International Journal of Academic Research in Business and Social Sciences
April 2012, Vol. 2, No. 4
ISSN: 2222-6990

Financial Instruments as Capital Management Tools for Maximizing Shareholders' Value

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Abstract
The world's financial markets have exploded with new products and new techniques such as derivatives and securitisations giving rise to huge new markets. Competition has transformed the financial services industry, forcing them into providing new products and supplies their services more cheaply. At the same time their clients constantly demand for effective and efficient management of their capital base, especially in the insurance industry while shareholders' expectations are also rising.

This paper reviews the key financial instruments including insurance as capital management tools for maximising shareholders' value and also looks at the current developments and tries to show how equity, debt and insurance are complementary to deriving optimal finance performance structures.

Key Words: Debt, Equity, Insurance, Financial Instrument, Risk

Introduction

Financial services industry has been seriously transformed as a result of competition forcing them to invent a stream of new products and supply services more cheaply. Their clients are also constantly raising the bar of services that will enable them to manage their capital base in ever more efficient and sophisticated manner while the shareholders expectations are also rising.

These factors are shaping an evolution in risk financing reflecting financial management needs such as capital productivity, value creations and the minimisation of risk, as a technical guideline of buying and selling which is becoming increasingly led by corporate finance. This change in emphasis is observed by a shift in decision making on the buyers side as insurance migrates to the realm of treasurers becoming a provider of capital. On the seller's side, it creates the need to acquire and deploy additional skills in risk management especially in the corporate finance area.

These changes are having a positive impact on capitals providers including insurers. Insurance has always played a role in managing risk exposures on the corporate balance sheet and income statement; but its value used to be realised only after a loss took place (Guizk, 2008). It was also observed that insurance was largely ignored as an instrument for optimising capital structures, but as the pressure intensifies to produce higher financial returns and minimise volatility, this function is being recognised more widely.

There are two principal reasons for this. First, insurance product can be more versatile than other financial instruments especially if they allow for off – balance sheet treatment (encompassing regulatory, accounting and tax arbitraging). Second, a better understanding of the economic value of insurance, expressed through net risk taking. This has triggered a wave of new products which apply a portfolio approach and capital efficiency concept resulting in three distinct product lines: integrated solutions, new classes of risk, and the application of financial market techniques to transfer residual risk from the optimised position of an underwriter to the capital markets.

The alternative risk financing market has seen intense innovation in the past decade. There has been a proliferation of "convergence products" that claim to blend financial with operational risk or foreign exchange risk with property and catastrophic risks or a myriad of other combinations.(Borch, 1990)

However, these products are sometimes produced without adequate attentions to the characteristic of the key financial instruments: equity, debt, and insurance and the underlying distribution of risk. It is observed that not enough recognition is given to the golden rule of balance.. As capital providers trip over each other in a race to deliver value the substitution of one form of capital with another inevitably dominates the sales pitch. But Zimmerman (2008) was of the opinion that instead of substituting one form of capital with another, these more complex solutions entail adjustment or regulation of financial instrument, and its parameters, to add the highest possible value to the capital structure of a client. This process should achieve both tangible benefits like saving money and intangible benefits, such as learning more about the relationship between the capital instruments. This paper looks at these developments and tries to show how equity, debt and insurance are complementary to deriving optimal finance performance structures.

The Review of Financial Instruments

A financial instrument is a tradable asset of any kind, either cash, evidence of an ownership interest, an entity or a contractual right to receive, or deliver, cash or another financial instrument. A financial asset or financial liability would be measured at amortized cost. if two conditions are met

- The instrument has basic loan features and
- The instrument is managed on a contractual yield basis

A financial instrument is an instrument having monetary value or recording a monetary transaction

The role of equity, debt and insurance in expanding, creating and preserving wealth cannot be overemphasized.

