



**The Management of Construction and Property Risk**

In the United States, the property and casualty insurance industry has reported a net profit of US\$7.8 billion and insured catastrophe losses of US\$1.9 billion in the first quarter of 2011<sup>1</sup>. The most recent publicly available data in the Nigerian insurance industry recorded activity valued at N200 billion (US\$13.3 million)<sup>2</sup> at the end of 2010. Only 5%<sup>3</sup> of this value was related to the real estate sector, which until recently, did not have a proper legal framework with regards to insurance. The sector has thus been open to inadequate and poor quality insurance products, exposing investors and clients to greater risks and liabilities.

While it is a fact that as at Q3 2010, the Construction Industry still contributes an abysmal 1.4%<sup>4</sup>, to GDP (by comparison, the UK construction industry contributes 8.2%<sup>5</sup>), insurance penetration in the sector is by far poorer. Comparable emerging economies such as South Africa with product penetration of 16%<sup>6</sup> recorded a 6.7%<sup>7</sup> year-on-year growth in the insurance sector in the past two years. Product penetration is currently an average 8%<sup>8</sup> in Nigeria. This suggests that either existing products are unsuitable, or that there is a poor regulatory and enforcement environment. The rising incidence of building collapse in the construction industry eventually led the municipal authorities in the city of Lagos to enact an insurance law for real estate development in 2010. This makes it mandatory for builders to take out Construction All Risk (CAR) Insurance for building projects of more than two floors.

This edition of Real Estate Insight provides an overview of insurance in real estate and specifically addresses the need for, and the benefits of appropriate insurance products in Nigeria's real estate industry.

**The Dynamics of the Real Estate Industry**

The real estate and construction industry is generally considered high risk. Inflation, interest and exchange rates, the labour market, the illiquid nature of real estate assets and other dynamics directly impact the direction of the real estate industry. The importance of the industry in personal and public life makes this even more apparent. The industry provides jobs to developers, designers, construction workers and real estate agents who all rely on the industry for their livelihood. For many others, a purchase or construction may represent the single largest investment of a lifetime therefore, safety and security of investment is of utmost importance.

The construction industry poses great risk exposure for the investor/developer. This is due to the industry's unique nature as no construction site/project is the same, each requires a varying number of skills (very wide skill pool on large projects), spanning a few months to many years. Timing, currency and other financial related issues, design, contractual, labour, and force majeure are some of the risks associated with the industry. Like majority of risks, if not properly managed, these could result in significantly high cost implications, impacting negatively on projects and has seen through many examples, derail the objective of the projects entirely.

**Insurance and the Construction Industry**

An insurance product is designed as a basic form of risk management to provide protection against possible loss to life or physical assets.<sup>9</sup> In construction, insurance products help to transfer a variety of risks from client, contractor, and other related agents to insurers, who provide contingency that mitigate losses through a promise of compensation for specific potential future losses in exchange for periodic payments.<sup>10</sup>

*"For any economy that aspires to be a global leader, insurance should play a major role. Besides using insurance products is also capable of closing the housing deficit".<sup>11</sup>*

In the United States, where insurance plays an important role in the mitigation of potential losses, the insurance density per capita (percentage of premium to total population) is over US\$3,500<sup>12</sup>. The sector helps to drive the economy and contributes to the success of its land tenure and mortgage systems. It provides protection against financial loss from defects in title and related land issues, mortgage payments, and ensures the security of investment for both lender and borrower. In 2008, hurricane Ike incurred an estimated privately insured loss of US\$17.6 billion including US\$2.6 billion for related storm surge water damage.<sup>13</sup> Without the insurance industry, the financial loss to the affected parties and the country would have been devastating.

**Real Estate/Construction Insurance in Nigeria**

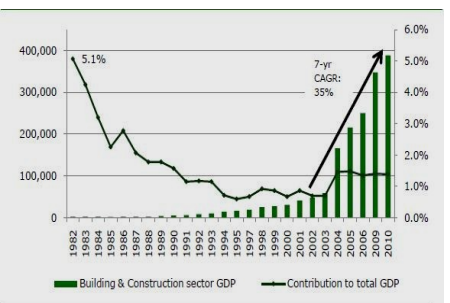
According to the President of the Nigerian In-



**Figure 1:** Managing Real Estate & Construction Risk Through Insurance  
**Source:** Just Dream Weaver

	\$
Net Earned Premiums	\$104.8
Incurred Losses (Including loss adjustment expenses)	78.5
Expenses	30.3
Policyholder Dividends	0.5
Net Underwriting Gain (Loss)	-4.5
Investment Income	12.6
Other Items	0.5
Pre-Tax Operating Gain	8.6
Realized Capital Gains (Losses)	1.0
Pre-Tax Income	9.6
Taxes	1.8
<b>Net After-Tax Income</b>	<b>\$7.8</b>
Surplus (End of Period)	\$564.7
Combined Ratio	103.3**

**Figure 2:** Property and Casualty Insurance in the US—First Quarter Results 2011  
**Source:** Insurance Information Institute Website



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**Figure 3:** Building and Construction GDP and Contribution to Total GDP in Nigeria  
**Source:** Vetiva—Construction Industry Report

Insurance Association (NIA), the insurance industry in Nigeria has witnessed some growth in the past four years. However, insurance density is still low at less than US\$10 per capital and 0.50% of premium share of GDP<sup>14</sup> as against 5.2%<sup>15</sup> in India and 3.5%<sup>16</sup> (of which 34% is from Property and Casualty Insurance) in Brazil. Post the insurance sector reforms in 2007, industry capitalization exceeded N200bn (\$1.62bn) from a pre consolidation level of N30bn (\$243m) with 71 active insurance companies.<sup>14</sup> Yet, 94% of Nigerians do not have insurance policies<sup>15</sup> of any kind (life or general) and majority do not recognise the importance of such product.

