Brokers and Control of Adverse Selection (Pre-contractual Opportunism) in the Nigerian Insurance Market

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Insurance opportunism at the pre-contractual stage go largely under-studied. This article explores the effectiveness of the insurance brokers' information gathering role at this stage to control adverse selection in the Nigerian insurance market. It also set to examine stakeholders' pressure effect on the brokers to control insurance opportunism. Although, semi-structured face-to-face interviews constituted the primary method of data collection, other methods were used as supplements. The findings suggest that this role, to a great extent, is performed creditably well in the Nigerian market. Expectedly, this has reinforced the theoretical framework that the insurance brokers enhance the competitiveness and efficiency of the insurance market through the resolution of adverse selection.

INTRODUCTION

Insurance opportunism or fraud has been recognised as a serious economic problem whereby insurance customers deprive the system of resources as well as cheat it out on resources (Derrig and Krauss, 1994). This happens when they mask their true risk-type while applying for insurance and when they are making claims for fabricated or genuine claims. It is a common knowledge that policyholders have the ability to use their informational advantage to make false declarations in order to be effectively covered or to pay lower premium (Alary and Besfamille, 2001). Suprisingly, applications, underwriting or premium fraud go largely under-studied.

Consequently, insurers have deviced various strategies to control the fraudulent trend. Such strategies involve contract-design (Townsend, 1979; Picard, 2000; Boyer, 2004) and audit (Crocker and Morgan, 1998; Major and Riedinger, 2002; Morse, 2005; Morley *et al*, 2006) approaches. But these two major approaches in the literature have achieved minimal results with insurance fraud assuming increasingly global dimension. But, this may not be unconnected with several factors.

Firstly, insurance contracts are inherently conducted under the atmosphere of informational asymmetry. This means that the information of the subject matter of insurance is tilted more to the side of the applicant (prospective insured) than the insurer. The second factor relates to bad attitudes on the part of the public which view insurance fraud as a crime of easy money with little risk of getting caught, or of few serious consequences if they are caught. Thirdly, people believe they are entitled to commit fraud after paying high premiums with no or few losses for many years. Fourthly, too many insurers are in denial about the scope of fraud and its impact on their bottom lines (CAIF, 2000).

While insurance intermediaries contribute to enhancing transparency in insurance markets due to the information asymmetries characterising them, they have been systematically excluded from using their position to deterring opportunistic tendencies of insurance customers. As a result, there seems to be a begging vacuum in the area of study of operational model of bridging of information gap by insurance intermediaries to stem the tide of all forms of opportunism in the insurance market.

Scholars have also observed that under adverse selection in insurance markets, the insured has no incentive to reveal his true risk which is costly to observe by the insurer (Dionne and Lasserre (1985). This is insurance opportunism that takes place at the precontractual stage of the insurance contract.

It is founded on the assumption that the more rigorous is the information gathering at the precontractual stage, the more difficult it is for customers to perpetrate opportunism. Insurance customers, particularly, the commercial clients, are aware that the insurers rate their risks on the amount of information they give. They, as a result, would like to give less "high risk" information in order to pay less premium. Two examples of this *ex ante* behaviours are such as: failing to report an accurate medical history when applying for health insurance *(concealment*), and in automobile insurance, declaring that the usual driver is the middle-aged car's owner while, in fact, it will be his young son (*misrepresentation*).

The first objective of this article is to explore how insurance brokers gather information from clients to control insurance opportunism perpetrated by the customers when they apply for insurance ex ante (precontractual). This is because they do not have the incentive to reveal all about their risks (at the pre-contractual stage) so as to pay less amount of premium. Secondly, the paper also aims to examine how brokers resolve the stakeholders' pressures that face them at this stage of the insurance contract in the interests of both clients and insurers.

Opportunism is defined as "self-interest seeking with guile. This includes but is scarcely limited to more blatant forms, such as lying, stealing, and cheating…More generally, opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse" (Williamson, 1985, p. 47). Translated into insurance parlance, this refers to the attempt by the insurance customer behaving opportunistically to obtain undue advantage while applying for insurance (precontractual) and while making a claim (postcontractual). *Opportunism* in this study is a compound word encompassing all kinds of guiles and deceit, whether calculated or not, from petty to organised scam and which serve the purpose of obtaining undue advantage from the insurance system at precontractual and postcontractual stages of the contract. The present focus is the precontractual phenomenon.