Equity, according to Sharpe, (1964) is the residual claim or interest of the most junior class of interest in assets after all liabilities is paid. In accounting context, shareholders equity or equity shareholders funds or shareholders capital represents the remaining interest in assets of a company spread among individual shareholders of common or preferred stock.

This creates a liability on the business in the shape of capital as the business is separate from its owner as legal entity. Ownership equity is also known as risk capital or liable capital (Arnold, 2000).

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Equity imitates wealth creation and assists the expansion of wealth through retained earnings. It goes hand in hand with ownership right and fiduciary duties. The investors' decision to provide equity capital is based on rate of return expectations (dividends and appreciation) and performance risk. Rates of returns are influenced not only by objective and diversifiable risks, such as hazard, perils but also by non – diversifiable and subjective risks encompassing regulatory, organisational and entrepreneurial exposures. Subjective risks are difficult, if not impossible to mitigate efficiently through third party markets as there is an underlying discrepancy in the assessment of their distribution. Objective risk can be transferred, but transaction costs reduce shareholders returns. Equity naturally has a high variability of rates of return. (Saunders, 1999)

Equity creates a liability on the business in the shape of capital as the business is separate from its owners. The accounting equation of business, sums of liabilities and assets after liabilities have been accounted for, the positive remainder is deemed the owners interest in the business In liquidation process or bankruptcy, all the secured creditors are paid against proceeds from assets. Afterwards a series of creditors ranked in priority sequence have the next claim against assets paid only after all other creditors are paid

Thus owners' equity is reduced to zero if nothing left to give out. Thus ownership equity is known as risk capital or liable capital

Debt

Debt assists the creations of wealth as a cost effective yet constrained substitute to equity. The lenders decision to make a loan is based on rate of return expectations and the risk of default compared with other investment opportunities. Risk of default is protected through loan covenants, collateral and other means. Debt can also be seen as an efficient "working capital" or a "stop loss" protection for shareholders, especially in the absence of insurance. Rates of returns have a low variability.

A debt is an obligation owed by one party (the debtor) to a second party, the creditor. Usually this refers to assets granted by the creditor to the debtor but the term can also be used metaphorically to cover moral obligations and other interactions not based on economic value. A debt is created when a creditor agrees to lend a sum of assets to a debtor. (Osisioma, 1994) Debt is usually granted with expected repayment in modern society of the original sum plus interest.

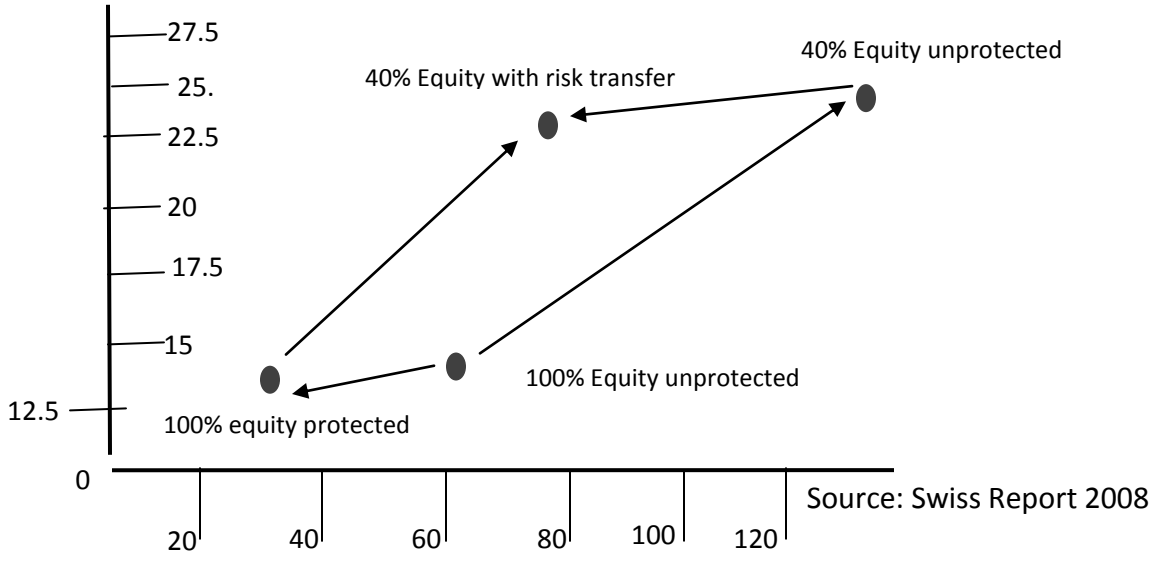
In finance, debt is a means of using anticipated future purchasing power in the present before it has actually been earned, while some companies use debt as part of their overall corporate finance strategy. (Miller, 1977)

