

**AN INVESTIGATION INTO FACTORS THAT DETERMINE  
FINANCIAL PERFORMANCE OF INSURANCE COMPANIES IN  
KENYA**

**BY  
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## **DECLARATION**

This research project is my original work and has not been submitted for an award of a degree in any other university.

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This research project has been presented for examination with our approval as the University Supervisors.

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## **DEDICATION**

I dedicate this work to my family for their love and support. To my parents Samuel (late) and Fracha thank you for helping me to grow and realize my purpose in life; you have been an inspiration to my life. To my sisters Rahab and Jane and my brothers John, Simon and Jackson thank you for your moral support and encouragement. To my fiancée Caroline thank you for unwavering support, encouragement and love. Your unconditional sacrifice and prayers played a great role in the completion of my course and study. I will always be grateful to you all

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## **ABBREVIATIONS AND ACRONYMS**

<b>IRIS:</b>	Insurance Regulatory Information System
<b>IAS:</b>	International Accounting Standards
<b>IASB:</b>	International Accounting Standards Board
<b>GDP:</b>	Gross Domestic Product
<b>GI:</b>	General Insurance
<b>OECD:</b>	Organisation for Economic Co-operation and Development
<b>OTC:</b>	Over the Counter
<b>ROA:</b>	Return on Assets
<b>ROE:</b>	Return on Equity
<b>AKI</b>	Association of Kenya Insurers

## **ABSTRACT**

The purpose of this study was to investigate the factors that influence the financial performance of insurance companies in Kenya. It looked in to some of the key factors that determine financial performance and the extent to which they influence financial performance of insurance companies. This study was conducted using a descriptive survey design. The target population for this study comprised the 46 insurance companies in Kenya. This study used systematic random sampling method to select the respondents. The study used questionnaires as the tool for data collection. Data was analysed through descriptive statistics and results presented in frequency tables, bar graphs and pie charts.

The findings of the study showed that fluctuations in interest rates affect the financial performance of insurance companies both ways. This is because it affects the rate of borrowing as well as the rate of return on investments. Profitability as an indicator of financial performance enables insurance companies to invest in viable ventures while avoiding the too risky ones. Competition was found to have an effect on insurance company's financial performance especially through the prices and innovation in new products. Liquidity affects financial performance of insurance companies and this is why the insurance companies have liquid investments. These would help them to settle claims especially if their underwriting income cannot cover claims. Majority of insurance companies rely on cash flow from operations in liquidity management. Based on the findings of this study, it is recommended that insurers should invest in financial analysts so that they can gauge when interest rates can work in their favour in increasing their income.

## CHAPTER ONE

### INTRODUCTION

#### 1.1 Background

The past decade has seen a dramatic rise in the number of insolvent insurers. The perceive causes of these insolvencies were myriad. Some of the insolvencies were precipitated by rapidly rising or declining interest rates, mispricing of insurance policies, natural catastrophes, changes in legal interpretations of liability and the filing of false claims, poor credit policies among others. The “churning” of polices by unscrupulous sales agents, insolvencies among the re-insurers backing the policies issued, non compliance with insurance regulation, and malfeasance on the part of officers and directors of insurance companies affected as well (Baltoni, 2008). As a result of globalization, deregulation and terrorist attacks, the insurance industry has gone through a tremendous transformation over the past decade (Sanchez, 2006). There are many factors to examine when looking at insurance companies. More than anything, both consumers and investors should concern themselves with the insurer's financial strength and ability to meet ongoing obligations to policyholders. Poor fundamentals not only indicate a poor investment opportunity, but also hinder growth. Nothing is worse than insurance customers discovering that their insurance company might not have the financial stability to pay out if it is faced with a large proportion of claims (Babbel&Klock, 1994).

Insurance companies sell protection to policyholders against many types of risks: property damage or loss, health and casualty, financial losses, etc. In return for this risk protection, insurance companies receive a premium from the policyholder that is used to cover expenses and the expected risk. For longer-term risk protections, part of the premiums is invested to get higher yields. Although the protection buyer mitigates the individual risk to the large and better-diversified portfolio of the insurer, the risk is not completely reduced because the insurer may default his obligations. Insurers need to have sufficient equity or buffer capital to meet their obligations in adverse conditions when their losses on the diversified portfolio exceed the expected losses. Pottier (1998) contends that this may affect the ability of the insurer to meet its obligations to policyholders and debtholders.

The majority of research on life insurer performance has been in terms of identifying those insurer-specific variables that aid in identifying insurers that are more likely to become insolvent. Examining the life insurance industry, BarNiv and Hershberger (1990) found insolvent insurers tend to be smaller in size than solvent insurers and changed their product mix more. Ambrose and Carroll (1994) found that financial variables combined with IRIS ratios in a logistic regression model outperformed A.M. Best's recommendations in distinguishing between insurers likely to remain solvent and those insurers likely to become insolvent. Combining all three types of predictors into one model provided the most accurate classification. Carson and Hoyt (1995) found that surplus and leverage measures are strong indicators of insurer financial strength, and also found a slightly higher risk of failure among stock insurers than mutual insurers.

Deakin(2005) examined the “run on the bank” risk, and found that prior to 1992 rating organizations generally did not appreciate the risks inherent in liabilities such as guaranteed investment contracts. Cummins et al,(1999) showed that cash flow simulation variables add explanatory power to solvency prediction models.

While insurance companies hold billions of shillings belonging to the general public, including buyers of their products, retirement benefit schemes and funds managers, information on these companies is scanty. For large consumers of insurance products, this group usually relies on the expertise of qualified risk management consultants to offer advice on where to place their insurance covers (Kumba, 2011). But it is the retail consumer of insurance who is left to grope in the dark, constantly dazzled by overzealous insurance agents, all trying to outdo each other in selling one product or the other. With a shortage of qualified insurance sales people to sell products, the general public is left without any basis on which to make an informed expenditure or investment decision on which company to place their cover with (Kumba, 2011).

Owing to an apparent lack of uniform financial reporting formats, a number of insurance companies have not published their profit and loss accounts, making it difficult for the general public to gauge their profitability, overall written premiums or even their net incomes. Companies using this format simply give a skeleton balance sheet, providing little or no information to the public. The scanty financial statements, released to the public by some companies, create a lot of grey areas and room for such unprofessional activities as tax evasion and concealing of critical ratios and figures. Based on available

credit rating methods, profit combined with other ratios and computations can provide useful indicators to anyone looking for a stable and financially sound insurance company (Kumba, 2011). Other financial ratios, includes current ratio which simply shows how fast an insurance company can settle a claim. These ratios are critical in determining the financial strength and ability of any insurance company to settle claims and stay in business. For those wishing to determine if their insurance company is failing, risk management experts advice that one needs to calculate the Debt/Equity ratio, which is total liabilities divided by shareholders equity. This ratio is also known as risk gearing and shows the extent to which a company is financed by borrowed funds. Other ratios include acid test ratios, which is liquid assets divided by current assets and the current ratio. All the above ratios can determine whether it is safe to place a cover with the insurance company, Kumba (2011), and whether the insurer is in a sound financial position to settle claims; factors which are of great importance to the investors, employees and policy holders.

### **1.1.1 The Insurance Industry in Kenya- An overview**

The concept of insurance has been around Africa for a long time. Members of a community pooled together resources to create a “social insurance fund”. The “premiums” ranged material to material support or other payments in kind from the fund “drawings were made out” to support a few unfortunate members exposed to perils. However, the history of development of commercial insurance in Kenya is closely related to the historical liberation of Kenya as a nation. With the conquest of Kenya as a British colony, settlers initiated various economic activities, particularly farming, and extraction

of agricultural product. These, substantial investment needed some form of protection against various risks exposures. British insurers saw an opportunity in this, and established agency offices to service the colony's insurance needs. Prosperity in the colony soon justified expansion of these agencies to branch networks with more autonomy and expertise to service the growing insurance needs. By independence, most of the branches had been transformed to fully fledged insurance companies. Since then, insurance industry in has flourished (Maxon, 1993)

The statute regulating the industry is the Insurance Act; Laws of Kenya, Chapter 487 which was enacted in 1985. The office of the Commissioner of insurance was established under these provisions to strengthen the government regulation on insurance. The Commissioner of insurance was created as a department under the ministry of finance. In order to enhance the supervisory capacity of the regulator, the government delinked the department from the ministry to give it some autonomy. The insurance (amendment) Act number 11 of 2006 established the Insurance Regulatory Authority (IRA) with the commissioner of insurance as the managing director and the chief executive officer to take the role of regulating, supervising and developing the insurance industry. This body replaced the functions of the commissioner of insurance. The role of the authority is to ensure effective administration, supervision, regulation and control of insurance and re-insurance business in Kenya (Insurance amendment Act, 2006). The authority is also mandated to license all persons involved in or connected with insurance business including insurance and re-insurance companies, insurance and re-insurance intermediaries, loss adjusters and assessors, risk surveyors and valuers. To protect the



interest of insurance policy holders and insurance beneficiaries in any contract of insurance. To promote the development of the insurance sector and to advise the government on the national policy to be followed in order to ensure adequate insurance protection and security for national assets and national properties among other functions (insurance act Cap 487). There is also a self regulation of the insurance by the Association of Kenya Insurers (AKI). The professional body of the industry is the Insurance Institute of Kenya (IIK), which deals mainly with training and professional education. According to the (AKI) insurance industry report for the year 2010, there were 44 licensed insurance companies at the end of 2010. Twenty companies wrote non-life insurance business only, nine wrote life insurance business only while fifteen were composite (both life and non life). During the year 2010, there were 137 licensed insurance brokers, 21 medical insurance providers (MIPs) and 3,076 insurance agents. Other licensed players included 106 investigators, 57 motor assessors, 18 loss adjusters, 2 claims settling agents, 5 risk managers and 26 insurance surveyors during the year (AKI Report, 2010).

The gross written premiums by the industry was Kshs. 64.47 billion compared to Kshs 55.19 billion in 2008, representing a growth of 16.8 %. The gross written premium in non-life insurance was Kshs 43.11 billion (2008: Kshs 36.89 billion) while that from life insurance business was Kshs 21.36 billion (2008: Kshs 18.30). Non-life insurance premium grew by 16.8 % while life insurance premium and contributions from deposit administration business grew by 16.7 %. The industry has consistently recorded growth over the last seven years. Twenty non-life insurance companies made an underwriting

profit. The overall underwriting profit posted under non-life insurance was Kshs 413 million. Kenya is underinsured at penetration rate of 3% for a population of 40 millions compares poorly with India at 4% penetration for a population of over a billion and contrasts with South Africa with a penetration of 16% for a population of 50 millions. This shows the importance of having a insurance sector which can add more to economic development of the country, which signifies a huge potential for the insurance business in country. From 2002, the insurance sector of Kenya shows a steady growth (Global Credit Rating Agency, 2010).

## **1.2 Statement of the Problem**

It has been noted that without the insurance sector, the economy and the wealth creation associated with it can be adversely affected (International Accounting Standards Board, 2007). The insurance industry forms an integral part of the country's financial sector and its benefits cannot be over-emphasized. If this crucial sector was missing, the consequence on the economy would be devastating, knocking off billions of shillings from the Gross Domestic Product (GDP) index. However, the insurance sector in Kenya and other countries while providing critical interventions and creating wealth through investments, has had a fair share of company collapses (Kumba, 2011; Greene, 2000 and Hagel, Brown & Davison, 2010). Over the last one decade, a number of insurance companies have closed shop and eventually liquidated. Most of these companies have gone under with billions of shillings, in cash, belonging to policy holders, pension schemes and life funds. This brings out the question of whether insurance companies are financially sound and whether they are disclosing enough information to enable investors

make informed decisions. Obviously financial health is critical for any business organization.