To address these objectives the paper is structured as follows. Section 2 contextualises the study while section 3 reviews some relevant literature on asymmetry information and conflicts of interest for insurance brokers. The theoretical framework is addressed in section 4 while section 5 presents the research methodology. Section 6 presents the findings; which are discussed in section 7 while section 8 concludes.

THE NIGERIAN INSURANCE BROKING SECTOR

The Nigerian insurance market is, in many respects the next frontier in the Nigerian financial space but unlike the banking story, the growth opportunity of the Nigerian insurance industry has been stagnated for too long. It is obvious that the Nigeria insurance market cannot be treated in isolation of the national economy. The Nigerian insurance market has been highly under-penetrated, particularly when compared with other African insurance markets. Of the estimated 20m people in formal employment across Nigeria, less than 1m currently holds personal insurance policies. This is despite a steady growth in incomes across the working population in recent years, and the emergence of a new middle-class group in Nigeria (Wiggle, 2009).

The industry is less 'highly' competitive, considering the slow pace of growth in overall market size; and the stringent conditions of entry of new policy. The competitive structure of the Nigerian insurance industry is complicated by the presence of a large number of insurance brokers (510 as at 2006), who are major intermediaries in the flow of business between corporate customers and insurance underwriters.

Over 70% of industry premiums are controlled by this large group of brokers. Corporate accounts in particular, can often only be secured with the involvement of a broker, as companies are comfortable with the competitive pricing and claims management support that brokers typically provide. Brokers have thus leveraged on this position of strength to dominate the industry. This situation might have been accentuated by the problem of asymmetric information characterizing the insurance market.

ASYMMETRIC INFORMATION

According to Puelz and Snow (1994: 237), information asymmetries arise in insurance markets because underwriters cannot judge with certainty the magnitude and frequency of the risks underwritten and consequently, the actuarially fair rate at which those risks should be priced. Therefore, in order to mitigate this problem, underwriters instigate appropriate contracting and contract monitoring solutions. D'Arcy and Doherty (1990) mention the three approaches that have gained currency in the literature namely; 1) *separating equlibria* or self-selection; 2) *multiperiod contracts* or experience rating and 3) the integrative contract.

Insurance opportunism (fraud), in real sense, can be traced to the underlying origin—*information asymmetry* (Derrig, 2002) that is present in every insurance contract. Put in other words, insurance opportunism (fraud) is traceable to the manipulations of information asymmetry by-products; namely adverse selection and moral hazard (Chiappori et al., 2004). But the focus of the present study is restricted to the precontractual opportunism resulting in adverse selection. This results when the insurance customer masks his true risk-type while applying for insurance at the precontractual stage. The insurer, also, without the insurance broker will consequently charge lesser than he should receive had the customer not misrepresented/concealed his true risk-type. This is called precontractual opportunism where one person seizes the opportunity of presence of private information to lie prior to a contract taking place (Molho, 1997). The implication of this scenario for the insurance market is depicted in Figure 1 below.