With a population of 150million, only 750,000 insurance products have been sold by insurance companies<sup>16</sup>. Practitioners link the hindrance to growth to poor enforcement of insurance laws, the low disposable income of majority of Nigerians, and a general lack of public awareness. Specific to the construction industry stakeholders state that the insurance gap has encouraged the entry of unqualified developers and contractors. One of the most obvious fall-outs of this is the increasing number of collapsed buildings in the country. Only last week, a building under construction collapsed in Abuja, Nigeria's capital city, with fatalities and injuries.<sup>17</sup> Records indicate that in 2009, at least 20 people died in collapsed buildings in Lagos alone.<sup>18</sup> Majority occurred on construction sites. Although developed since 2003, the alarming rate of building collapse compelled the Lagos State Government to pass the Construction/Building Insurance Act in March 2010.<sup>19</sup>

While in support of the law, many construction industry stakeholders initially expressed concern about the potential implication on the cost of construction and property prices. The importance of effective monitoring and transparency from insurance companies in issuing out certificates to applicants was also a point of concern. A year after, insurance companies agree that through partnerships with builders' societies the building insurance law is being adhered to, although majority of private/individuals still do not comply.<sup>20</sup>

**The Impact of a Thriving Insurance Industry**

Property and construction insurance is advantageous and imperative. With builders and insurers already collaborating to achieve efficiency,<sup>21</sup> the gains of the Insurance Law (Lagos State) will soon become apparent. The slow response of construction industry service providers should not be seen as a signal of an ineffective law, particularly with the current lull in the property market.

A thriving industry results in an improvement in competence, efficiency and increased competition - as contractors and consultants become compelled to adopt professional best practices. Insurance companies will create (or adapt) a number of products, offering more variety to a wider market. The quality (type and depth) of insurance cover procured may become a prerequisite for securing mandates from clients for services from contractors and consultants. The knock-on effect of ongoing risk management by insurance companies

will help to improve monitoring, enforcement and also foster efficient practices amongst service providers thereby improving the quality of real estate, providing better grade building stock.

As a result of the policy, owners of properties affected by building collapse (whether as a result of negligence on the part of contractors, consultants) force majeure or environmental hazards such as flooding and construction workers affected by accidents, theft and loss of life may seek redress with their insurance providers.

The cost of insurance will be passed on to buyers and tenants, leading to a small increase. However, the safety of life, property and project funds has far greater beneficial effects. Investors, (and all parties involved) rest assured knowing that their interest is protected. As far as delivering low-income housing is concerned, insurance premium discounts, alongside other incentives can be used to encourage affordable housing delivery.

**Conclusion**

No economy can thrive without a vibrant insurance sector. In addition to protecting an individual, company, or investments from financial loss which more often than not occurs as result of risk exposure in the industry, the insurance policy may also be a means of financial inclusion. Premiums paid for insurance cover, coupled with a stronger capital base as a result of recent recapitalisation, the insurance industry can serve as a means for access to long term funds (presently eluding the industry) which may be given as loans to affordable housing developers for development of housing can be reinvested to support the growth of real estate industry.

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<sup>21</sup> Saving Lagos from Ruins. Next Newspaper, June 2, 2010  
<sup>22</sup> The National Voice—Lagos Tightens Building Control, Demands Insurance Certificate  
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<sup>24</sup> Nigerian Tribune - Builders Partner Insurers Over Lagos Building Law

Countries	2007			2006		
	Total	Life	Non-Life	Total	Life	Non-Life
<b>Developed Countries</b>						
United States	8.90	4.20	4.70	8.80	4.00	4.80
United Kingdom	15.70	12.60	3.00	16.50	13.10	3.40
France	10.30	7.30	3.00	11.00	7.90	3.10
Germany	6.60	3.10	3.60	6.70	3.10	3.60
Japan	9.60	7.50	2.10	10.50	8.30	2.20
<b>Developing Countries</b>						
Brazil	3.00	1.40	1.60	2.80	1.30	1.60
Russia	2.40	0.10	2.40	2.30	0.10	2.30
Taiwan	15.70	12.90	2.80	14.50	11.60	2.90
Malaysia	4.60	3.10	1.50	4.90	3.20	1.70
Singapore	7.60	6.20	1.50	6.50	5.40	1.10
Thailand	3.40	1.80	1.50	3.50	1.90	1.60
India	4.70	4.00	0.60	4.80	4.10	0.60
South Africa	15.30	12.50	2.80	16.00	13.00	3.00
World	7.50	4.40	3.10	7.50	4.50	3.00

Figure 4: International Comparison of Insurance Penetration  
 Source: Swiss Re Sigma

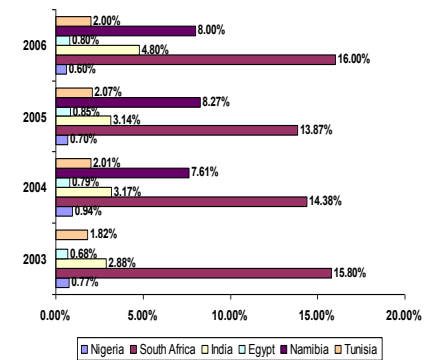


Figure 5: Insurance Penetration in Africa (2003—2006)  
 Source: Accenture - Transformation and Insurance Growth In Africa



Figure 6: Collapsed Building in the Central Business District in Lagos  
 Source: TJS Blog—Morocco, West Africa, Mozambique