A number of studies have looked at the PSV insurance sector in Kenya. Omondi, (1988) conducted a study on the operations of Kenya motor insurance pool (KMIP) 1985. The studies sought to document operations of the KMIP and determine the attitudes of the executives of the pool member companies towards it. Ramadhan (2009) investigated the impact of the 2003 reforms on the PSV insurance sector in Kenya; case study of “matatu” and concluded that the implementation of legal notice number 161 in 2003 by the government influenced insurers practices with respect to underwriting and claims in the PSV sector. More insurance company covering PSV face the risk of collapse unless urgent measures are taken. Wekesa j. N., (2010). A task force appointed by IRA in 2008 observes that the current PSV underwriting system is unsustainable. Incidentally the task force presented its report to IRA in March 13 2009, two days after the industry regulator placed Standard Assurance Ltd under statutory management (Ondari, 2009)

Makembo(1992), investigated problems on the compensation system (fault system) for personal injuries and deaths in motor insurance in Kenya. The study aimed at establishing the problems and identifying the possible solutions to them. Jelala (1993) carried out a study on motor theft implications on the underwriting practice in Kenya 1989 – 1992. A survey of the credit policies on the insurance company in Kenya found out that competing in the insurance industry is cut throat and firms have been forced to

differentiate themselves in order to survive in the long term. This explains the reason for undercutting and introduction of credit facilities (Karanja, 2010)

No specific study that has however addressed the factors that determine financial performance of the insurance companies in Kenya. This is a knowledge gap that the study sought to fill. The study sought to answer the question what and how certain specific factors determine performance of insurance companies in Kenya.

### **1.3 Objective of the study**

The general objective of this study was to investigate the factors that influence the financial performance of insurance companies in Kenya.

### **1.4 Research Questions**

The study sought to answer the following research questions

- a) What are some of the key factors that determine financial performance of insurance companies?
- b) To what extent do these factors influence the financial performance of insurance companies?
- c) What are the insurance companies doing to enhance or to mitigate the effect of these factors determining their financial performance?

### **1.5 Significance of the study**

#### **1.5.1 Stakeholders**

It is important for investors and stakeholders to know the financial position of their insurance company and the factors which could be affecting it. These would enable them to make the right decisions at the right time and cut their losses. It is therefore hoped that this study would shed some light regarding them same.

### **1.5.2 Investors**

The investors might benefit from the findings of this study by learning the factors which could be affecting the financial performance of insurance companies. Resultantly, they can be in a position to compare different companies and hence make the right decisions before investing.

### **1.5.3 Policy holders**

The findings of this study are hoped to give the policy holders a better understanding as to why some insurance companies work hard against paying claims. Based on this, they can understand that it is imperative to consider the financial position of an insurance company before they buy policies, to establish the insurance companies which are viable and the ones which are not.

### **1.5.4 Interested researchers**

This study adds on to the literature on factors that determine the financial performance of insurance companies and hence might shed some light to any interested researchers in future.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter is structured based on the research objectives. It reviews relevant literature available that focuses on factors that influence the financial performance of insurance companies in Kenya. This chapter widely explores interest rates, profitability, competition and liquidity and how these factors affect the financial performance of insurance companies in Kenya.

#### **2.2 Global insurance industry**

The insurance industry forms an integral part of the global financial market, with insurance companies being significant institutional investors. In recent decades, the insurance sector, like other financial services, has grown in economic importance. This growth can be attributed to a number of factors including, but not exclusively: Rising income and demand for insurance, Rising insurance sector employment, and increasing financial intermediary services for policyholders, particularly in the pension business (Ward and Zurbruegg, 2002). Expanding on the link between GDP and insurance market development, it must be remembered that the insurance industry's primary function is to supply individuals and businesses with coverage against specified contingencies, by redistributing losses among the pool of policyholders. Insurance companies, therefore, engage in underwriting, managing, and financing risks.

### **2.3 Theoretical Framework**

The concept of finance theories involves studying the various ways by which businesses and individuals raise money, as well as how money is allocated to projects while considering the risk factors associated with them. It also includes the study of money and other assets, managing and profiling project risks, control and management of assets, and the science of managing money (Eckardt, 2007). This study was guided by Rational Choice Theory. This theory is used to understand the social and economic behaviours of the individuals. The application of the term rationality varies with the subject. Many other theories are concerned about the mechanism of the market that enables the production and distribution of goods. But the Rational Choice Theory is extensively used in applying the same principles that are used by other theories to understand interactions that include resources like prestige, time and many more.

According to the Rational Choice Theory, human beings are prompted by their own goals and preferences (Eckardt, 2007). Human actions are regulated primarily by the information regarding the conditions under which a particular individual is going to work and would try to achieve his or her goal. It is almost impossible for the human beings to get whatever they desire for. Choice of goals along with the selection of a proper method to reach the previously set target is very important in the domain of Rational Choice Theory. According to the Rational Choice Theory, an individual should have a proper understanding of his or her own selection of goals and the consequences of that selection.

Rational people always choose only those options that can offer good results. According to the Rational Choice Theory, each and every kind of social contact or social interaction is treated as a method of social exchange. It considers reward and punishment as benefit and cost respectively and the theory holds that the human action is dominated by their desires of getting good rewards (Organisation for Economic Co-operation and Development, 2003).

This theory can be applied in the insurance industry. Individuals take policies in order to be protected in case of risks. However, in order to get benefits from insurance, they must have the right policies with the right companies. The rational choice for companies is pegged on several factors like the financial performance of the insurance company. Most individuals would not buy policies if they knew that their prospective company is going bankrupt because in case of a risk, they would not get the benefits out of the policies. They would therefore choose an insurance company which is performing well financially because only then do they stand a chance of being compensated for their losses.

### **2.3.1 Interest Rate**

An interest rate is the cost of borrowing money (Hoyt, 1994). Since insurance companies make their promises or commitments to insurants at the time of the sale of policies to the latter, they are not free to adjust the rates fixed or agreed in the sale subsequently depending on circumstance. This feature of insurance exposes them directly to the risks associated with changes in interest rates. Insurance companies invest much of the collected premiums, so the income generated through investing activities is highly



dependent on interest rates. Declining interest rates usually equate to slower investment income growth impacting on the insurance company's financial performance (Staking & Babbel, 1995). Another downside to interest rate fluctuations (not exclusive to insurance companies) is the cost of borrowing.

However, Schich (2008) contends that insurance companies may also benefit from rising interest rates, because much of their profit is earned on the float, the period between when premiums are collected and claims paid out. During this time, insurers invest the premium. Rising interest rates imply a higher return on bonds, one kind of investment, although higher rates lower the value of bonds currently in their portfolio. Large home insurers benefit more than do smaller auto insurers.

It is argued that a continuing decline in market interest rates tends to make it more difficult for insurance companies to provide high interest rates for their customers or insureds and-as a result-to maintain hence high levels of profitability. This proposition was tested in Taiwan over a period of declining market interest rates for insurance companies. Flannery's (1981) model (quoted in Yang, 2007) was used to examine the relations between changes in market interest rate and the profitability of 12 domestic insurance companies. The results suggest that the effects of changes in interest rates on insurance company profitability depend on how profits are measured, that it differs depending on the profit indicator that is employed. This result is not apparent, with there being no obvious influence of interest rates on profitability, if the entire insurance sector is considered as a whole.

Yang (2007) argues that the extent of the fluctuations in interest rates does not have an obvious impact on the income, cost, operating profit, or the assets return rate, net return rate, operating profit margin, operating profit rate and net profit rate of the 12 sample insurance companies, except in the case of the profitability indices for Cathay Life, Central Insurance and First Insurance. This may have something to do with the length of observation. When market interest rate fluctuations are taken into account, three of the effects examined, those for insurance companies' profits on new assets, and two of the effects, those for insurance companies' cost of liabilities, become significant, suggesting that in these cases at least market interest rates may have an influence on the profits on new assets of the insurance companies. Moreover, in the case of nine insurance companies in the sample profits on new assets were higher than the cost of new liabilities, suggesting that in these companies at least profits on new assets increase relatively rapidly, bringing about a gradual increase on operating net profits to the insurance companies concerned.

In a study of the relation between insurance market conditions and insolvencies, A. M. Best(1992) found that the number of insolvencies is correlated with the accident and health underwriting cycle (lagged one to three years). The increased number of insolvencies also is correlated with increases in interest rates and the life-health insurance industry's focus on investment-related products. The Best study did not examine the various economic factors in a multivariate framework, thus precluding the ability to identify the relative significance of the individual factors.

Changes in interest rates have a direct impact on the value of insurers. As interest rates decline, the value of bonds in an insurer's portfolio rises, and vice versa. Staking and Babbel (1995) note that one way insurers incur risk with their financial portfolio is by holding assets with a longer duration than their liabilities. This mismatch creates an interest rate risk since the magnitude of the change in the value of assets will be greater than that of liabilities when interest rates move. When interest rates decrease, insurers with this duration mismatch experience an increase in surplus. On the other hand, an increase in interest rates leads to a larger decline in the value of assets than liabilities, and thus a decrease in surplus. Young (1996) document a positive asset/liability maturity mismatch for the majority of life insurers in their sample. The asset/liability mismatch results in increased leverage and a greater risk of poor performance for the insurer (Carson and Hoyt, 1995). Changes in interest rates are expected to be negatively related to insurer performance.

### **2.3.2 Profitability**

As with any company, profitability is a key determinant for deciding whether to invest. For an insurance company, there are two components of profits that we must consider: premium/underwriting income and investment income (Santomero&Babbel, 1997). Underwriting income is just that: any revenue derived from issuing insurance policies. By averaging the premium's growth rates of several past years, you can determine the growth trends. Growing premium income is a "catch 22" for insurance companies. Ideally, you want the growth rate to exceed the industry average, but you want to be sure that this higher growth does not come at the expense of accepting higher-

risk clients. Conversely, a company whose premium income is growing at a slower rate might be too picky, looking for only the highest quality insurance opportunities. The one thing to remember is that higher premium collections do not equate to higher profits. Lower numbers of claims (via low risk clients) contribute more to the bottom line.

Santomero and Babbel (1997) contend that the second area of profitability that should be included in the analysis is investment income. As mentioned earlier, a greater proportion of an insurer's income comes from investments. To evaluate this area, take a look at the company's asset allocation strategy (usually mentioned in the notes of the financial statements). A majority of the assets should be invested in low-risk bonds, equities or money market securities. Some insurers invest a substantial portion of their assets in real estate. If this is so, take a look at what type of property it is and where it is located. A building in Nairobi may be more liquid than one in Marsabit.

$$\text{Return on Assets (ROA):} \quad \frac{\text{Net Income} + \text{Interest Expense}}{\text{Total Assets}}$$

ROA indicates the return a company is generating on the firm's investments/assets. In general, a life insurer should have an ROA that falls in the 0.5-1% range.

$$\text{Return on Equity (ROE):} \quad \frac{\text{Net Income}}{\text{Shareholder's Equity}}$$

ROE indicates the return a company is generating on the owners' investments. In the policyholder owned case, you would use policy holders' surpluses as the denominator. As a general rule for insurance companies, ROE should lie between 10-15%.