FIGURE 1

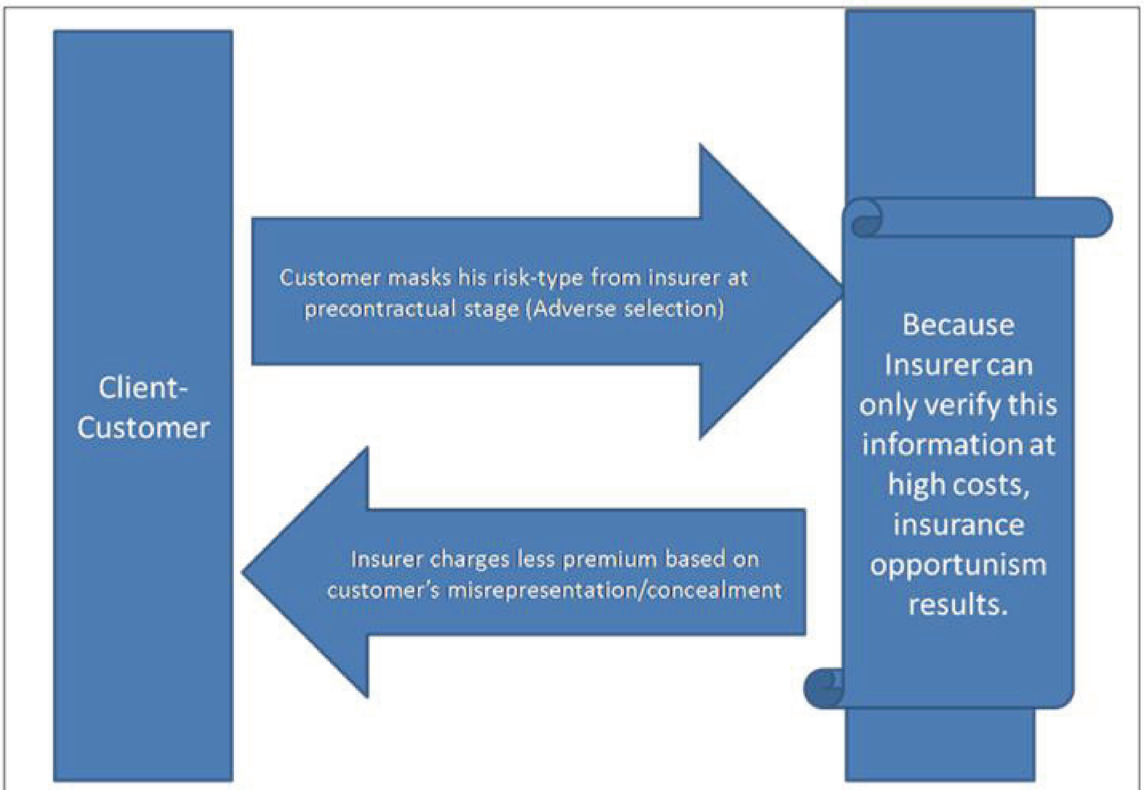

Fig. 1. Asymmetric information in the insurance market without intermediaries

Adverse Selection

According to Akerlof (1970), adverse selection refers to the risk that contracting parties have incentives to actively withhold private information from each other ex-ante in order to secure economic advantages later on. In his famous landmark piece: *"The Market for "Lemon": Quality Uncertainty and Market Mechanism",* the author applies this concept to the insurance market by arguing that because it is not always commercially favourable for insurers to sell policies for applicants above the age 65 even if price levels are raised for this set of people. The reason for this is tied to the fact that the people who insure themselves will be those who are increasingly certain that they will need the insurance; for error in the medical check-ups, doctors' sympathy with older patients and so on make it much easier for the applicant to access the risk involved than the insurance company. The result is that the average medical condition of insurance applicants deteriorates as the price level rises—with the result that no insurance sales may take place at any price.

Formally stating this, *Adverse selection* arises when one party—generally, the subscriber—has a better information than the other party—the insurer—about some parameters that are relevant for the relationship (Chiappori, 2000: 367). Alary and Besfamille (2001) focus on this particular type of information asymmetry that takes place during insurance policy negotiation. The authors argue that it is well acknowledged by practitioners that at this stage, many policyholders often lie and misreport their private information. They do this on the understanding that the insurers decide to cover them or determine their rate upon those declarations. They may probably make false declarations in order to pay lower premiums. The authors further argue against this behaviours by citing two instances of either failing to report an accurate medical history when applying for health insurance (concealment), or declaring that the usual driver would be the middle-aged car's owner while, in fact, it would be his young son (misrepresentation) in the case of automobile insurance.

Assumptions of the Conceptual Framework

The conceptual framework adopted for this study is based on the following assumptions:

- There is principal-agent relationship between the broker and client on the demand side of the market and between broker and the insurer on the supply side.
- The broker serves as agent for both insurer and client.
- The broker maintains relational repetitive contract with client.
- The broker is remunerated sometimes by either parties (client or insurer) or both of them at the sometimes by commissions to mitigate asymmetric information (adverse selection) in the market.
- The broker is a risk averse agent incentivized to control insurance opportunism
- The broker is weary of reputational damage that professional indemnity could cause him should he fail to report all the information gathered and verified from the client to the insurer.
- The regulatory environment is cost effective to control insurance opportunism.

The implication of these assumptions of the framework is that the agent or broker who fails to provide accurate information on the short-run faces the loss of his relationship with the insurer because the insurer would be required to sustain underwriting losses to identify the dishonest agents. The same consequence is equally applicable to the client who is in the habit of masking his true risk-type ex *ante.*

RESEARCH METHODOLOGY

A case method was adopted of the Nigerian insurance broking sector. Using the unusual case sampling strategy (Auerbach, 2003), Lagos city was selected where over 80% of the insurance brokers head offices are located. In all, 45 interviews were conducted among various insurance broking executives with titles such as Managing Director, Head of Property-Liability Department, Accounts executives, and other insurance experts working with the regulatory authority as well as loss adjusters. (See Appendix 1).