Insurance is a risk transfer mechanism. In its basic form of risk taking by a third party assets in the preservation of wealth through protecting a balance sheet and mitigates the impact of unexpected expenses affecting the income statements. The insurance capital provided through loss payments is a single party usually permanent, and thus behaves like equity. Insurance capital resembles equity with contingencies attached. (Costing is scaled down by the impact of diversification and fiduciary responsibilities) in that it is activated by a trigger (a loss event). If there is a repayment condition, the insurance capital resembles debt.

Probabilities of insurable risks are typically objective, but in circumstances where a subjective view of risk by an underwriter prevails (unreliable data, moral hazard or substantially asymmetry of information). Insurance may also take the form of debt. (Ross, 1998) The economic power of insurance is in the diversification of objective risks. Its enhanced value arises from the combination of debt and equity like characteristics, supplemented by a preferred accounting treatment and accelerated tax deductions. Insurance lies somewhere between debt and equity on the volatility of returns curve.

Life insurers and other financial institutions have an ordinately high degree of financial leverage on the liability side of their balance sheets.
The greater part of a life insurer funds are raised through issuing debt (claims against itself that are sold to policy holders) other than capital put in by owners.
The role of a life insurer is to assume life contingent risks that are transferred to it. In this regard, life insurers differ from banks and other financial institutions in the case of latter there is no uncertainty about whether and when a debt is to be redeemed.
In the case of life insurer, the risk is both on the liability and asset side of the balance sheet
Guzik (2008) believes that the economic power of insurance is in the diversification of objective risks. Its enhanced value arises from the combination of debt – and equity like characteristics, supplemented by a preferred accounting treatment and accelerated tax deductions, Insurance lies somewhere between debt and equity on the volatility of returns curve. From the scenario painted, it is becoming clear that equity debt and insurance are complementary to deriving optimal financial performance structures. This is where the real solution to the complex needs of sophisticated clients lies, but the unresolved issue of these instruments' relative value is slowing the market progress. Reilly, et al (2003) is of the opinion that unless capital and service providers can identify the right combination of forms of capital, much of the energy spent reshaping the market will be wasted and client's value will be lost.

Fig 1 Impact of leveraging (60% debt, 40% equity) and risk transfer (insurance) on risk / return profile



Source: Swiss Report 2008

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Leveraging is more efficient in a structure where risk transfer instrument have been implemented.

Return - volatility Framework

The methodology to evaluate insurance compared with the other forms of capital should be built using a return – volatility framework. To be able to reduce the volatility is to identify the best combination, while following three principles.

Profit Maximisation: companies create wealth for shareholders, by making returns in excess of the risk – free rate of return and by improving the productivity of their equity base. The risk free rate of return represents the interest an investor would expect from an absolutely risk free investment over a specified period of time.

Risk free rate of return is also in theory, the minimum return an investor expect for any investment because he or she will not accept additional risk unless the potential rate of return is greater than the risk free rate.