Lapse Ratio:  $\frac{\text{Lapsed Life Insurance Specified Period}}{\text{Contracts in Force (in effect) at Start of Specified Period}}$

Contracts in Force (in effect) at Start of Specified Period

This ratio compares the number of policies that have lapsed (expired) within a specified period of time to those in force at the start of that same period. It is a ratio used to measure the effectiveness of an insurer's marketing strategy. A lower lapse ratio is better, particularly because insurance companies pay high commissions to brokers and agents that refer new clients. ROA, ROE, and the lapse ratios (discussed above) are also useful for evaluating the profitability of the insurer. In order to determine whether management has been increasing return for shareholders, the ROA and ROE numbers over the past several years should be calculated. The lapse ratio will help to tell whether the company has managed to keep marketing expenses under control. The more policies that remain in force (are not cancelled), the better

These views are supported by Hagel, Brown and Davison (2010) who proposed that most economic analysts and investors tend to focus on return on equity as their primary measure of company performance. ROE focuses on return to the shareholders of the company. If you are a shareholder, this gives you a quick and easy to understand metric. However, they argued that ROE can obscure a lot of potential problems. If investors are

not careful, it can divert attention from business fundamentals and lead to spiteful surprises. Companies can resort to financial strategies to artificially maintain a healthy ROE — for a while — and hide deteriorating performance in business fundamentals. Growing debt leverage and stock buybacks funded through accumulated cash can help to maintain a company's ROE even though operational profitability is eroding. Mounting competitive pressure combined with artificially low interest rates, characteristic of the last couple of decades, creates a potent incentive to engage in these strategies to keep investors happy. Excessive debt leverage becomes a significant albatross for a company when market demand for its products heads south, as many companies discovered during the current economic downturn. It actually creates more risk for a company in hard times.

These efforts can become addictive. If underlying profitability continues to deteriorate, more stock buybacks or debt leverage will be necessary to maintain return on equity, further increasing company exposure to unanticipated downturns in consumer demand or financial market crises. But letting ROE decline is often too painful to contemplate since the impact on stock performance hence financial performance can be immediate. The risks on the other side are less immediate and less quantifiable, so there is an understandable temptation to avoid immediate pain (Hagel, Brown & Davison, 2010).

### **2.3.3 Competition**

One of the most significant trends in the insurance industry is the prevalence of mergers and acquisitions among insurance carriers and agencies (Schich & Kikuchi, 2004). Due to strong investment returns, record profits have allowed many carriers to amass substantial

"war chests" earmarked for acquisition. As a result, the large insurance companies are getting larger and smaller agencies are being forced to band together in "clusters." In addition, networks have become more competitive in an effort to improve their bargaining position with carriers whose demands for profitable premium growth have steadily increased. All of these have a major impact on consumers.

Over time economists have approached the measurement of competition in industries in a variety of ways. The earliest studies attempted to infer the competitive conduct and performance of firms from the market structure of the industry. This approach is mainly associated with Bain (1956) quoted in Hochhauser (2004). The number of firms and any concentration of market share are believed to determine the competitive conduct. Fewer firms with more concentrated market shares are more likely to engage in anti-competitive behaviour than when the industry is populated by numerous small firms. Alternatively, a small number of large companies may form a cartel and dictate prices and conditions. Furthermore, one or two dominant firms may act as price setters while the many smaller peripheral firms accept the former's price leadership. This structure-conduct-performance approach provides regulators with a convenient yardstick, when they rule on the competitive impact of mergers.

Blundell-Wignall, Atkinson and Lee (2008) proposed an alternative approach to competitive behaviour and examined the revenue and cost structures of companies, using the framework of perfect competition as the reference position. Firms in an industry operating under conditions of perfect competition are unable to absorb any of the cost

increase. They are forced to pass on the entire rise of input costs in output prices and revenue, leaving output unaffected. Of course, not all firms survive. By contrast, under monopolistic conditions in equilibrium, a rise in input prices, such as wages or administrative costs, results in a reduction in output and a rise in prices by a smaller amount than the increase in costs, leading to a shrinking of total revenue. Marginally profitable firms may have to leave the industry.

A group of firms offers a range of insurance products. By differentiating their products they are able to create downward sloping demand curve segments for their insurance products through advertising and other selling costs. The many competitors allow each firm to believe that its actions will not prompt retaliatory actions. Entry into the industry is relatively easy and collusion such as price fixing or market sharing virtually impossible (Brigham & Philip, 2004). Under monopolistic competition in long-run equilibrium output is determined where the average cost curve is tangential to the average revenue curve. Companies do not make economic profits since long-run average cost equals price. Since firms produce at less than minimum cost, the theory of monopolistic competition suggests that the industry is operating under excess capacity. As a result more firms exist than if production occurred at the average cost minimum. The market becomes overcrowded. If production occurred at the long-run cost minimum, the return on assets would, of course, be higher.

According to Donlon and Gutfreund (1998) firms in this industry generate revenue through underwriting of insurance risks and from investing their assets. Market pressure



appears to force companies to employ similar investment strategies enabling them to match competitors' investment yields. As they record consistently underwriting losses, that is, premium income falls short of claims payments and expenses, there is considerable pressure on companies to generate satisfactory investment returns. Finance theory suggests that a higher return from a given amount of available funds may only be had by investing in riskier assets. This implies that firms in the GI industry have to take greater risk than would seem to be compatible with prudence, considering their underwriting losses. Applied to the problem at hand this means that firms can only recoup rising costs in investment markets by reshuffling their portfolios towards more risky assets and thus reap higher returns. The asset risk materializes in the form of market and credit risks (O'Connor, 2000).

#### **2.3.4 Liquidity**

Black, Wright and Bachman (1998) define liquidity ratios as the amount of money that companies and other private entities have on hand at any time available to pay their debt. When looking at any company's financial statements and attempting to understand where it stands as regards to its viability, liquidity ratios are quite important. The higher a company's liquidity ratio, the healthier it is. Entities with high debt and low liquidity are more likely to fail and riskier investments. Liquidity risk could include two different types of risk: the risk that an insurance company will become unable to assure itself of adequate funding due to a decline in new premium income caused by a deterioration, etc. of its financial position, an increase in surrender value caused by large-lot cancellations, or an outflow of funds caused by a big disaster, or it will incur losses because it is forced

to sell assets at markedly lower prices than normal and therefore unable to maintain cash flow (capital liquidity risk), and the risk that upheavals, etc. in the market will render it impossible to trade and therefore force the company to engage in transactions at prices that are markedly more disadvantageous than normal (market liquidity risk) (Black, Wright & Bachman, 1998).

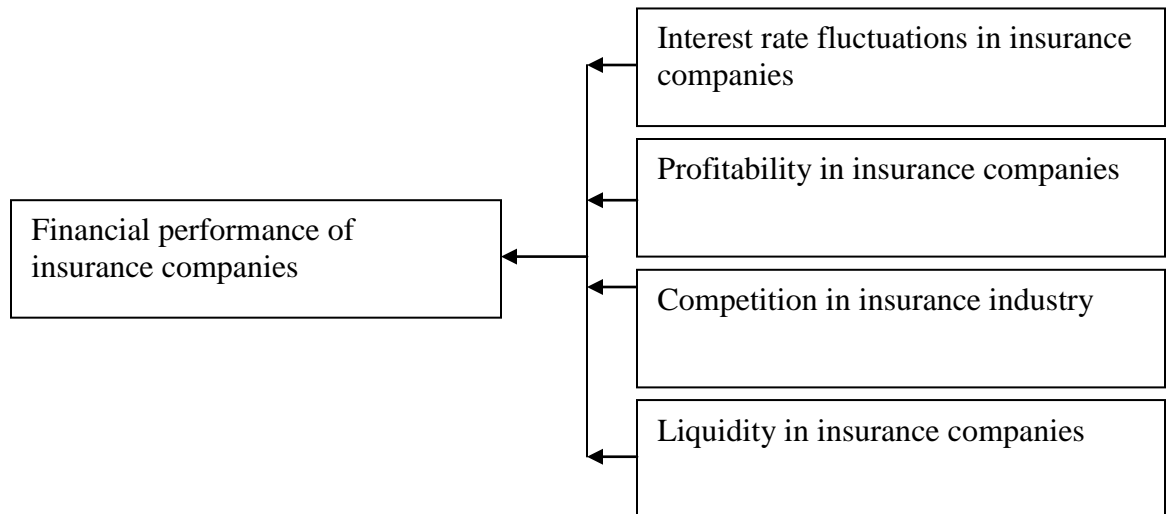
According to Barney (1997) the first test of an insurer's ability to meet financial obligations is the acid test. It tests whether a firm has enough short-term assets (without selling inventory) to cover its immediate liabilities. Poor liquidity causes investment losses and hence poor financial performance when the insurer must sell assets prematurely to cover claims. An insurer should almost always have a positive cash flow. Cash flow is crucial to an entity's survival. Having ample cash on hand will ensure that creditors, employees and others can be paid on time. If a business or person does not have enough cash to support its operations, it is said to be insolvent, and a likely candidate for bankruptcy should the insolvency continue. Other things to keep an eye on are the investment grades of the company's bond portfolio. Too many high and medium risk bonds could lead to instability hence poor financial health.

## 2.4 Conceptual framework

The study is conceptualised as follows

### Dependent variable

### Independent variables



Source: Researcher, 2012

## 2.5 Empirical studies

Sigma (2001) contends that the largest insurance sectors are to be found in the United States and Japan, which together generate more than 50 percent of global premium income, followed by the United Kingdom, Germany, France, and Italy. Furthermore, during the last four decades the global insurance sector has on average outpaced global economic growth. Between 1984 and 2001, the global insurance industry grew with an annual growth rate of 9.7 percent (roughly comprised of 11.8 percent from the life insurance sector, and 7.5 percent from the property–casualty sector). Over the last few years, growth in the global property–casualty market has significantly slowed down and has only grown in line with general economic growth (Sigma, 2001). This development is mainly due to the sustained downward trend in commercial business experienced until

recently, the economic and financial crisis in Asia, particularly in Japan, and the deregulation of the European market resulting in appreciable price decreases. This is in contrast to the life insurance sector, which has continued to grow at around 5.4 percent across the world since 2000. The increase in the life insurance business is mainly attributable to the increased demand for private pension provisions in the United States and Western Europe and the soaring demand for unit-linked products. Measured in total premiums, OECD countries accounted for 95.52 percent and 93.99 percent of the life insurance business, and 91.19 percent and 92.50 percent of property– casualty premium volume in 1994 and 2001, respectively.

A more recent development has been the strengthening of global market share among emerging economies, with premium growth rates inside such economies often reaching double-digit figures. Furthermore, insurance markets within the OECD countries have faced falling premium income, reduced capital market yields, and low interest rates, all of which have put insurers under some pressure (Sigma, 2002). Also, the growing importance of the insurance industry in emerging markets is reflected in growing insurance density and insurance penetration of the non-OECD insurance markets (Sigma, 1996, 2001). Nevertheless, emerging markets still have some way to go before matching the relative sizes and importance that the insurance industry has in industrialized countries.

A comprehensive policy that is effectively implemented enables the financial institutions to maintain sound credit underwriting standards; assess, monitor and control credit risks;

properly evaluate new business opportunities and identify administer and collect problem credits (Baldoni, 2008).

The credit policy should specify credit risk philosophy governing the extent to which institution is willing to accept credit risk; levels of authority should be subject to timely review to ensure that it remains appropriate to current market conditions and expertise of credit officers. A credit policy should be drawn up to give consistency to process and procedures. The policy should be communicated to all those involved with customer terms and payments including sales agents so that they can set the correct expectations with customers. An effective credit control policy should deal with mechanisms for approving credit for new customers, mechanisms for approving credit ratings and terms for new customers and procedures for taking against customers and procedures where premium due is not paid.

Credit policies should also incorporate criteria to allow business to determine the conditions of sale to be issued to customer. Business may require to devise different conditions of sale to be issued depending on the risk involved with offering the customer credit payment terms and conditions, interest payable to be applied to accounts which become overdue, details of any cash discounts, details of assessing which credit ratings should apply to customers details of when accounts will be frozen and recovery action taken thereafter details of the stage of which legal action should be raised against the debtor, whether or not credit data from external sources should be investigated and whether credit insurance should be taken out.

## **2.6 Conclusion**

The study investigated the factors influencing the financial performance of insurance companies. While there are many factors which influence the financial performance of insurance companies, this study was delimited to four factors; interest rate fluctuations, profitability, competition and liquidity.