Being a study in the area of incentives and agency relationships, qualitative approach may enable the observation and discursive evaluation of best-and-worst-practice examples that the proponents of such practices may be unaware of, or which they may be unable or unwilling to report or evaluate without bias (Lewis, 1998; Morley et al. 2006). Although, semi-structured face-to-face interviews constituted the primary method of data collection, other methods were used to supplement these interviews—reviews of professional journal articles, magazines, annual reports, information gathering templates, claim forms templates and so on. The number of interviews was not pre-set, but was determined in part by pragmatic considerations, such as time constraints, and also by the attainment of theoretical saturation (Glaser and Strauss, 1967; Flick, 2002).

For strategic reason, the researcher adopted an approach that completely refrained from using the word, "opportunism" throughout correspondence and actual meeting with broker-interviewees so as not create negative and suspicious mindset. Rather, the word, 'bridging information gap' was used in substitution. In most interview sessions, the word 'opportunism (fraud)' was only used when the researcher had exhausted the main research questions and smoother relationship had developed with respondents. And as expected, this researcher found the approach quite useful to corroborate Davies's (2007) view that the interview method would assist while exploring individual or situational perspectives and gain an in-depth understanding of personal feelings and experience.

After collecting the data which spanned for four months, the analysis is presented drawing from Auerbach's (2003) three-phase (six-step) coding method and data analysis. This process is broken down into i) *Making the text manageable,ii) Hearing what was said, and iii) developing theory.*

FINDINGS AND DISCUSSION

The information gathering role of brokers entails collecting detail information about the risks to be insured. This would include sourcing for prospects, meetings, tools for gathering information, verification, and prospect' management quality and presenting the information to insurers to obtain actuarially fair quotes from which the prospect would make a choice. This procedure is taken up next.

Verification Tools: How Effective?

How effective are these information gathering tools in eliciting the required information before insurers are invited for quotations? Brokers generally believe that they are credible and effective; based on the experience they have garnered while doing the same job time and time again. The verification process often makes brokers to cross-check with published annual report figures of the clients' assets—movable and fixed while any discrepancy is ironed out with the client. The verification exercise would involve brokers contracting with technical experts for surveying the clients' premises and operations where these are of complex and highly industrialised nature. Some of them justify the relevance of this procedure as:

> "*…safeguard(ing) us in terms of what we are presenting to the insurer because they can go out there and get their own facts as well. So that does help. Sometimes, we also obtain surveys from the particular place from qualified surveyors, property surveyors and liability surveyors and we would pay them to take…prior to signing an agreement with the client" (New Business Executive).*

The brokers are not contented only on the aforementioned verification exercise; they would also authenticate such information by carrying out a check on the past claim history of the prospects with past insurers:

> "*…all insurance quotes are all subject to authenticated (previous) claim experience being provided. So, if the client withholds, and we incept cover and we get the*

experience, and it doesn't match up with what client had told us, then insurers have the right to review terms already quoted"(Commercial Department).

The implication of this point is to underscore the credibility and usefulness of the service of the brokers. The report on past claim history would reveal the risk level of the new prospect and this might mitigate adverse selection to ensure actuarially fair rating of the new risks being brought on to the pool. The added usefulness of this is prevention of insurance opportunism of clients who might want to present less "high risk" information to pay less premium. This role is also akin to Rejda's (2003) "first underwriting" and Hall's (2000) "field underwriting"—a process meant to select and classify applicants according to the risk they represent. "Failure to effectively underwrite or classify potential insureds can lead to the problems of adverse selection and price inequity" (Hoyt et al, 2006: 3).

More importantly, the underwriting survey provides broker with a valuable source of information and is important in obtaining favourable terms. Insurers feel more confident in providing their best terms when they have the fullest understanding of the risks.

Transmitting Information to Insurers

Presenting information gathered from new prospects to insurer is a crucial function of the broker at the precontractual stage. Brokers, having gathered and verified the information from new prospects must present it properly without which the initial purpose of fact-finding would be defeated. Bad presentation could mar comprehensive and well collected information. Findings suggest that all the information gathered from new prospects is often vetted by brokers while passing only that part which the insurers require to quote for the risk exposures.

"*We, in the main, we would disclose to the insurers all the information which we gathered from client which is material fact and pertinent to placing the insurance cover with them. Once we have obtained information, and based on the duty of disclosure the information is passed on to the underwriters to allow them to quote. We are not allowed to withhold any information which is considered to be material fact in placing insurance cover* "(Manager, Oil and Gas Department).