The risk free for a given period is taken to be the return on government bonds over the period. This is because a government cannot run out of its own currency as it is able to create more as necessary. Any other investment should produce greater returns than risk free rate. The extra return (the risk premium) reflects the extra risk. These additional returns come with a risk; therefore "risk minimisation" is a complementary objective. Shareholders can mitigate the impact of risk by diversifying their investment portfolios, or request management to eliminate undesired exposures through preventive actions or by transferring risks to a third party (entailing a portfolio diversification on the balance sheet of the risk taker).(Mathias, 1983)

A high ratio of assets to equity reflects rising financial leverage and enables a firm to yield high rate of returns on equity even when returns generated on assets (income) is low. To financial institutions this means that equity owner of these institutions would earn very high return on low equity states. The risk to these owners is low because their losses are limited to the low equity states they hold. (Mekinnon, 1973)

Higher risks deserve higher rewards: Core risks of the company, as opposed to non – core or event risks, should be acceptable to investors as they contribute to higher returns (although returns are tempered by the cost of transferring or managing non – core exposures). Event risks are also attached to market. Event risks do not attract returns, as they are not the investment object of the shareholder. (Osisioma, 1994)

Owners of financial institution stand to gain a lot if the institutions invest in risky projects and securities. In fact excessive profits can come precisely from investments in such risky avenues which give higher returns.

Kutty (2008) submitted that the holders of the institution debt customers, who have purchased its claims against itself, are left nothing if the institution reneges on its promises. Unlike in manufacturing, there are no real assets like plant, machinery and inventory on which one can lay claim.

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Regulatory Compliance: - this makes it imperative that the state and the regulator step in to protect the interest of the customers and stakeholders. A distractive characteristic of financial institution is that managers are required to act as agents to two principals. On the one hand they have to pursue policies and courses of actions that would make profit for the firm's owner (equity holders) and maximise the value of the enterprise. On the other hand they also have an agent principal relation with the government and the respective regulatory authority that portends that financial manager of financial institution cannot pursue asset liability management strategies solely for the benefit of the owner.

Efficient markets: are not efficient in themselves. There is no market equilibrium, but a constant adjustment process largely dependent on external factors relating to certain goods and risks. Other factors influencing the market's efficiency include asymmetry of information, differing risk appetites among market participants or corporate stakeholders, the accounting regime and varying tax codes. Insurers have traditionally filled the gaps created by market inefficiencies. However, economic globalisation and new technology are narrowing these gaps and making them short – lived. Insurers and other capital providers must become more sophisticated to take advantage of ever more market breakdowns.

While current efficiency improvement in the market are focusing on quantification and pricing of risk, the next significant challenge will be the refinement of capital efficiency concepts. Capital efficiency is already improving through consolidation. A consolidation capital base compensates for the time horizon normally required to spread risks, potentially reducing pricing. New risk classes that have traditionally been covered by the equity base are also affecting insurers' capital utilisation and efficiency.

Many players realise these new dynamics and are striving to find the perfect vehicle to take advantage of the distinction between different forms of capital. Commercial banks compete openly with investment banks, and both challenge the insurance market. But only those with the highest productivity of capital, and the ability to deliver a well calibrated product, will succeed. If the insurance markets continues to improve its capital productivity and eliminates operational inefficiencies, there may not be a compelling need to substitute insurance for other forms of capital.

In this environment, financial risk management quickly becomes a key competency. An understanding of the tools available to structure capital may not be enough to solve problems and add value, capital providers – risk financiers included will also need to understand the organisation's key objective and strategies. Once the tools and processes are in place, tangible values will be realised through enhanced financial performance.

What would be the next stage in the market's evolution? Some market participants believe that across the board commoditisation of product is inevitable. The market needs to prepare for this final efficiency game, and along the way, client needs must be satisfied and customer value delivered.