Past studies show that interest rate changes affects insurance companies financial performance both ways. Yang (2007); Staking and Babbel (1995); A. M. Best (1992); Young (1996) and Carson and Hoyt (1995) claimed that changes in interest rates affect the insurance companies negatively. However, Schich (2008) found out that fluctuations in interest rates could have a positive effect on the financial performance of insurance companies.

In relation to profitability, Santomero and Babbel (1997) and Hagel, Brown and Davison (2010) found a positive relationship between insurance companies' profitability and their financial performance. Competition was also found to affect the financial performance of insurance by Schich and Kikuchi (2004); Hochhauser (2004); Blundell-Wignall, Atkinson and Lee (2008); Brigham and Phillip (2004) and Danlon and Gutfreund (1998).

In relation to liquidity, Barney (1997) and Black, Wright and Bachman (1998) found a positive relationship between liquidity and the financial performance of insurance companies. The past studies are not consistent; consequently, this study will reconcile them as well as establish the extent to which these factors influence the financial

performance of insurance companies in Kenya. The study will also expound on the local studies done by people like Maina (2003) Karuiru (2005) to cover other factors which could be affecting the financial performance of insurance companies.

## **CHAPTER THREE**

### **RESEARCH DESIGN AND METHODOLOGY**

#### **3.1 Introduction**

This chapter deals with the research methodology in the study. This includes the research design, target population, sampling, data collection, and data analysis.

#### **3.2 Research Design**

This study was conducted using a descriptive survey design. The survey is a non-experimental, descriptive research method. It is the collection of information from a common group through interviews or the application of questionnaires to a representative sample of that group. This design was preferred because very large samples are feasible, making the results statistically significant even when analyzing multiple variables. Surveys are useful in describing the characteristics of a large population. Additionally, high reliability is easy to obtain by presenting all subjects with a standardized stimulus which ensures that observer subjectivity is greatly eliminated (Mugenda&Mugenda, 1999).

#### **3.3 Target population**

The target population for this study comprised the 46 insurance companies in Kenya (Appendix III). The respondents were the top level management of these companies.



### **3.4 Sample Size**

Sampling is the process of selection of appropriate number of subjects from a defined population (Kothari, 2008). This study used systematic random sampling method. Mugenda and Mugenda (1999) contend that a 10% sample can be used to represent a population. However, they argued that the bigger the sample, the more representative of the population it is. In this case, 50% of the insurance companies were selected and it is from these that the respondents were drawn. From each insurance company, two top management and three lower level managers were randomly selected. This gave a total of 115 respondents.

### **3.5 Data Collection**

The study used questionnaires as the tool for data collection. A questionnaire is a research instrument consisting of a series of questions and other prompts for the purpose of gathering information from respondents (Mugenda&Mugenda, 1999). The researcher opted for the questionnaire because the responses are gathered in a standardised way, so questionnaires are more objective compared to other tools of data collection. It is also relatively quick to collect information using a questionnaire. Additionally, potential information can be collected from a large portion of a group (Kothari, 2008). The questionnaires were administered to the respondents through drop and pick method. The filled questionnaires were picked four days after. The drop and pick approach was considered an appropriate method for the study because it gave the respondents time to fill the questionnaire and allowed the researcher an opportunity to review the questionnaires before picking them to ensure completeness of responses. Secondary data

on the performance of insurance companies was collected over a period of five years from the audited annual reports and accounts of the concerned insurance company in order to provide a good period for analysis.

### **3.6 Data Analysis**

The questionnaires were checked for completeness in preparation for analysis. The simplest way to present information according to Ngechu (2006) is in descriptive statistics. Data was appropriately coded for ease of use with Statistical Package for Social Sciences (SPSS). Using the SPSS program can give such descriptive statistics and therefore the program is much appropriate for the analysis. Descriptive statistics enabled the researcher to meaningfully describe a distribution of scores or measurements using a few indices or statistics (Kothari, 2008). The qualitative data was analysed through content analysis. Each research question has quantitative and qualitative data. For the quantitative data, the responses were coded, tallied and their frequencies and percentages identified. For the qualitative data, similar responses were coded and tallied after which deductions were made. In determining the factors, the study will use factor analysis method.

Model,  $Y = f(C+L+P+I)$

Where;

Y=Financial performance

C=Competition

L=Liquidity

P=Profitability

I=Interest rate

## CHAPTER FOUR

### DATA ANALYSIS, INTERPRETATION AND PRESENTATION

#### 4.1 Introduction

This chapter presents data analysis, interpretation and the presentation. These are based on the objectives of the study.

#### 4.2 Questionnaire Return Rate

Out of the 115 respondents who were given the questionnaires, 106 returned completely filled questionnaires. This gave a 92.2% response rate.

#### 4.3 Interest rate fluctuations and their effect on insurance company

In order to fulfil this objective, several items were used as discussed in the following paragraphs

##### 4.3.1 Effect of changes in interest rates on the financial performance of the company

This item sought to get information on how the changes in interest rates affect the financial performance of the insurance company. The participants responded as shown in Table 4.1

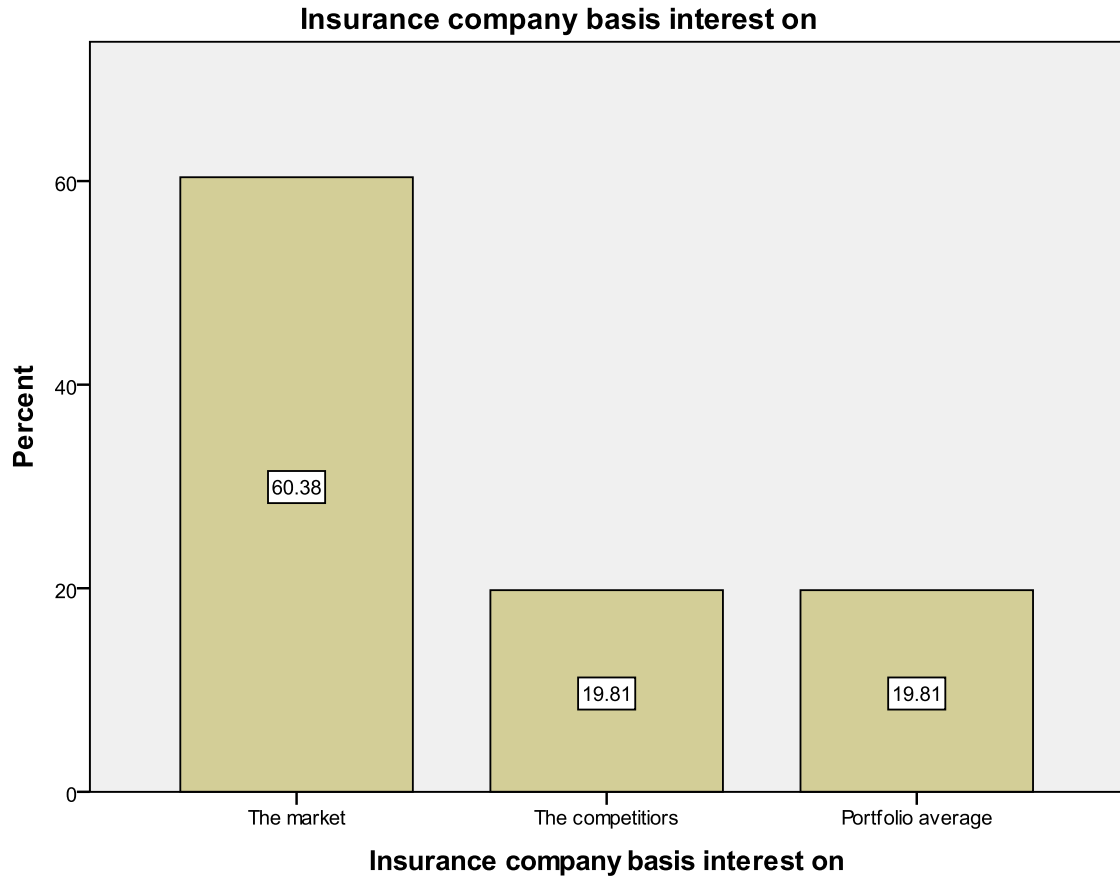
**Table 4.1**Effect of changes in interest rates on financial performance of the company

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Positive	63	59.4	59.4
Negative	43	40.6	100.0
<b>Total</b>	<b>106</b>	<b>100.0</b>	

As indicated in Table 4.1, majority of the participants reported that changes in interest rates affect the financial performance of the insurance companies positively. This is mainly because low interest rates on borrowing enable insurers to borrow and invest more in higher risk areas thus improving their investments and financial performance. The respondents who said that changes in interest rates have a negative effect on the financial performance of the insurance companies said that high interest rates affect the insurance companies' ability to borrow and invest. However, high interest rates increase the return on investments for example; rising interest rates imply a higher return on bonds, one kind of investment, although higher rates lower the value of bonds currently in their portfolio. These findings therefore imply that fluctuations in interest affect the financial performance of insurance companies both ways.

#### **4.3.2 What the company bases interest on**

The participants were asked what their insurance companies base their interest on. They responded as indicated in Figure 4.1

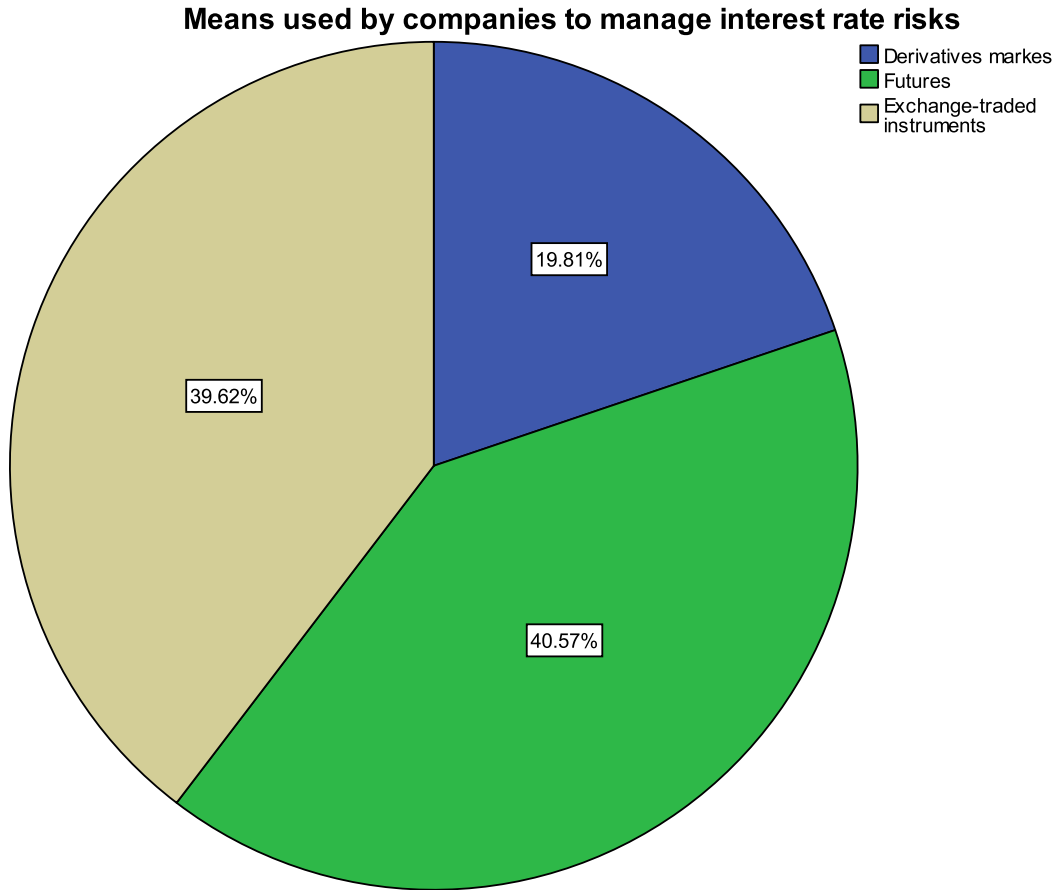


**Figure 4.1 What the company bases interest on**

As evidenced in Figure 4.1 most of the companies (60.4%) based interest on the market. This implies that since the market keeps on changing, the interest rates are also likely to keep on changing. On the other hand, when the interest rates change, rate of return on investments change also and this can affect the financial performance of the insurance firms either positively or negatively depending on whether the interest rates go high or low.