In whose interest is the vetting of information done? Is it the client, the insurer or the broker? How material is the *material fact* passed on to the insurer? These and other types of conflict of interests which are inherently present in the intermediary role of brokers are treated later in the next section.

Brokers' Role in Controlling Opportunism at the Pre-contractual and Renewal stages

Brokers agree that they are very relevant in deterring and controlling insurance opportunism at the precontractual stage for their invaluable services in eliciting the proper information from prospective clients. Apart from marketing the products of the insurers, they base such relevance on the fact-finding exercises they embark upon in building trust with the client. In the literature, *asymmetric information* has been mostly alleged as the underlying cause of the fraud phenomenon (Puelz and Snow (1994; Derrig, 2002). This implies that insurance customers have the ability to use their informational advantage about the nature of their risks to obtain cheaper quotes. The information gathered by the brokers helps to improve the efficiency of the insurance markets by reducing adverse selection. From the findings, brokers do go extra length to identify the extent of their clients' risks:

"*It is easier for clients to hide something when they are dealing directly with insurers and it would be for brokers to make a visit to the clients and say, well, you told us that the building was metal- roofed, while in fact it was a timber roofed. That's where we can gather information to see whether the information from client is providing is correct". (Head, Broking Team).*

More importantly, in Nigeria where insurance culture is still very low, the brokers' role could prove quite invaluable. In the first place, most commercial prospects—small-scale businesses are just being introduced into the insurance market to be aware of their risk exposures. The visit by the brokers might be their first experience of the workings of insurance and its usefulness. At this first visit, they tend to be as honest as much as they can. With a skilful broker versed in the art of eliciting facts from people, the most relevant questions are asked and later translated into the insurance language. Brokers, though working for their own self-interests are saving the insurers the hassles of discovering such 'innocent' clients who have scanty knowledge about insurance to want to mask their risk-type at the precontractual stage. They are able to collect raw facts from this set of prospects; from where their risk profiles are developed. These raw facts are subsequently improved upon at the renewal stage when new developments crop up in the client's business in terms of additions and deletions as well as the need for revaluation of the insured assets.

Stakeholders' Pressures on Brokers

The findings from the study has revealed that insurance brokers which play the role of information agents in the insurance market are under immense pressures to deliver and not soil their reputation through conflicts of interest induced by economic gains. What is evident from this study is that these pressures may have varying effects on the brokers depending on the level of development of the insurance environment and how well they are regulated to ensure compliance with the rules of the business.

Lawsuits and reputational damage for professional negligence

Most reputable brokerage firms or those that are upcoming are often confronted and influenced by the fear of facing legal suits from their clients should they be involved in any act of professional negligence. Such fears are a function of the regulatory and legal environment as well as the level of enforcement of such rules. Hence, there is the need for regulatory mechanisms of controlling conflicts of interest in financial firms generally and in the broking sector especially; thereby bolstering their prospective role in the governance process. It reflects in the study where senior members of staff of broking firms are monitoring the junior ones responsible for gathering information.

Professional reputation management has quite simply become every company's duty. For the broker, trust is a key component of relationship quality with customers which gives the broker a competitive edge and also determines whether the relationship will continue in the future. High service quality leads to satisfaction in the service provider which in turn leads to 'relationship quality' or a long-term relationship between the service provider (the broker) and the client. A slip up in this area by the broker could prove fatal for its existence and survival in the long-run. A broker has this to say:

> *Everybody gets to know much about you that any job from that place should be suspicious. The next day, they either avoid you or they jack your rate up. They would not accept your terms and they would always insist that you must pay before…no credit insurance for you again and no more latitude for you to play around with in terms of any of those considerations they may give to other brokers"(General Manager, Underwriting).*

Hence, brokers are always weary of reputation loss with both clients and insurers in their information bridging role to maintain high level quality service.

Sanctions by regulatory authority

Another external pressure confronting the insurance brokers from the finding is the fear of sanctions for breach of the rules when the monitoring team of the regulatory authority comes to inspect the records of the brokerage firms. Apart from examination of the broking records, complaints received from members of the public or clients are taken seriously to ensure that brokers treat their customers fairly. Sanctions for erring brokers could be in form of fines, suspension, and license withdrawal and so on to serve as deterrence. The Nigerian regulatory body—NAICOM—recently sanctioned some brokers for failing to remit premiums to the insurer within the stipulated 90 days of signing of the contract.

