

**EFFECT OF BANCASSURANCE ON FINANCIAL PERFORMANCE OF  
COMMERCIAL BANKS IN KENYA**

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## DECLARATION

This research project report is my original work and has never previously been presented for a Degree in any other University or institution of higher learning for any academic award.

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My deep appreciations also goes to my research assistant, for coordinating data retrieval and gathering of the information that I needed and finally the school of business at the University of Nairobi, that offers this course for offering this opportunity to me.

## **DEDICATION**

This work is dedicated to my family who provided me with the motivation and for their care and sacrifice throughout my studies. Their love, care, concern, support, encouragement and enthusiasm inspired me to achieve this goal.

## **ABSTRACT**

Bancassurance is viewed as the future of the banking industry. It originates from French usage of banks to carry out their insurance transactions which has been adopted globally. Its growth was boosted by fact that household savings have moved from deposits to more remunerative investments causing a drop in traditional banking profitability forcing banks to compensate the decrease in their interest margin by offering investment banking or insurance services to diversify the resources required to manage risk.

The study analysed the effects of bancassurance on performance of commercial banks and observed that the banking sector in Kenya is very dynamic and highly profitable as an investment avenue with a declining asset to liability ratio, reducing cost to income ratio, and an increasing return on assets ratio. An analysis of bancassurance performance showed an increasing profitability, increasing return on assets and increasing return on investment where 96% of the banks with bancassurance reported profits within the study period. A model was created that can be used to analyze the effects of bancassurance on net profit margins of the banks which is 96.2% efficient and reliable. The study concludes that profitability of bancassurance has significant effect to the overall profitability of the banking industry, and has made key findings to support this observation.

The study recommends that the banking sector should invest more into bancassurance by improving marketing strategies for its products such that more customers are attracted to these services. The study also observed that the banking sector needs more experts on bancassurance to help in rolling out better products that suits customer niche and embrace customer uniqueness in the Kenyan insurance market. The regulators should find ways to offer solutions to the challenges that were observed to hinder bancassurance investment. The study found that further research to assess the factors that causes successful implementation of bancassurance should be carried out and also assess the effects of bancassurance on the financial performance of insurance firms in Kenya.

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## ACRONYMS

<b>AIDS</b>	:	Acquired Immune Deficiency Syndrome
<b>EMH</b>	:	Efficient-market hypothesis
<b>KLIA</b>	:	Korea Life Insurance Association
<b>LIC</b>	:	Local Insurance Companies
<b>OECD</b>	:	Economic Co-operation and Development
<b>SPSS</b>	:	Statistical Package for Social Sciences
<b>SWOT</b>	:	Strengths, Weaknesses, Opportunities and Threats

## OPERATIONAL DEFINITION OF TERMS

- Commercial banks** -Financial institutions that provide services, such as accepting deposits, giving business loans, auto loans, mortgage lending and basic investment products like savings accounts and certificates of deposit. The traditional commercial bank is a brick and mortar institution with tellers, safe deposit boxes, vaults and ATMs.
- Bancassurance** -An arrangement in which a bank and an insurance company form a partnership so that the insurance company can sell its products to the bank's client base. This partnership arrangement can be profitable for both companies.
- Insurance premium** -The specified amount of payment required periodically by an insurer to provide coverage under a given insurance plan for a defined period of time. The premium is paid by the insured party to the insurer, and primarily compensates the insurer for bearing the risk of a payout should the insurance agreement's coverage be required.

## **CHAPTER ONE: INTRODUCTION**

### **1.1 Background of the Study**

Financial markets have undergone dynamic changes over the past decades due to consolidation of the industry, globalisation of the market, and the convergence of financial services (Moshirian, 2008 and Claessens, 2009). Specifically regarding the convergence of financial services, the traditional walls between banking, insurance, and securities markets are breaking down as a result of deregulation and liberalisation of financial services (Singhal and Vij, 2006 and Yeager *et al.*, 2007). This change occurred late in East Asian countries compared with European countries, as the regulations for cross-selling of financial products have been only recently established by the local regulators in East Asian countries (Corbett, 2007). Nevertheless, the growth of the market due to these changes in financial services is emerging with bewildering rapidity, when compared to other countries in Europe (Prasad, 2009).

