THE DETERMINANTS OF FINANCIAL PERFORMANCE IN GENERAL INSURANCE COMPANIES IN KENYA

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Abstract

The contribution of the general insurance industry in Kenya to the gross domestic product is at 2.08%. This is low and hence the need to establish factors that can influence improved performance of some of the key players – the general insurance companies. The study was therefore to establish the factors that affect the profitability of general insurers in Kenya. The study employed multiple linear regression, with return on assets as the dependent variable, and considered all the general insurance companies in Kenya for the period 2009-2012. Profitabilitywas positively related to leverage, equity capital, management competence index and negatively related to sizeand ownership structure. The study did not find a relationship between performance and retention ratio, liquidity, underwriting risk and age. The study recommends that for general insurers in Kenya to perform better they should increase leverage, equity capital and quality of staff.

Keywords: General Insurance Companies, Return on Assets, Firm Specific Factors

Introduction

Insurance companies provide unique financial services to the growth and development of every economy. Such specialized financial services range from the underwriting of risks inherent in economic entities and the mobilization of large amount of funds through premiums for long term investments. The risk absorption role of insurers promotes financial stability in the financial markets and provides a sense of peace to economic entitiesThe insurance companies' ability to cover risk in the economy hinges on their capacity to create profit or value for their shareholders. A well-developed and evolved insurance industry is a boon for economic

development as it provides long- term funds for development (Charumathi, 2012; (Ahmed, Ahmed, and Ahmed, 2010; and Agiobenebo and Ezirim, 2002).

Financial performance is a measure of an organization's earnings, profits, appreciations in value as evidenced by the rise in the entity's share price. In insurance, performance is normally expressed in net premiums earned, profitability from underwriting activities, annual turnover, returns on investment and return on equity. These measures can be classified as profit performance measures and investment performance measures. Profit performance includes the profits measured in monetary terms. Simply, it is the difference between the revenues and expenses. These two factors, revenue and expenditure are in turn influenced by firm-specific characteristics, industry features and macroeconomic variables. Investment performance can take two different forms. One the return on assets employed in the business other than cash, and two, the return on the investment operations of the surplus of cash at various levels earned on operations(Chen and Wong, 2004; and Asimakopoulos, Samitas, and Papadogonas, 2009).

At the micro level, profit is the essential pre-requisite for the survival, growth and competitiveness of insurance firms and the cheapest source of funds. Without profits insurers can not attract outside capital to meet their set objectives in this ever changing and competitive globalized environment. Profit does not only improve upon insurers' solvency state but it also plays an essential role in persuading policyholders and shareholders to supply funds to insurance firms. Thus, one of the objectives of management of insurance companies is to attain profit as an underlying requirement for conducting any insurance business(Chen and Wong, 2004; and Harrington and Wilson, 1989).

General insurer's profitability is influenced by both internal and external factors. Whereas internal factors focus on an insurer's specific characteristics, the external factors concern both industry features and macroeconomic variables. The firm-specific factors include; leverage which is measured by the ratio of total debt to equity (debt/equity ratio). This ratio shows the degree to which a business is utilizing borrowed money. It reflects insurance companies' ability to manage their economic exposure to unexpected losses. This ratio represents the potential impact on capital and surplus of deficiencies in reserves due to financial claims (Adams and Buckle, 2000).

Another determinant of financial performance is the level of liquidity. Liquidity refers to the degree to which debt obligations coming due in the next twelve months can be paid from cash or assets that will be turned into cash. Insurance liquidity is the ability of the insurer to fulfill

their immediate commitments to policyholders without having to increase profits on underwriting and investment activities and/or liquidate financial assets. The cash and bank balances are to be kept sufficient to meet the immediate liabilities towards claims due for payment but not yet settled(Chaharbaghi and Lynch, 1999).