#### **4.3.3 Means of managing interest rate risks**

This item sought for information on the means that companies use in an effort to manage interest rate risks. The participants responded as shown in Figure 4.2



**Figure 4.2 Means of managing interest rate risks**

As indicated in Figure 4.2, majority of the respondents (40.6%) reported that their insurance companies used futures to manage interest rate risks. The other 39.6% used exchange traded instruments while 19.8% used derivatives markets. This implies that all insurance companies are aware of the risks which come as a result of fluctuations in interest rates. That is why they have ways of managing such risks. This is all because interest rates can affect the financial performance of a company.

#### **4.3.4 Measures used by companies to profit from changes in interest rates**

When asked the kind of measures that the insurance companies use in order to profit from changes in interest rates, the participants reported that companies diversify their investment portfolio through buying bonds, investing in property, equity, shares as well as increasing their borrowed capital when rates fall. All these measures are done to improve the financial performance of the insurance companies.

#### **4.3.5 Extent to which fluctuations in interest rates affect the financial performance of insurance companies**

In response to the extent to which fluctuations in interest rates affect the financial performance of insurance companies, the participants' responses were as indicated in Table 4.2

**Table 4.2 Extent to which fluctuations in interest rates affect the financial performance of insurance companies**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Great extent	63	59.4	59.4
Moderate extent	43	40.6	100.0
<b>Total</b>	<b>106</b>	<b>100.0</b>	

According to Table 4.2, majority of the respondents (59.4%) were of the opinion that fluctuations in interest rates affect the financial performance of insurance companies. No respondent indicated that changes in interest rates had no effect on the performance of insurance companies. This means if the interest rates increase, insurance companies may decline investments as they try to cut their costs. This would make their financial performance decrease. On the other hand, decrease in interest rates may promote the rate

of borrowing as well as investments thus improving the financial performance of insurance companies.

#### **4.4 Profitability and its effect on insurance companies' financial performance**

In order to meet this objective, several items were used as discussed in the following paragraphs.

##### **4.4.1 Total valuation of assets owned by the insurance companies**

This item sought for information on the total valuation of assets owned by the insurance companies in an effort to gauge their financial performance. The participants' responses are summarised in Table 4.3

**Table 4.3 Total valuation of assets owned by the insurance companies**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Below 10 billion	43	40.6	40.6
10 - 60 billion	21	19.8	60.4
60 - 90 billion	42	39.6	100.0
<b>Total</b>	<b>106</b>	<b>100.0</b>	

Most of the respondents (40.6%) as referenced in Table 4.3 indicated that the value of their assets is below 10 billion followed by 39.6% who reported that their companies are worth between 60 and 90 billion shillings in term of assets while the other 19.8% indicated that their companies has assets worth between 10 and 60 billion shillings. The more assets an insurer has, the better they are financially because if the underwriting income is low, the insurer can rely on the investment income to settle large claims.



#### 4.4.2 Total valuation of liabilities in the company

Regarding the liabilities that the insurance companies have, the participants responded as shown in Figure 4.4



**Figure 4.3**Total valuations of liabilities in the company

As shown in Figure 4.3, most respondents (60.4%) indicated that their insurance firms have liabilities worth less than 10 billion while the other 39.6% said that the liabilities in their insurance companies are worth between 10 and 60 billion. This implies that most companies have more assets than liabilities. However, more liabilities places the insurer at a risky position financially especially if they are needed to settle major claims.

#### **4.4.3 Whether the company has performance indicators to gauge business**

On being asked whether their insurance companies have performance indicators for gauging business, 60.4% said yes while the other 39.6% said no. For the companies whose respondents reported that they have performance indicators, they said that they mainly use KPI's, targets, benchmarking, claims, operational costs, new businesses, return on investment and profits. This is an indication that most insurance companies are aware of the way they are performing financially hence they can take appropriate measures when their financial performance goes down. For the insurance companies with no performance indicators, it is difficult to know when they are performing well or poorly. The implication is that they may not know when it is necessary to make drastic financial decisions depending on the market. This can have a negative effect on the financial performance of the insurance companies.

#### **4.4.4 Trend of profitability in the company in the last one financial year**

On the trend of profitability in the company in the last one financial year, all the respondents indicated that it has been on the increase. This could be because the economy in the country is also growing. The participants were asked whether their insurance companies have any specific investment preference. All of them said that they do. The most preferred investment was real estate and mortgage industry. These companies try to avoid investing in the stock market mainly because of the uncontrolled return trends. The findings show that the insurance companies mind their profitability by investing in the viable ventures while avoiding the too risky ones. This is evidence that profitability affects the financial performance of the insurance companies.

#### **4.4.5 Extent to which company profitability affects its financial performance**

This item sought for information to gauge the extent to which company profitability affects its financial performance. The responses are summarised in Table 4.4

**Table 4.4 Extent to which company profitability affects its financial performance**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Great extent	84	79.2	79.2
Moderate extent	22	20.8	100.0
<b>Total</b>	<b>106</b>	<b>100.0</b>	

According to Table 4.4, 79.2% of the respondents were of the opinion that company profitability affects its financial performance to a great extent. The other 20.8% reported that it affects company's financial performance to a moderate extent. This is an indication that company's profitability has an effect on the financial performance of the said company.

#### **4.5 Competition and its effects on insurance company's financial performance**

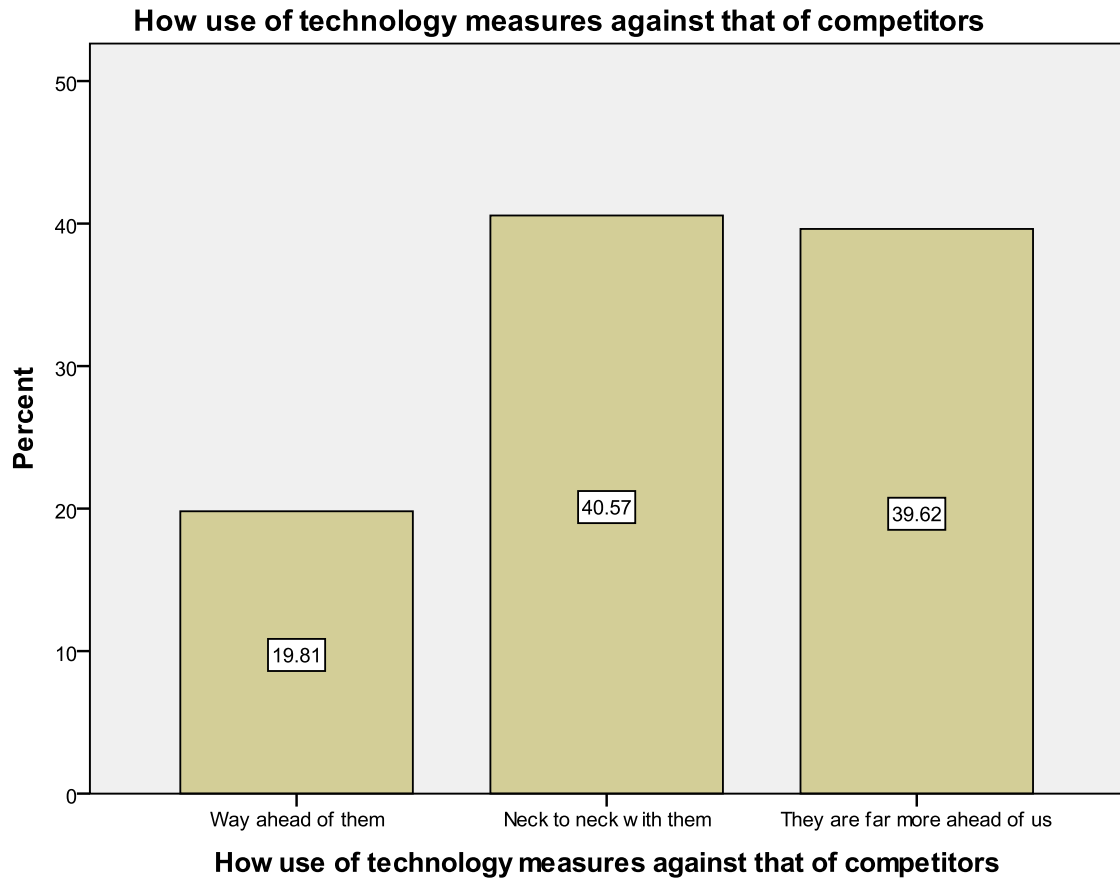
In order to fulfil this objective, the study used several items as discussed in the following paragraphs.

##### **4.5.1 Knowledge on current activities about the competitors**

All the respondents indicated that they have knowledge on the current activities about the competitors. With knowledge of competitors' current activities, insurers can take measures to match up or improve their products and services beyond their competitors in order to gain a competitive edge.

#### 4.5.2 Measure of technology against that of competitors

On being asked how the company's technology measures against that of the competitors, the participants responded as shown in Figure 4.4



**Figure 4.4** Measure of technology against that of competitors

According to Figure 4.4, 40.6% of the respondents reported that the technology in their insurance is neck to neck with that of their competitors while 19.8% said they are ahead of competition in terms of technology. The other 39.6% admitted that the competition is ahead of them technology-wise. Being ahead of competition gives an insurer a competitive edge and this would be the aim of most insurers because they are in business to make money. However, being behind in technology can make an insurer lose

customers especially the ones who prefer the convenience that comes with the use of technology.

#### **4.5.3 Ways of ensuring that the company has the necessary market intelligence**

The respondents were asked to indicate what their organization does in order to have the necessary market intelligence for gauging competition. They responded as shown in Table 4.5

**Table 4.5 Ways of ensuring that the company has the necessary market intelligence**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Market research	42	39.6	39.6
Competitor's advertisement	42	39.6	79.2
Others	22	20.8	100.0
<b>Total</b>	<b>106</b>	<b>100.0</b>	

As shown in Table 4.5, 39.6% of the respondents reported that the insurance companies use market research while another 39.5% said they use competitor's advertisement. The other 20.8% use customers' feedback. This implies that insurers are aware that competition can reduce their market share hence their financial performance and that is why they get ways of gauging competition.