Cross-selling of insurance products to bank customers, popularly known as “bancassurance” (Fields *et al.*, 2007), in developing countries has only occurred relatively recently when compared with European countries. This is primarily due to the late establishment of regulatory frameworks and guidelines in the financial service industry. Most countries in Europe started “bancassurance” in the early 1970s-1980s, whereas in east Asia Taiwan started “bancassurance” in 1998, Korea in 2002, and China in 2003 (Chen *et al.*, 2009). However, despite the late start of “bancassurance” in these countries, SwissRe (2007) report indicates that “bancassurance” in the region has shown a significant growth in past decade, mainly led by Korea coupled with a high sales performance in Taiwan. As for Korea, in spite of financial crisis in 2008, the

“bancassurance” market grew by a compound average growth rate of 16 per cent from the 2005 fiscal year to the 2009 fiscal year (Korea Life Insurance Association (KLIA), 2011). In Taiwan, the “bancassurance” market represents 69 per cent of new insurance issued, which highlights that out of ten new insurance premiums collected, almost seven were generated through cross-selling activities at bank branches (Taiwan Life Insurance Association Monthly Report, Q1, 2010).

Bancassurance seems to be spreading very fast across the globe. This is because of its risk-freeness nature. Bancassurance is a system in which a bank has a corporate agency with one insurance company to sell its products. By selling insurance policies bank earns a revenue stream apart from their banking business. It is called as fee-based income. This income is purely risk free for the bank since the bank simply plays the role of an intermediary for sourcing business to the insurance company. Bancassurance has grown at different places and taken shapes and forms in different countries depending upon demography, economic and legislative prescriptions in that country. Bancassurance, the sale of life insurance and pensions products through a bank, has proved to be an effective distribution channel in a number of countries. In a broad sense, bancassurance is the distribution of insurance products to a bank’s client base. However, beyond this definition, bancassurance business models vary widely from country to country (Karunakaran, 2006).

### **1.1.1 Concept of Bancassurance**

For the first time, the term “bancassurance” has been used in France, where cooperation between banks and insurance companies started earlier than in other European countries. This word was originally coined to indicate simple distribution of insurance products by

bank branches, while at present it is used to describe all kinds of relationship between the banking and the insurance industries (Quagliariello, 2004). The convergence between different sectors of financial intermediation (conglomeration) has been encouraged by the deregulation process started at the end of the Eighties. In Europe the 1989 Second Banking Directive allowed universal banking and unlimited reciprocal participations with investment and insurance firms. In USA regulatory hedges between financial institutions have been removed later, by the 1999 Gramm-Leach-Bliley Act: nowadays financial conglomerates are present in all developed countries.

Bancassurance, however, cannot be viewed simply as a result of the deregulation process: as pointed out by Locatelli *et al.* (2003), changes in financial services needs have been particularly determinant. Household saving has moved from deposits to more remunerative investments determining a dramatic drop in traditional banking profitability. Banks have tried to compensate the decrease in their interest margin by entering investment banking or insurance. Life business has appeared as a particularly interesting opportunity for various reasons as the progressive ageing of population in all developed countries and the decrease in welfare state protection offered by governments, other than the existence of some similarities and complementariness between the banking and the insurance activities, especially for life products. The cooperation between banks and insurance companies, initially limited to the distribution of life products through bank branches, has gradually become a more strict relationship aiming to operate the financial market in a more integrated way; despite the existence of some differences between countries, it is possible to sustain that simple distribution agreements during the

Seventies and the Eighties became a mix of partnerships and share exchanges in the early Nineties.