The size of the firm is another factor that determines an insurance company's financial performance. The size of the firm affects its financial performance in many ways. Large firms can exploit economies of scale and scope and thus being more efficient compared to small firms. Size can be determined by net premium which is the premium earned by an insurance company after deducting the reinsurance ceded. The premium base of insurers dictates the quantum of policy liabilities to be borne by them(Ahmed, Ahmed, and Ahmed, 2010; and Teece, 2009).

Another factor is the age of a company. Older firms are more experienced, have enjoyed the benefits of learning, are not prone to the liabilities of newness, and can therefore enjoy superior performance. Older firms may also benefit from reputation effects, which allows them to earn a higher margin on sales. On the other hand, older firms are prone to inertia, and the bureaucratic ossification that goes along with age; they might have developed routines, which are out of touch with changes in market conditions, in which case an inverse relationship between age and profitability or growth could be observed (Shiu, 2004; and Demirgüç-Kunt and Maksimovic, 1998).

The other factor determining financial performance is underwriting risk which reflects the adequacy, or otherwise, of insurers' underwriting performance.Sound underwriting guidelines are pivotal to an insurer's financial performance. The underwriting risk depends on the risk appetite of the insurers. The ratio of benefits incurred to net premium is a measure of underwriting risk (Adams and Buckle, 2000).

Equity capital which is the capital raised from owners in the company, is the residual claimant or interest of the most junior class of investors in assets, after all liabilities are paid; if liability exceeds assets, negative equity exists. In an accounting context, shareholders' equity (or stockholders' equity, shareholders' funds, shareholders' capital) represents the remaining interest in the assets of a company, spread among individual shareholders of common or preferred stock; a negative shareholders' equity is often referred to as a positive shareholders' deficit. More capital influx will enable the firm to expand and open new branches, which in turn may lead to growth and possibly would be accompanied by economies of scale and hence improved financial performance (Lee, 2008; and Hansen, 1999).

Retention ratio is the percentage of the underwritten business which is not transferred to reinsurers. A higher retention ratio with lower claims ratio is likely to impact on the performance of insurers' positively. Theoretically, a more efficient insurance company in underwriting decisions accompanied by higher retention should have higher profitability (Charumathi, 2012).

Another factor that impacts the financial performance of an insurance company is the ownership. There are two main dimensions of the ownership structure: Ownership concentration that is, the distribution of shares owned by majority shareholders and identity of owners especially, foreign investors and institutional investors. Ownership structure influences the management of the company to either pay dividends or interest, or decide whether to retain much of its profits for further use in the company (Agiobenebo and Ezirim, 2002).

According to an IRA annual report released in the year (2012), the Kenyan general insurance industry comprises of 23 companies. According to the Association of Kenya Insurers, general insurance penetration as at 2012 stood at 2.08%, this was represented by gross written premium of Kshs 71.46 billion. The general insurers' profitability wasKshs 11.82 billion for the year.

Research Problem

The concept of financial performance has received significant attention from scholars in the various areas of business. It is of primary concern of virtually all business stakeholders in any sector since financial performance is an ingredient to organizational health and ultimately its survival. High performance reflects management effectiveness and efficiency in making the use of a company's resources and this contributes to the economy at large (Ansah-Adu, Andoh, and Abor, 2012; Batra, 1999; and Barney, 1991).

The insurance industry (Kenya's included) is a vital part of the entire financial system. Apart from commercial banks, insurance companies contribute significantly to financial intermediation of the economy.As such, their success means the success of the economy; their failure means failure to the economy (Ansah-Adu, Andoh, and Abor, 2012; and Agiobenebo and Ezirim, 2002).

Identifying the key success indicators of insurance companies can help in facilitating the design of policies that may improve the profitability of the insurance industry. Hence, the determinants of insurers' profitability have attracted the interest of investors, researchers, financial markets analysts and insurance regulators.The scientific knowledge of the determinants of insurers' profitability has further been

reinvigorated by the 2007/2009 global economic and financial crises(Asimakopoulos, Samitas, and Papadogonas, 2009).