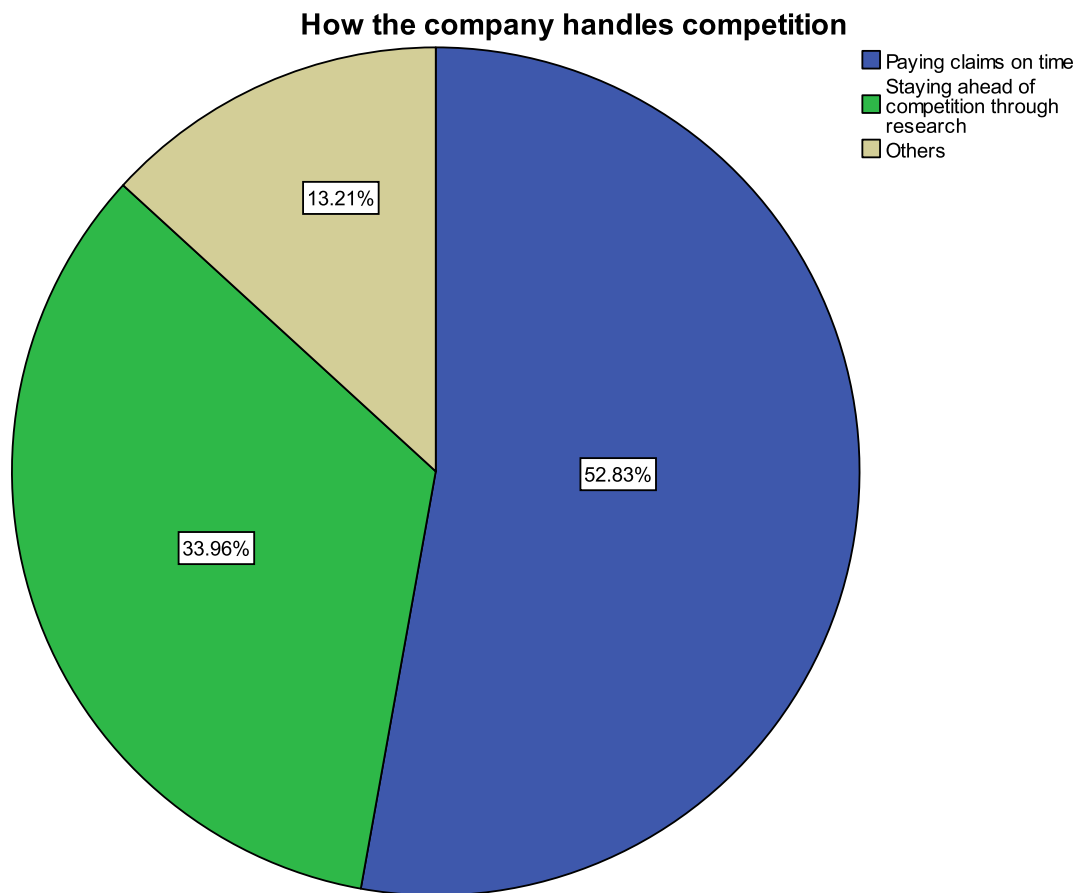
#### **4.5.4 Whether the company encourages clients to give them feedback**

On whether the company encourages clients to give them feedback regarding the quality, price, packaging or placement of their products or services, all the respondents said yes. The companies achieve this through maintaining complaints and compliment registers while others have a customer experience unit that embark on gauging the satisfaction their clients receive. Other insurance firms organize agents for forums on the same. This

is an indication that the insurance companies care about their customers and they try to keep them coming back by ensuring that they are satisfied. This is a way of staying ahead of competition hence improving financial performance.

#### 4.5.5 Ways in which companies handle competition

On how the companies handle competition, the participants responded as shown in Figure 4.5



**Figure 4.5 Ways in which companies handle competition**

As shown in Figure 4.5 most of the companies (52.8%) handle competition through paying claims on time, 34.0% do research in order to stay ahead of competition while 13.2% use innovation to come up with products that are in tandem with the clients'

needs. This is an indication that all the insurance firms are aware that there is competition and each uses different ways to stay ahead. This means that competition can affect the financial performance of an insurance firm and that is why the insurers take measures to stay ahead of competition.

#### **4.5.6 Whether the company has an edge on competition**

This item sought for information on whether the company has an edge on completion.

The responses are summarised in Table 4.6

**Table 4.6 Whether the company has an edge over competition**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Yes	84	79.2	79.2
Somewhat	22	20.8	100.0
<b>Total</b>	<b>106</b>	<b>100.0</b>	

When asked whether the insurance company has an edge on competition, 79.2% of the respondents said yes while the other 20.8% said no. For the ones who said that they have an edge on competition, they said that from the IRA and AKI reports, their market share has continued to increase thus increasing their profits. Others said that their company has a strong financial standing and a good claims paying experience. Others have efficient and customer-friendly services. For the ones with no edge on competition, they explained that they are yet to enhance their products. Having an edge on competition may improve an insurer's financial performance because they become more preferred by clients.

#### **4.5.7 Opinions regarding competition**

This item sought for the respondents' opinions regarding issues on competition. They responded as shown in Table 4.7

**Table 4.7 Opinions regarding competition**

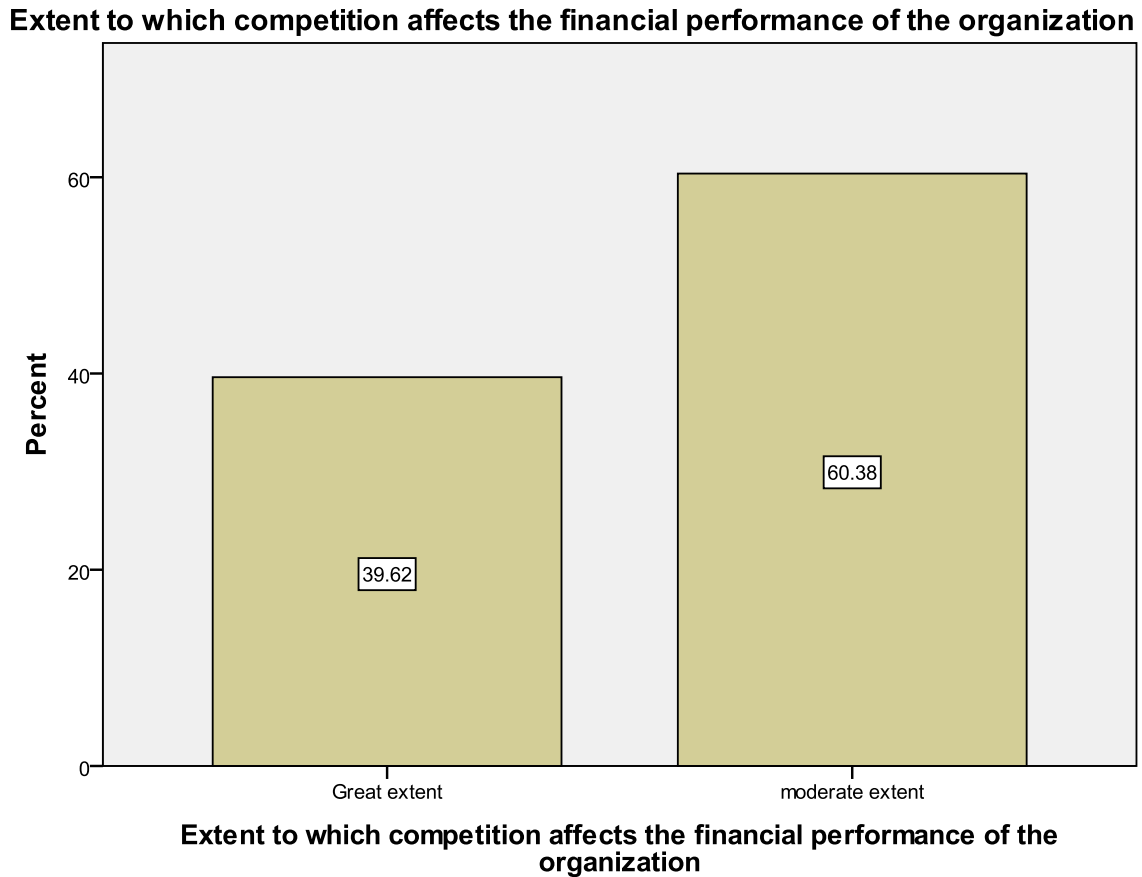
<b>Statement</b>	<b>Agreed</b>	<b>Disagreed</b>	<b>Total</b>
Business environment supports company's survival	100%	0	100%
The demand for our products will be high	100%	0	100%
Profit margin increase is very high	40.6%	59.4%	100%
The competition is intense related to the prices	100%	0	100%
Competition is intense related to quality of products	19.8%	80.2%	100%
The competition is intense related to the innovation	59.4%	40.6%	100%

According to Table 4.7, all the respondents agreed that the business environment supports their company's survival, the demand for their products will be high and the competition is intense related to the prices. While 40.6% agreed that profit margin increase is very high, 59.4% refuted. On whether the competition is intense related to quality of products, 19.8% agreed while 80.2% disagreed. On whether the competition is intense related to the innovation embedded in new products, 59.4% agreed while 40.6% disagreed. These findings show that the main areas in which the insurance companies are affected by the competition are prices and innovation in new productions. The findings also imply that the competition eats up into the market of the insurance companies reducing their profit margin.

#### **4.5.8 Extent to which competition affects financial performance the organization**



In relation to the extent to which competition affect the financial performance of the insurance companies, the participants responded as shown in Figure 4.6



**Figure 4.6 Competition affects financial performance of the organization**

According to the findings shown in Figure 4.6, competition affects the financial performance of organization to a great extent (39.5%) and to a moderate extent (60.4%). No respondent indicated that competition has no effect on the financial performance of insurance firms. This shows that competition plays a role in determining how an organization performs financially. This is especially through the prices and innovation in new products.

#### **4.6 Liquidity and its effects on insurance companies' financial performance**

In an attempt to fulfil this objective, the study used different items as discussed in the following paragraphs.

#### **4.6.1 Liquidity of the company's investments**

This item sought for information on how liquid the company's investments were. The participants responded as shown below

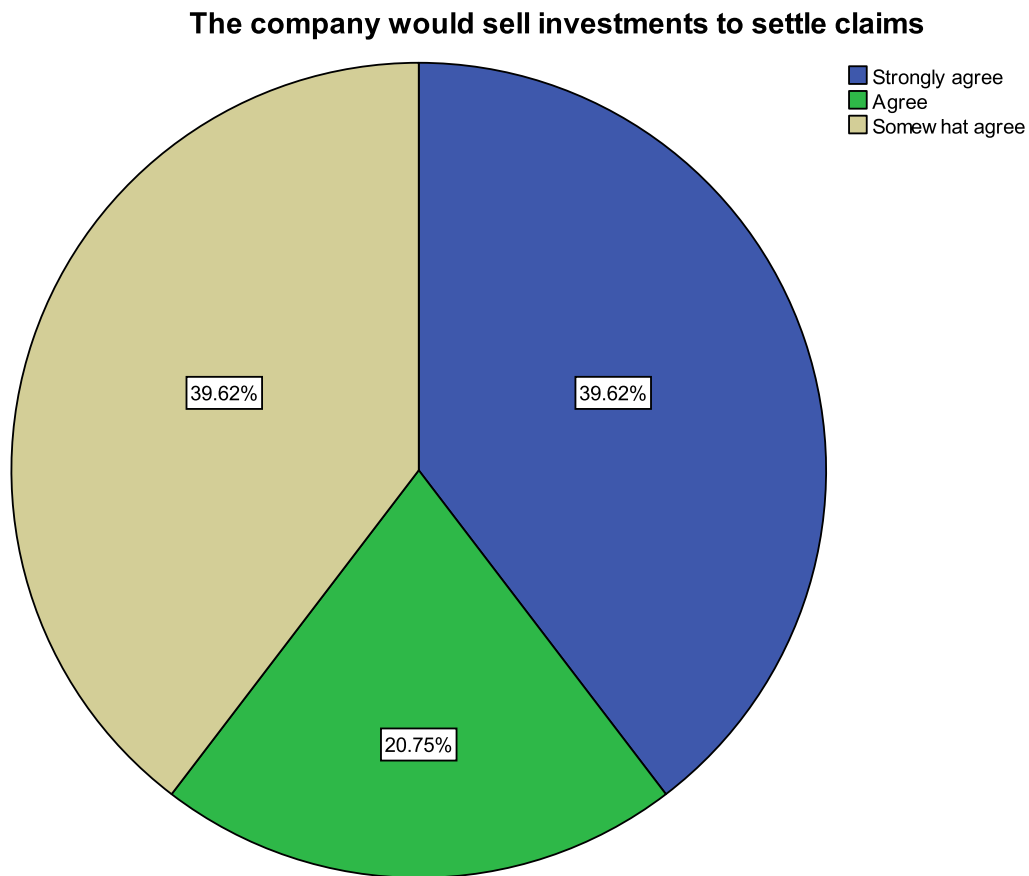
**Table 4.8 Liquidity of the company's investments**

<b>Response</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Very much	64	60.4	60.4
Much	42	39.6	100.0
<b>Total</b>	<b>106</b>	<b>100.0</b>	

As indicated in Table 4.8, most of the respondents reported that the investments in their companies were very much liquid while the others (39.6%) said they were much liquid. This shows that all the insurance companies have liquid investments. This would help them to settle claims especially if their underwriting income cannot cover claims.