### **1.1.2 Financial performance**

Performance is the outcome of all of the organisation's operations and strategies (Wheelen and Hunger, 2002). Measuring performance accurately is critical for accounting purposes and remains a central concern for most organisations. Performance measurement systems provide the foundation to develop strategic plans, assess an organisation's completion of objectives, and remunerate managers (Ittner and Larcker, 1998).

Although assessment of performance in the past literature is still very important, it is also complicated (Pont and Shaw, 2003). While consensual measurement of performance promotes scholarly investigations and can clarify managerial decisions, managers have not been able to find clear, current and reliable measures of performance on which marketing merit could be judged. Two approaches have been adopted in the literature to measure financial performance. The first subjectively measures the performance of firms based on their own evaluation and expectations or comparison with their competitors. The second is objective, based on the absolute measure of performance such as financial ratios (Appiah-Adu, 1998).

Financial performance in banks has been measured using different approaches. Ratio analysis was used to measure bank financial performance. Calculating a small number of ratios is enough to build a good picture of the position and performance of the business (McLaney and Atrill, 2001). However, it is necessary not to place too much importance on one ratio, but rather to use other ratios to evaluate the complex nature of a bank's

operations (Davidson, 2001). Unfortunately, there is no generally accepted list of ratios or standard methods to measure financial performance (Al-Shammari and Salimi, 1998). The average of assets utilisation, return on assets (ROA), and return on equity (ROE) from the last five years were used in this research (2000-2004) to measure bank financial performance. These ratios were mainly found in textbooks and in journal articles that studied bank performance. The five-year span was selected because the data remained stable over this period of time.

### **1.1.3 Bancassurance and Banks**

In the present day, the literature regarding the financial alliances between banks and insurance companies is limited. Wever (2000) refers to bancassurance as the distribution of insurance products through banking networks; in other words, as the collaboration between banks and insurers to distribute insurance products to bank customers. Staikouras and Nurullah (2008) find that banking and insurance entities have more similarities than differences, characteristics that may favour joint production and business synergies. Through diversification, the bancassurance approach reduces the resources required to manage risk, which in turn results in lower costs (Hughes *et al.*, 1999). Korhonen *et al.* (2006) applied the expert panels and the analytical hierarchy process (AHP) to explore the most preferred alternative alliances between banks and insurance companies from executive management perspectives, supervisory authorities, and customers, respectively. Wu *et al.* (2008) adopt the modified Delphi method to construct the framework of mutual fund performance and the AHP model to design an assessment method for mutual fund performance.



Prior empirical studies evaluated the efficiency of bancassurance from the bank viewpoint, assessing its profitability as a bank product. But since bancassurance is also an insurance company product, we need to assess it from the insurance viewpoint as well. McKillop *et al.* (1996) investigated cost efficiency in large Japanese banks and found that different cost function specifications led to different results. Bergendahl (1995) claimed that the economic reasons for banks selling multiple products included efficiently using fixed capacity resources, customer demand for several products from a single channel, and product combination strategy. On the other hand, most insurance companies believe that increasing the number of marketing channels to attract more customers and sales represents the way to profitability. Besides, using their own sales representatives, insurance companies try to sell products through banks. Bancassurance becomes an insurer's second marketing channel for selling insurance.

#### **1.1.4 Commercial Banks in Kenya**

There are forty four (43) commercial banks in Kenya and several nonbank financial institutions like building societies and mortgage finance companies. However, the banking industry is dominated by four (4) major banks which include: Kenya Commercial Bank Limited (a local bank which is a listed company), Equity Bank, Co-operative bank and Standard Chartered Bank. A few international banks have established branches and subsidiaries in Kenya. Micro-finance institutions which were previously unregulated were in December, 2006 brought within the regulation regime. The Islamic banking market although nascent in Kenya is growing. Two fully fledged Islamic banks have been licensed to operate, and many other mainstream banks are opening Islamic

banking windows. Work remains to be done on appropriate regulatory frameworks for Islamic banking, (CBK, 2012).