Several studies have been conducted on the Kenyan insurance industry. Mwangi (2013) sought to establish the factors; and the extent to which they influence financial performance of insurance companies. He used profitability as a financial performance indicator. He noted that interest rate fluctuations, liquidity, and competition are the key factors that influence financial performance of Kenyan insurance companies, but he did not state their relationship.

Wabita (2013) sought to establish the determinants of financial performance of insurance companies in Kenya. He established that; growth of the insurance industry positively affects financial performance, leverage of the insurance industry negatively affects financial performance, and the amount of tangible assets held by the industry positively affects financial performance. Mutugi (2012) sought to establish factors that influence financial performance of life assurance companies in Kenya. His findings were that capital structure, innovation and ownership structure are determinants of financial performance.

Literature from past studies reveal that the findings from most researchers have not reached a common conclusion. Specifically, their findings did not specify the relationship between the various factors which they found to determine financial performance of general insurance companies of Kenya. Furthermore, the findings by Mwangi (2013), Wabita (2013), and Mutugi (2012) were inconclusive. Studies elsewhere reveal that the factors that influnce organizational performance are specific and different in different markets. This study thus aimed to establish the determinants of financial performance of general insurance companies in Kenya.

Methodology

The study adopted a descriptive research design.The population comprised all the 23 general Kenyan insurance firms. The study used secondary data for the four financial periods, 2009-2012. The study employed a multiple regression analysis model, given by:

$$Y=\alpha+\beta_1X_1+\beta_2X_2+\beta_3X_3+\beta_4X_4+\beta_5X_5+\beta_6X_6+\beta_7X_7+\beta_8X_8+\beta_9X_9+\varepsilon$$

With the notations as defined in Table 1.

Table 10: Dependent and Independent Variables

Notation	**Variable**	**How Measured**
Y X1	Return on Assets (ROA) Leverage (LEV)	Profit after tax/total assets Total debt/Equity
X2	Retention ratio (R)	Net Premium (Total Premium earned - Reinsurance ceded)/Gross Premium
X3	Liquidity (LIQ)	Current Assets/Current Liabilities
X4	Underwriting Risk (UWR)	Benefits paid/Net Premium
X5	Equity Capital (EC)	Log of Equity Capital
X6	Size (A)	Log of total assets
X7	Management Competence index (MI)	Profit /number of professionals
X8	Ownership (F)	Number of foreign owners
X9	Age (Y)	Number of years since establishment

Results and Discussion

The data was gathered from 22 general insurance companies on the variables of interest representing a 95.65% response rate. One firm was dropped from the sample as it had been placed under receivership as at the time of the study.

Table 2 provides a summary of the descriptive statistics.

Table 2: Descriptive Statistics

Variable	**Mean**	**Std. Dev**	**Minimum**	**Maximum**
Performance (ROA)	0.06	0.03	0.01	0.13
Leverage (LEV)	2.85	2.05	1.12	9.73
Retention Ratio (R)	0.70	0.14	0.46	0.98
Liquidity (LIQ)	1.48	0.21	1.10	1.89
Underwriting Risk (UWR)	0.96	0.50	0.51	2.35
Equity Capital (EC)	14.04	0.75	12.84	15.63
Size (A)	15.30	0.91	13.81	17.17
Management Competence Index	26,442	17,212	2,866	59,590
Ownership (F)	6.88	16.28	0.00	52.25
Age (Y)	37.59	21.22	3.00	94.00

Source: Research Findings

The results of the multiple regression analysis are shown in Table 3.

