involves "the reduction of financial uncertainties of one party called the insured, through the transfer of another party, called the insurer, who offers a restoration at least in part of economic financial losses suffered by the insured". According to Nwite (2006), the most common form of risk transfer is by way of insurance.
Financial risks can be transferred through insurance and non-insurance transfer mechanisms (Nwite, 2006).

REASONS FOR TRANSFERRING RISKS TO INSURANCE COMPANIES

Every organization has purpose to satisfy, where the need which the organization desires to satisfy is not clearly defined making plans and setting goals becomes tedious and unfulfilling (Victor, 2004).

Households, corporate organizations, governments and general insuring public have legion of objectives for insurance protection. No matter the reasons of any, and irrespective of the type of insurance a person desires to contract, the primary reasons for insurance remains providing financial security or insurance guarantee to the policyholder (Victor, 1998).

The process of insurance has been evolved to safeguard the interest of the people from uncertainty by providing certainty of payment at a given contingency. The insurance principle comes to be more and more useful in modern world. The importance of insurance in this context will be discussed under two headings – primary functions of insurance and secondary functions of insurance.

PRIMARY REASONS FOR INSURANCE

⇒ Provision of Financial Security or Insurance Guarantee to the Policyholders

Households, corporate organizations, government and general insuring public have legion of objectives for insurance protection. No matter the reason of any, and irrespective of the type of insurance, the primary function (object) of insurance is provision of financial security; i.e. to pay sum incurred or compensate an individual insured for his financial loss resulting from the occurrence of the insured events within the contractual stipulation.

Secondary Reasons For Modern Insurance

The secondary functions of modern insurance are numerous. Some of them are highlighted as follows

⇒ **Insurance Engenders Confidence and Eliminate Fear:**

The insured purchase financial security and peace of mind. These security and peace of mind undoubtedly engender confidence and eliminates fear associated with risk of loss.

⇒ **Insurance Eliminates Dependency**

At the death of the husband or father, the destruction of family income may follow. Similarly, at destruction of property and goods, the family would suffer a lot. It brings reduced standards of living and the suffering may go to any extent of begging from relatives, neighbours, or friends. Insurance is here to assist them and provide adequate amount at the time of suffering.

⇒ **Life Insurance Encourage Savings:**

The element of protection and investment are present only in case of life assurance. In most of the life policies elements of saving predominates. Systematic saving is possible because regular premiums are required to be compulsorily paid.

⇒ **Insurance Protects Mortgaged Property**

At the death of the owner of the mortgaged property, the property is taken over by the lender of the money and the family will be deprived of the use of the property. The insurance will provide adequate amount to the dependents at the early death of the property owner to pay off the unpaid loans. Similarly, the mortgagee gets adequate amount at the destruction of the property.

⇒ **Insurance Provides Revenue to Government**

The profit of insurance companies, Reinsurance companies and other related companies are normally fixed. Therefore a lot of money have gone into government treasury through company taxes on insurance industry.

⇒ **Insurance Provides Employment Opportunities**

The insurance industry is capable of reducing the level of unemployment in a nation. It does this by providing opportunities for people to make a living from insurance either as an insurance staff, agent, broker, insurance consultant, underwriter or manager in any of the branches of the insurance industry.

⇒ **Insurance Earns and Conserves Foreign Currency**

Insurance business is an international business of risk spreading, especially as it relates to reinsurance transactions.

Both insurers and reinsurers do attract insurance protection from other countries more importantly, if the insurance market is developed and capable of handling such risks.

⇒ **Insurance Promotes Industrial Safety and General Loss Prevention Measures:**

Every loss of life or property is a national waste. The value lost to fire, lightening, earthquake, war, civil commotion or other peril is a drain to national wealth.

For insurance to be effected, insurers usually impose certain safety and preventive measures as conditions precedent to the contract of insurance. Insurers being the professional risk bearers underwrites risks to be insured. Insurance also ensures and teaches safety measures, maintenance culture, education of people on loss prevention techniques and other risk improvement measures.

Insurance provides pension to retirees, retirees take up insurance policies in their active services so that if they retire, the pension will be provided

⇒ **Insurance Create Wealth**

A lot of invisible earnings to individuals shareholders and the government on provided. Government tax insurance companies there are other invisible funds they pay to the government.

⇒ **Insurance Increases Investment**

More money made from insurance premium is always invested in other sectors of the economy and this helps in economic growth.

⇒ Insurance also reduces burden on the government. It reduces government burden by reducing problems of widows orphans and other dependents.