IMPLICATION AND CONCLUSIONS

This article sought to explore the effectiveness of the insurance brokers' information gathering role at the precontractual of the insurance contract to control opportunism caused by adverse selection in the insurance market. It also set to examine stakeholders' pressure effect on the brokers to control insurance opportunism. The findings suggest that this role, to a great extent, is performed creditably well in the markets. Expectedly, this has reinforced the theoretical framework that the insurance intermediaries are relevant information agents that enhance the competitiveness and efficiency of the insurance market through the resolution of adverse selection. The effectiveness of this role enhances competitive biddings which ensures that insurance customers receive fair deals from their brokers while also safeguarding the interest of the insurers in the control of insurance opportunism.

Through the discussion on stakeholders' pressures on the brokers, the study has highlighted the reality of this phenomenon in the insurance market from the regulators, insurers and the clients' perspectives. It situates the broker as standing between two principals with differing interests. The client-customer wants the widest coverage at the cheapest price while the insurer wants to maximize profits and the value of the company by attracting only good risks. Through the involvement of the broker, the transaction costs of searching for the best-match by the two parties are overcome through the mitigation of the adverse selection problem. The regulators are also involved in putting pressures on the brokers to ensure that customers are treated fairly through threats of various forms of sanction. Hence, it can be reasonably concluded that insurance intermediaries (brokers) are vital agents in the insurance market to control opportunism resulting from adverse selection due to asymmetric information.

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APPENDIX

LIST OF INTERVIEWS

Interview No.	Structure: Small or medium size	Job title	Name (first)	Date of interview
1.	Medium	M.D. (Operations)	Sally	25/12/2007
2.	Medium	Head (Broking team)	Steve	25/12/2007
3.	Medium	Accounts Executive	David	23/01/2008
4.	Small	Commercial Team	Craig	5/02/2008
5.	Small	Broking Team	Marc	20/03/2008
6.	Medium	Head (Renewals)	Mal	27/06/2008
7.	Small	Head (Operations)	John	30/06/2008
8.	Small	Member (Commercials)	Paul	14/11/2008
9.	Medium	Head (Claims)	David	12/02/2008
10.	Medium	M.D. (Group)	Peter	16/05/2008
11.	Medium	New Business Executive	Kevin	30/06/2008
12.	Medium	Corporate Team	Monica	2/07/2008
13.	Medium	Head (Renewals)	Praful	05/07/2008
14.	Medium	M.D	Abolarin	11/07/2008
15.	Medium	Manager (Oil and Gas)	Aremu	11/07/2008
16.	Small	Manager (General)	Ade	11/07/2008
17.	Small	Head (Liability)	John	11/07/2008
18.	Medium	Director (Property and Liability)	Osundosumu	16/07/2008
19.	Small	Broking Team	Paul	16/07/2008

20.	Medium	Head (Accident and Motor)	Balogun	22/07/2008
21.	Medium	Director (Underwriting)	Osinuga	22/07/2008
22.	Medium	Head (New Business)	Ojeah	22/07/2008
23.	Small	Manager (Underwriting)	Ogunleye	23/07/2008
24.	Small	Manager (Claims)	Segun	23/07/2008
25.	Medium	Head (Renewals)	Olaoye	23/07/2008
26.	Small	Head (Motor claims)	Biodun	23/07/2008
27.	Medium	Head (Oil and Gas)	Rauf	24/07/2008
28.	Small	General Manager	Niyi	29/07/2008
29.	Medium	NAICOM (Head Lagos zone)	Adebowu	29/07/2008
30.	Medium	Registrar, Loss Adjuster	Opara	30/07/2008
31.	Medium	Head (Claims)	Livinus	05/08/2008
32.	Medium	Head (Broking team)	Lanre	06/08/2008
33.	Medium	Account Executive	Ogedengbe	08/08/2008
34.	Small	General Manager	Yemi	17/08/2008
35.	Small	General Manager	Wole	19/08/2008
36.	Small	General Manager	Segun	21/08/2008
37.	Small	Claims department	Goke	22/08/2008
38.	Medium	Head (New Business)	Sina	29/08/2008
39.	Medium	Accounts executive	Samuel	4/09/2008
40.	Small	General Manager	John	5/09/2008
41.	Small	Accounts Executive	Yemi	5/09/2008
42.	Small	General Manager	Peter	11/09/2008
43.	Medium	Head (Liability Claims)	Saka	22/09/2008
44.	Small	Accounts Executive	Taju	23/09/2008
45.	Small	General Manager	Musiliu	24/09/2008

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