#### **4.6.2 The company would sell investments to settle claims**

On whether the company would sell off their investments if it does not have enough money to settle claims, the participants' responses were as shown in Figure 4.7



**Figure 4.7**The company would sell investments to settle claims

Figure 4.7 shows that 39.6% of the respondents strongly agreed that the company would sell off their investments if they lacked money to settle claims, 20.8% agreed while 39.6% somehow agreed. These findings show that most companies would be willing to sell their investments so that they can settle clients' claims.

#### **4.6.3 Company's financial strength to meet the ongoing policyholders' obligations**

The respondents rated the company's financial strength to meet the ongoing policyholders' obligations as shown in Table 4.9

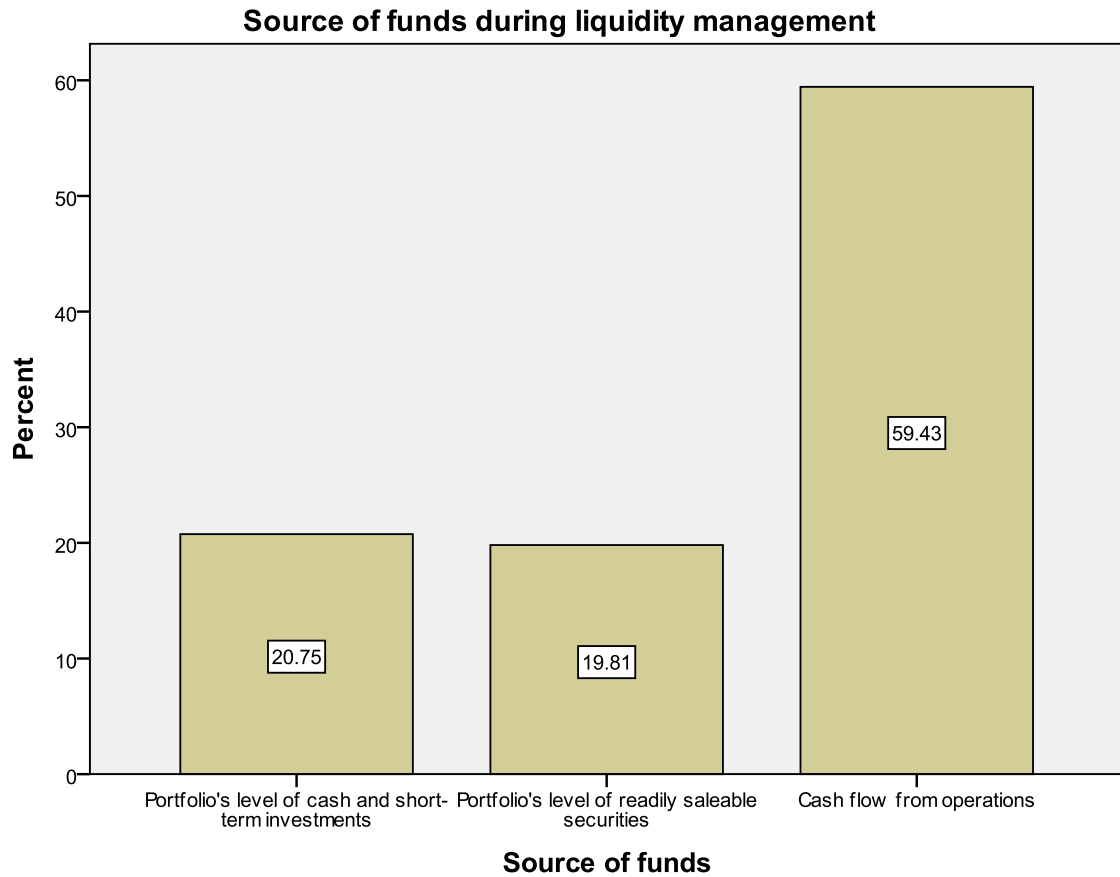
**Table 4.9 Company's financial strength to meet the ongoing clients' obligations**

<b>Rating</b>	<b>Frequency</b>	<b>Percent</b>	<b>Cumulative Percent</b>
Excellent	84	79.2	79.2
Good	22	20.8	100.0
<b>Total</b>	<b>106</b>	<b>100.0</b>	

The financial strength to meet the ongoing client's obligations was mainly excellent (79.2%) in most companies. The others (20.8%) reported that it was good. This shows that most insurance companies put effort to ensure that they are in a position to settle claims. Probably because settling of claims and indemnifying is the main purpose of insurance companies and this is the only way they can maintain clients.

#### **4.6.4 Company's source of funds during liquidity management**

This item sought for information on whether the companies get their money from when it comes to liquidity management. The responses are as shown in Figure 4.8



**Figure 4.8** Company's source of funds during liquidity management

As shown in Figure 4.8, majority of insurance companies (59.4%) rely on cash flow from operations in liquidity management. The other 20.8% consider portfolio's level of cash and short term investments while 19.8% use portfolio's level of readily saleable securities. This implies that all companies have a certain source of funds for liquidity management.

#### **4.6.5 Extent to which liquidity affects financial performance of insurance companies**

In rating the extent to which liquidity affects the financial performance of insurance companies, all the respondents agreed that it affects to a great extent.

## **CHAPTER FIVE**

### **SUMMARY, CONCLUSIONS AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter presents summary, conclusions, recommendations of the study and suggestions for further research.

#### **5.2 Summary of the study**

The purpose of this study was to investigate the factors that influence the financial performance of insurance companies in Kenya. It was based on the following research questions: What are some of the key factors that determine financial performance of insurance companies? To what extent do these factors influence the financial performance of insurance companies? And what are the insurance companies doing to enhance or to mitigate the effect of these factors determining their financial performance?

This study was conducted using a descriptive survey design. The target population for this study comprised the 46 insurance companies in Kenya. This study used systematic random sampling method to select the respondents. The study used questionnaires as the tool for data collection. Data was analysed through descriptive statistics and results presented in frequency tables, bar graphs and pie charts.

The findings on the effect of interest rates on the financial performance of insurance companies showed that changes in interest rates affect the financial performance of the insurance companies positively and negatively. Low interest rates on borrowing enable insurers to borrow and invest more in higher risk areas thus improving their investments and financial performance. This is in line with Staking and Babbel (1995). High interest

rates increase the return on investments for example; rising interest rates imply a higher return on bonds, one kind of investment. This is in line with Schich (2008). Most of the companies (60.4%) based interest on the market. This implies that since the market keeps on changing, the interest rates are also likely to keep on changing. On the other hand, when the interest rates change, rate of return on investments change also and this can affect the financial performance of the insurance firms either positively or negatively depending on whether the interest rates go high or low. Majority of the respondents (40.6%) reported that their insurance companies used futures to manage interest rate risks. This implies that all insurance companies are aware of the risks which come as a result of fluctuations in interest rates. That is why they have ways of managing such risks. This is all because interest rates can affect the financial performance of a company. In order to profit from changes in interest rates, most participants reported that companies diversify their investment portfolio through buying bonds, investing in property, equity, shares as well as increasing their borrowed capital when rates fall. All these measures are done to improve the financial performance of the insurance companies. Majority of the respondents (59.4%) were of the opinion that fluctuations in interest rates affect the financial performance of insurance companies. This is in line with Best (1992) and Carson and Hoyt (1995).

The findings on profitability and its effect on insurance companies' financial performance showed that most insurers (40.6%) have assets worth below 10 billion shillings. The more assets an insurer has, the better they are financially because if the underwriting income is low, the insurer can rely on the investment income to settle large

claims. This is in line with Hagel, Brown and Davison (2010). Most respondents (60.4%) indicated that their insurance firms have liabilities worth less than 10 billion. More liabilities place the insurer at a risky position financially especially if they are needed to settle major claims. Most respondents (60.4%) indicated that their insurance companies have performance indicators like KPI's, targets, benchmarking, claims, operational costs, new businesses, return on investment and profits for gauging business. This is an indication that most insurance companies are aware of the way they are performing financially hence they can take appropriate measures when their financial performance goes down. For the insurance companies with no performance indicators, it is difficult to know when they are performing well or poorly. On the trend of profitability in the company in the last one financial year, all the respondents indicated that it has been on the increase. The most preferred investment was real estate and mortgage industry. These companies try to avoid investing in the stock market mainly because of the uncontrolled return trends. This is in line with Santomero and Babbel (1997) findings. The findings show that the insurance companies mind their profitability by investing in the viable ventures while avoiding the too risky ones. This is evidence that profitability affects the financial performance of the insurance companies as shown by 79.2% of the respondents were of the opinion that company profitability affects its financial performance to a great extent.

Findings on competition and its effects on insurance company's financial performance showed that all the respondents have knowledge on the current activities about the competitors. With knowledge of competitors' current activities, insurers can take measures to match up or improve their products and services beyond their competitors in



order to gain a competitive edge. 40.6% of the respondents reported that the technology in their insurance is neck to neck with that of their competitors while 19.8% said they are ahead of competition in terms of technology. The other 39.6% admitted that the competition is ahead of them technology-wise. Being ahead of competition gives an insurer a competitive edge and this would be the aim of most insurers because they are in business to make money. 39.6% of the respondents reported that the insurance companies use market research while another 39.5% said they use competitor's advertisement. The other 20.8% use customers' feedback. This implies that insurers are aware that competition can reduce their market share hence their financial performance and that is why they get ways of gauging competition. This is in line with Donlon and Gutfreund (1998). On whether the company encourages clients to give them feedback regarding the quality, price, packaging or placement of their products or services, all the respondents said yes. The companies achieve this through maintaining complaints and compliment registers while others have a customer experience unit that embark on gauging the satisfaction their clients receive. Other insurance firms organize agents for forums on the same. This is an indication that the insurance companies care about their customers and they try to keep them coming back by ensuring that they are satisfied. This is a way of staying ahead of competition hence improving financial performance. On how the companies handle competition, most participants reported that insurers handle competition through paying claims on time, 34.0% do research in order to stay ahead of competition while 13.2% use innovation to come up with products that are in tandem with the clients' needs. When asked whether the insurance company has an edge on competition, 79.2% of the respondents said yes while the other 20.8% said no. For the

ones who said that they have an edge on competition, they said that from the IRA and AKI reports, their market share has continued to increase thus increasing their profits. Others said that their company has a strong financial standing and a good claims paying experience. Others have efficient and customer-friendly services. All the respondents agreed that the business environment supports their company's survival, the demand for their products will be high and the competition is intense related to the prices. While 40.6% agreed that profit margin increase is very high, 59.4% refuted. On whether the competition is intense related to quality of products, 19.8% agreed while 80.2% disagreed. On whether the competition is intense related to the innovation embedded in new products, 59.4% agreed while 40.6% disagreed. Competition affects the financial performance of organization to a great extent (39.5%) and to a moderate extent (60.4%). This shows that competition plays a role in determining how an organization performs financially. This is especially through the prices and innovation in new products. This is in line with (O'Connor, 2000).