Table 3: Regression Results for Financial Performance as Dependent Variable and Various Factors as Predictors

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.9492(a)	.9011	.7740	.0140

Goodness of Fit - ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.012	9	.0013	7.09	.009(a)
	Residual	.001	12	.0002		
	Total	.133	21			

Regression Coefficients

Model		B	Std. Error	t	Sig.
1	(Constant)	1.299	.425	3.06	.018
	Leverage	.210	.055	3.78	.007
	Retention ratio	.014	.036	.038	.713
	Liquidity	-.372	.158	-2.36	.051
	Underwriting risk	.026	.015	1.72	.128
	Equity capital	1.030	.280	3.68	.008
	Size	-1.033	.278	-3.72	.007
	Management competence	.0001	.000	6.20	.000
	Ownership	-.002	.000	-3.56	.009
	Age	.000	.000	.680	.518

a Dependent Variable: Financial Performance

The goodness of fit results of standard linear multipleregressionwith financial performance as the dependent variable and various determinants as predictors are reported in Table 3(a). The model summary is in Table 3 (b). The model reveals a statistically significant relationship between financial performance and determinants (Sig.=< 0.05). The multiple regression model had an Adjusted R^2 = .7740, F = 7.09, and a standard error of 0.014. The model coefficients are shown in Table 3(c). The findings indicate that the significant predictors of financial performance were leverage(β = 0.210, p=<0.05), equity capital(β = 1.030, p=<0.05), size (β = -1.033, p=<0.05),management competence (β = 0.0001, p=<0.05),and ownership(β = -0.002, p=<0.05). Financial performance was not significantly predicted by retention ratio(β = 0.014, p>0.05), liquidity(β = -0.372, p>0.05), underwriting risk (β = 0.026, p>0.05),and age(β = 0.000, p>0.05).

The study explored the relationship between financial performance and various determinants by suggesting that there is a statistically significant relationship between financial performance of insurance companies and

selected factors. Results of this study indicate that the relationship between financial performance of insurance companies and selected factors is statistically significant (p=<0.05) for fivepredictor variables (leverage,equity capital, size,management competenceand ownership). The null hypothesis was rejected and therefore the alternate one was accepted, meaning that there is a significant relationship between financial performance of insurance companies and determinants.

The analytical model which was:

$Y=\alpha+\beta_1X_1+\beta_2X_2+\beta_3X_3+\beta_4X_4+\beta_5X_5+\beta_6X_6+\beta_7X_7+\beta_8X_8+\beta_9X_9+\varepsilon$

is therefore specified as:

$Y=1.299+0.210X_1+0.014X_2-0.372X_3+0.026X_4+1.030X_5-1.033X_6+0.0001X_7-0.002X_8+0.000X_9$

Since the regression coefficients of retention ratio, liquidity, underwriting risk and are not statistically significant and therefore their beta regression coefficients were not different from zero,the regression model can then be simplified to:

$Y=1.299+0.210X_1+1.030X_5-1.033X_6+0.0001X_7-0.002X_8$

Conclusion

The study findings are that the higher the leverage, equity capital and management capability the better the financial performance of general insurers in Kenya. However size and foreign ownership appear to be negatively related to return on assets. The study recommends that for general insurers in Kenya to perform better in terms of their return on assets, they should improve on their leverage. But insurance firms should be careful not to leverage too much as this can also be detrimental to their long-run sustainability. Companies that are highly leveraged may be at risk of bankruptcy if they are unable to make payments on their debt. The study also recommends that firms need to increase their capital in order to improve their performance. The firms should also increase managerial competency of the staff as this is positively related to performance. As the relationship between size and performance was negative, perhaps due to diseconomies of scale, it may be prudent to focus on performance instead of growth for its own sake.

The model used in the study focused on firm specific determinants of financial performance of general insurers in Kenya. Therefore, other determinants such as macroeconomic factors were not part of the study. Thus, industry and macro-economic factors were not controlled for in the present study. The use of regression analysis also means that there is an assumption of linearity with the various models which may not be the case besides the study was conducted for a period from year ending 2009 until year ending 2012. As such only the companies having operation over this span have been considered.

Further research needs to be carried out similar to this by including both general insurers and life insurers. Then, an analysis should be carried out jointly and separately for the two classes of insurers. Studies in the future should also use panel data and introduce other macroeconomic determinants of financial performance of insurance firms in Kenya.

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