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Conclusion: To keep providing value, insurance and other key instruments must fulfil basic customer needs, such as preservation of wealth. Basic needs are generally stratified by commodities. Consequently, new alternative risk transfer structure may ultimately become a commodity after pricing, capital deployment and operational inefficiencies are eliminated or meaningfully reduced. When the financial service market gets to this stage, competition will be based on pricing and distribution channels. With the progress in risk evaluation and pricing sophistication, coupled with undifferentiated serving features, markets success will depend on the quality of intellectual input and commitment of capital (insurance or otherwise).

Insurance, including alternative risk transfer, will remain a risky business. The industry's risk appetite will play a role in determining the value and shaping the future of insurance. In this context, the insurance segment of the financial services market is in strong position to lead the way because of its underwriting expertise, well diversified portfolios and risk appetite. Efficiency improvement will be driven primarily by demand from sophisticated buyers. But the needs of these buyers must be translated into practical applications that result in commercially driven, value oriented product. If such product is built, insurance will continue to provide value, and perhaps gain ground on other forms of capital.

Recommendation: in response to competition in the financial services industry, a number of powerful tools have developed under the banner of alternative risk transfer (ART). This term covers a multitude of products that lie somewhere within the debt, insurance and equity triangle.

ART is the process of financially engineering out the downside risk from a company's balance sheet or income statements. It can be applied to individual risk management problems, such as a protection programme for hard – to – insure product liability or environmental risk. Or it can form an integral part of the company's financial management to improve risk – returns ratios.

An ART programme designed to solve a particular risk problem will often comprise a combination of net risk transfer and risk funding – the ART provider will offer to take hazard, timing and even financial risks onto its books, given a risk – sharing commitment from the client company. Finite risk (re) insurance is an example of this.

More comprehensive ART solution includes:
Risk bundling: as corporation become increasingly performance – driven, the importance of reducing costs by centralising and streamlining the (re) insurance and hedging programmes grows. Captives or high self – insured retentions are ways of bundling risks together so the company benefits from its own diversification across different classes of risk and over a longer time – frame. In the (re) insurance world, subsets of individual risks are being bundled into multi –line – year (re) insurance programme. The main feature of true multi –line programme is an aggregated retention for various risk exposures.

Hybrid solution: these encompass both hazard and financial risk by combining features of multi –line programme to enhance the benefit of risk integration. The cover is typically built by

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following the principle of portfolio theory. It may be triggered on the basis on insurance loss experience and or financial performance.

Insurance – linked securities: insurance risks can be passed on to the capital markets through insurance – linked bonds and options. Activity in the insurance securitisation markets has been growing over the past few years.

Risk transfer instrument such as traditional (re) insurance, because of the cost of capital consideration, a company may prefer to finance its losses by using a contingent third party capital in the form of (re) insurance. A capital provider uses the power of exposure diversification and its asset / liability matching expertise to scale down the size and cost of risk – adjusted capital to cover risk.

Securitising Risk: Many have put their stock in the development of insurance securitisation instruments, which package hazard risk and pass it on to financial market investors.

This is a promising way to improve the capital efficiency by distributing event risk into non – event risk portfolios. Insurance securitisation also allows holders of event risk access to the huge amount of money available in the global capital markets. (Epetimehin, 2011)

But investors are tentative about taking on new risks that are difficult to analyse. The physical nature and distribution characteristics of hazard risks differ from typical capital market risk such as interest rates, exchange rates and commodities that investors are familiar with. This has led investors to demand rates of return that include a novelty premium which exceeds risk expectations, while other investment product provides competition for investors' attention.

The securitisation of catastrophe risk has therefore made only modest progress. Recently, investment banks and large insurance markets have started structuring transactions for more predictable classes of risk, such as automobile, workers' compensation and life. (Outreville, 1996)

The drive behind insurance securitisation has largely stemmed from the benefits of diversifying investment portfolios through non – financial risks.

The necessary condition for investment is the ability to provide acceptable risk – adjusted returns. Such returns can only come from high premium rates, and the prolonged period of cheap premiums will inhibit the growth of this product.

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International Journal of Academic Research in Business and Social Sciences
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