⇒ Insurance also encourages international multi-national and global trade. No nation would like to involve himself in any business that is not secured.

⇒ Surprisingly insurance reduces inflation from the premium they collect from people.

Problems of Transferring Insurance Business To Insurance Companies

The problems associates to the transferring of insurance business to insurance companies include;

1. Insurance insulates too much: Insurance company may inadvertently find that its insureds may not be as risk averse as they might otherwise be (since by definition, the insured has transferred the risk to the insured), a concept known as moral hazard. To reduce their own financial exposure, insurance companies have contractual clauses that mitigate their obligation to provide coverage if the insured engages in behaviour that grossly magnifies their risk of loss or liability.
2. The relationship between the insurer and the insured is likely of antagonistic relationship unlike other business contracts.
3. Complexity of the insurance policy. As a result, many people buy policies on infavourable terms.
4. Claim settlement. Disputes between insurers and insureds over the validity of claims or claims handling practices often escalate into litigation.
5. High cost of premium on the policies to be undertaking at times is not affordable.
6. Limited consumer benefits – Some times, the individual policyholders seem to benefit low or none on the contract unlike other businesses.
7. Redlining- This involves the practice of denying insurance coverage in specific geographic areas, supposedly because of a high likelihood of loss.

PROSPECTS OF INSURANCE BUSINESS TO ORGANIZATIONAL DEVELOPMENT

Adequate and effective insurance policies will impact on the organizational development in some many ways, they include;

i. It will engender confidence and eliminate fear associated with risk of loss in future business endeavours.
ii. It will protect the organizational workforce and assets against injury, damages or loss.
iii. It will promote industrial safety and general loss prevention measures.
iv. It will accelerate production cycles of an organization by engendering the spirit of enterprise and venturesome.
v. It will serve as a source of income or finance to an organization thereby increases their investment opportunities.

Concept Of Premium

Premium according to Okonkwo (1998) refers to the money paid by the insured to the insurer for insurance protection provided by the insurer. Irukwu (1990) opined that it is the consideration which the insured pays to the insurer in return for the insurer pays to the insurer in return for the insurer’s undertaking to pay the sum insured or its equivalent in event of a loss or damage arising from the insured event happening. The premium must be paid in full in the inception of the insurance contract.

Factors Considered In Charging Premium

The insurers put the following factors in consideration before charging premium.

a. The expected claims experience (cost of claims)
b. The likelihood of catastrophe risk (chance of disastrous claim or series of claim).
c. The estimated administrated administrative costs (business) expenses such as salaries, cost of building, printing costs, stationeries cost etc.
d. The provision of reserves for the unexpected and for prudent management of insurance fund.
e. The desired returns (profits) for the numerous claimants on the company say shareholders, debenture holders, government, employees and the society.

VII. CONCLUSION

Finance is a driven force of every organization manufacturing industry as one of the most lucrative sub-sectors of any economy cannot do without financial involvements. The optimum use of financial management of any firm is always the umbrella term for multiple types of risks associated with financing, company loans in risk of default most be given holistic attention.

In view of the study, “the financial risk management approaches in manufacturing industries”, the author concluded that;

Firms transfer their financial risk either to insurance, non-insurance means or transferring them to the third party.

Appropriate financial risk handling will impact positively to manufacturing industries.

The manufacturing firms seek alternative means of financial risk transfer due to lack of full confidence on the insurance companies and the problems associated to the insurance method of risk transfer.

Insurance risk transfer is always beneficial for the future goal of manufacturing firms.

The manufacturing industries has reasons for embarking on financial risk insurance as a medium to manage their financial risks.

RECOMMENDATIONS

Following the findings of this research, the author recommends that;

1. Insurance industries should develop a new type of relationship that will restore the individuals confidence thereby create a fertile environment for the insurance policy buyers.
2. More policies should be developed by government for the regulations of the fraudulent practices of the insurance companies.
3. The manufacturing companies should always know the type of cover they are buying, the policy involvements and the costs attached to each before going for it.
4. Insurance covers should be provided for every geographical area to solve the problem of exemption of some geographical environments due to high risk inherent or occurrance.
5. Manufacturing companies should not depend on only insurance as their last resort for financial risk management but develop other strategies that can best prevent the chance of loss.
6. The management of an organization should be educated and trained on the likelihood of risk and preventive measures necessary for each.
7. The organizations should always protect themselves from risk of negligence which may cause more severe loss in the organization.
8. Financial management department of organizations should be handled by professionals in financial managements.
9. Financial decisions of every organization should be made with special care and approaches and if possible, the services of professionals or experts in financial management should be hired.

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