Findings on liquidity and its effects on insurance companies' financial performance showed that most insurers have very much liquid investments while the others (39.6%) said they were much liquid. This shows that all the insurance companies have liquid investments. This would help them to settle claims especially if their underwriting income cannot cover claims. This is in line with (Black, Wright & Bachman, 1998). 39.6% of the respondents strongly agreed that the company would sell off their investments if they lacked money to settle claims, 20.8% agreed while 39.6% somehow agreed. These findings show that most companies would be willing to sell their

investments so that they can settle clients' claims. The financial strength to meet the ongoing client's obligations was mainly excellent (79.2%) in most companies. The others (20.8%) reported that it was good. This shows that most insurance companies put effort to ensure that they are in a position to settle claims. Probably because settling of claims and indemnifying is the main purpose of insurance companies and this is the only way they can maintain clients. This is in line with Barney (1997). Majority of insurance companies (59.4%) rely on cash flow from operations in liquidity management. The other 20.8% consider portfolio's level of cash and short term investments while 19.8% use portfolio's level of readily saleable securities. This implies that all companies have a certain source of funds for liquidity management. In rating the extent to which liquidity affects the financial performance of insurance companies, all the respondents agreed that it affects to a great extent.

### **5.3 Conclusions of the study**

Based on the findings of the study, it can be concluded that fluctuations in interest rates affect the financial performance of insurance companies both ways. This is because it affects the rate of borrowing as well as the rate of return on investments. Most of the companies based interest on the market. Most insurers use futures to manage interest rate risks. In order to profit from changes in interest rates, most insurers diversify their investment portfolio through buying bonds, investing in property, equity, shares as well as increasing their borrowed capital when rates fall.

On profitability and its effects on financial performance of insurance companies, it can be concluded that it has an effect. Most insurance companies have performance indicators like KPI's, targets, benchmarking, claims, operational costs, new businesses, return on

investment and profits for gauging business. All the respondents indicated that the trend of profitability in the company in the last one financial year has been on the increase. The most preferred investments were real estate and mortgage industry. The findings show that the insurance companies mind their profitability by investing in the viable ventures while avoiding the too risky ones.

Competition was found to have an effect on insurance company's financial performance. This is why all the respondents indicated to have knowledge on the current activities about the competitors. With knowledge of competitors' current activities, insurers can take measures to match up or improve their products and services beyond their competitors in order to gain a competitive edge. A significant number of insurers' competition is ahead of them technology-wise. Most insurance companies use market research while another while others use competitor's advertisement and customers' feedback. Insurers mainly handle competition through paying claims on time. Competition plays a role in determining how an organization performs financially. This is especially through the prices and innovation in new products.

Liquidity affects financial performance of insurance companies. This is why all the insurance companies have liquid investments. These would help them to settle claims especially if their underwriting income cannot cover claims. All the respondents at least somehow respondents strongly agreed that the company would sell off their investments if they lacked money to settle claims. The financial strength to meet the ongoing client's obligations was mainly excellent in most companies. Majority of insurance companies

rely on cash flow from operations in liquidity management. This implies that all companies have a certain source of funds for liquidity management.

#### **5.4 Recommendations of the study**

Based on the findings of this study, it is recommended that

- a) Insurers should invest in financial analysts so that they can gauge when interest rates can work in their favour in increasing their income. This would enhance their financial performance hence they would be able to settle all claims irrespective of the amount of money involved.
- b) The insurers without performance indicators should adopt some. This way, they would know when to invest or not. This would place them in a better financial position.
- c) All insurers should find an area they excel and capitalize on it to get a competitive edge while trying to upgrade on the areas in which they are weak. This would place them ahead of competition.
- d) The insurers should work towards increasing their cash flow to avoid sale of investments in case of settling huge claims. This would make them financially healthier.

#### **5.5 Limitations of the study**

A few challenges were encountered during this study. It was not possible to control the attitude of the respondents regarding the topic of study. However, the researcher assured the respondents of the anonymity of their identity as well as explained the need for this

study. These made it more likely for the respondents to give accurate information. It was limiting to use profitability as a factor of financial performance. The study therefore used profitability as a factor in determining investment behaviour of insurance companies. The factors under study could not be measured accurately. This is due to the limited resources of time and the sample size taken. The study also concentrated in Nairobi where majority of the insurance companies are located.

### **5.6 Suggestions for further research**

The researcher suggested that a similar study to investigate the factors affecting the financial performance of companies in other sectors should be conducted. A similar research can be undertaken on wider scale say in East Africa.

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## **APPENDICES**

### **Appendix I: Introduction letter**

**University of Nairobi**

**Department of Accounting**

**P.O Box 30900 - 80100**

**NAIROBI**

The Manager,

Dear Sir/Madam,

#### **REQUEST TO CONDUCT RESEARCH IN NAIROBI MUNICIPALITY**

I am a final year Master of Business Administration student at the University of Nairobi. My area of specialization is Finance. I am currently undertaking research study on the factors that determine the financial performance of insurance companies in Kenya.

I would be grateful if you could spare some time and complete the enclosed questionnaire. Your identity will be treated with utmost confidentiality. A copy of the final report will be made available to you on request. Your timely response will be highly appreciated.

Yours,

**MWANGI CALEB MUYA**

**Appendix II: Questionnaire**

This questionnaire aims to acquire information on the factors that determine the financial performance of insurance companies. Please respond to all items. Unless otherwise instructed respond to each item by putting a tick (√) next to the response that is applicable.

**SECTION A : DEMOGRAPHIC INFORMATION**

**SECTION B: MAIN ISSUES**

**I: Interest rate fluctuations and their effect on insurance companies**

1. a) How do changes in interest rates affect the financial performance of your company

Positively ( )

Negatively ( )

No change ( )

b) Explain your answer

.....  
.....  
.....

2. What does your company base your interests on?

The market ( )

The competitors ( )

New money ( )

Portfolio average ( )

Others (specify) .....

3. What means does your company use to manage interest rate risks?

Derivatives market ( )

Futures ( )

Exchange-traded instruments ( )

Over-the-counter (OTC) instruments ( )

Others (specify).....

4. What measures does the company have in order to profit from changes in the interest rates?

.....  
.....  
.....

5. To what extent do fluctuations in interest rates affect the financial performance of insurance companies?

- Great extent ( )
- Moderate extent ( )
- Small extent ( )
- No extent ( )

**II: Profitability and its effect on insurance companies' financial performance**

6. a) What is the total valuation of assets that your company owns?

- Below Kshs. 10, 000, 000,000 ( )
- 10,000,000,000 – 60,000, 000, 000 ( )
- 60,000, 000, 001 – 90,000,000 000 ( )
- Above 90,000,000,000 ( )

b) What is the total valuation of liabilities that you have?

- Below Kshs. 10, 000, 000,000 ( )
- 10,000,000,000 – 60,000, 000, 000 ( )
- 60,000, 000, 001 – 90,000,000 000 ( )
- Above 90,000,000,000 ( )

7. Does your company have performance indicators to gauge business?

- Yes ( ) No ( )

If yes, name three performance indicators used in your company

.....  
.....  
.....

8. What is the trend of profitability in your company for the last one financial year?

Increase ( )

Decrease ( )

No change ( )

9. a) Do you have any specific investment preference?

Yes ( )

Somewhat ( )

No ( )

b) If the answer to the above question is yes, explain the kind of investment preference you have

.....  
.....

c) What kind of investments do you want to avoid? (Explain)

.....  
.....

10. To what extent does the company's profitability affect its financial performance?

Great extent ( )

Moderate extent ( )

Small extent ( )

No extent ( )

**III: Competition and its effect on insurance companies' financial performance**

11. Do you have knowledge of current activities about your competitors? Yes ( ) No ( )

12. How does your use of technology measure against your main competitors?

We are way ahead of them ( )

We are neck to neck with them ( )

They are slightly ahead of us ( )

They are far more ahead of us ( )

13. What does your organization do to ensure that it has all the necessary market intelligence necessary to gauge competition?

Market research ( )

Competitors' advertisements ( )

Others (specify).....

14. Do you encourage your clients to give your organization feedback regarding the quality, price, packaging or placement of your products and services? Yes ( ) No ( )

Explain

.....  
.....

15. How does the company handle the competition?

Ensuring quality of products ( )

Paying claims on time ( )

Stay ahead of competition through research ( )

Capitalizing on competitors' weaknesses ( )

Others (specify).....

16. Does the company have an edge over the competition? Yes ( ) No ( )

Explain.....

.....

17. Please indicate your opinion regarding the following sentences

	Disagree	Agree
The business environment supports our company's survival	( )	( )
The demand for our products will be high	( )	( )
Profit margin increase is very high	( )	( )
The competition is intense related to the prices	( )	( )
The competition is intense related to the quality of products	( )	( )
The competition is intense related to the innovation embedded in new products	( )	( )

18. To what extent does competition affect the financial performance of your company?

Great extent ( )

Moderate extent ( )

Small extent ( )

No extent ( )

**IV: Liquidity and its effect on insurance companies' financial performance**

19. How liquid are your company's investments?

- Very much ( )
- Much ( )
- Little ( )
- Not liquid ( )

20. To what degree do you agree with the statement 'the company would sell off their investments if it does not have enough money to settle claims?'

- Strongly agree ( )
- Agree ( )
- Somewhat agree ( )
- Disagree ( )

21. How would you rate your company's financial strength to meet the ongoing policyholders' obligations?

- Excellent ( )
- Good ( )
- Poor ( )

22. During liquidity management, what is your company's source of funds?

- Portfolio's level of cash and short-term investments ( )
- Portfolio's level of readily saleable securities ( )
- Cash flow from operations ( )
- Others (specify).....

23. To what extent does liquidity affect the financial performance of insurance companies?

- Great extent ( )
- Moderate extent ( )
- Small extent ( )
- No extent ( )

**Thank you for your cooperation**



### Appendix III: Insurance companies in Kenya

1	Africa Merchant Assurance Ltd	30	Mercantile Insurance Company Ltd
2	APA Insurance Company Ltd	31	Metropolitan Life Assurance Company Ltd
3	Apollo Life Insurance Ltd	32	Monarch Insurance Company Ltd
4	Blue Shield Insurance Company Ltd	33	Occidental Insurance Company Ltd
5	British American Insurance Company Ltd	34	Old Mutual Life Assurance Company Ltd
6	Cannon Assurance Company Ltd	35	Pacis Insurance Company Ltd
7	Capex Life Assurance Company Ltd	36	Pan Africa Life Assurance Company Ltd
8	CFC Life Assurance Ltd	37	Phoenix of E. A. Assurance Company Ltd
9	Chars Kenya Insurance Company Ltd	38	Pioneer Life Assurance Company Ltd
10	Concord Insurance Company Ltd	39	REAL Insurance Company Ltd
11	Cooperative Insurance Company Ltd	40	Shield Assurance Company Ltd
12	Corporate Insurance Company Ltd	41	Takaful Insurance of Africa Ltd
13	Directline Assurance Company Ltd	42	Tausi Assurance Company Ltd
14	Fidelity Shield Insurance Company Ltd	43	Trident Insurance Company Ltd
15	First Assurance Company Ltd	44	UAP Insurance Company Ltd
16	GA Insurance Company Ltd	45	UAP Life Assurance Company Ltd
17	Gateway Insurance Company Ltd	46	Xplico Insurance Company Ltd
18	Geminia Insurance Company Ltd		
19	Heritage Insurance Company Ltd		
20	Insurance Company of East Africa Ltd		
21	Intra Africa Assurance Company Ltd		
22	Invesco Assurance Company Ltd		
23	Jubilee Insurance Company Ltd		
24	Kenindia Assurance Company Ltd		
25	Kenya Orient Insurance Company Ltd		
26	Kenyan Alliance Insurance Company Ltd		
27	Lion of Kenya Insurance Company Ltd		
28	Madison Insurance Company Ltd		
29	Mayfair Insurance Company Ltd		