The banking industry is governed by the Banking Act (Chapter 488, Laws of Kenya) and the Central Bank of Kenya Act (Chapter 491, Laws of Kenya) (CBK Act). The banking industry is regulated by the CBK established under the CBK Act. The Insurance Industry: There are approximately forty (40) insurance companies and three (3) re-insurance companies operating in Kenya. Foreign equity participation in an insurance company has a ceiling of 66.7%. The governing statute for insurance matters is the Insurance Act (Chapter 487, Laws of Kenya) (the “IA”). Other Financial Sectors: Kenya has a few investment banks and venture capital funds. These are licensed and regulated by the Capital Markets Authority. These institutions are not however as yet active in provision of investment capital. Examples of investment banks include Kestrel Capital, Suntra Investment Bank and Dyer & Blair Investment Bank. Aureos and Actis are examples of venture capital funds, (CBK, 2012).

The Capital Markets: The primary legislation dealing with capital markets is the Capital Markets Authority Act (Chapter. 485A, Laws of Kenya) (the “CMA Act”). The Capital Markets Authority (the “CMA”) is established under the CMA Act. The CMA licenses securities exchanges, investment banks, venture capital funds, stock brokers, investment advisors, fund managers, collective investments schemes and credit rating agencies. The Nairobi Stock Exchange (the “NSE”) was formed in 1954. Over forty five (45) companies have listed their shares on the main segment of the NSE. 2007 and 2008 witnessed increased activity in the NSE with about seven (7) new listings. The Central Depository and Settlement Corporation provide central depository services for securities

in Kenya. The initial public offering in 2008 of the government's 25% stake in Safaricom Limited (a leading mobile service company) was a landmark transaction not only in Kenya's capital markets but also in the East African region. It raised approximately US\$ 1 billion and was oversubscribed by 532% by both regional and international investors. The government is also considering tapping the international capital markets for the first time by listing a sovereign bond on an international exchange. The targeted amount is provisionally set at USD 300 million and will be used to finance infrastructure development in Kenya, (CBK, 2012).

## **1.2 Problem Statement**

The insurance sector has undergone a big change in the last decade, ever since the sector was opened up for private players. Traditionally, insurance products are sold only through individual agents and they account for a major chunk of the business in retail segment. With the opening up of this sector to private players, competition has become more intense and the public sector major LIC has been challenged with a flood of new products and new means of marketing. Insurance industry in Kenya has been progressing at a rapid pace since opening up of the sector to the entry of private companies in 2000. The size of the country, a diverse set of people combined with problems of connectivity in rural areas, makes insurance selling in Kenya a very difficult proposition. Insurance companies require immense distribution strength and tremendous manpower to reach out to such a huge customer base. This distribution will undergo a sea change as various insurance companies are proposing to bring insurance products into the lives of the common man by making them available at the most basic financial point, the local bank branch, through Bancassurance. Simply put, bancassurance is the process through which

insurance products are sold to customers at their local banks. With banking network of 65,000 branches serving more than 400 million retail banking customers, insurance can be available at affordable prices to people even in remote corners of the country.

The relationship is symbiotic; but there are challenges. The most common challenges to success are poor manpower management, lack of a sales culture within the bank, no involvement by the branch manager, insufficient product promotions, failure to integrate marketing plans, marginal database expertise, poor sales channel linkages, inadequate incentives, resistance to change, negative attitudes toward insurance and unwieldy marketing strategy. Even insurers and banks that seem ideally suited for a bancassurance partnership can run into problems during implementation. Before targeting the market, it is essential to do a SWOT analysis. One more important obstacle in development of bancassurance in Kenya has been a set of regulatory barriers. Some of these have recently been cleared with the passage of the Insurance (Amendment) Act, Looking at the west where sales through the banking network have been a roaring success, the Kenyan banking sector has far to go. But one thing stands obvious. If insurance in Kenya is to succeed, it can only be through the Bancassurance channel.

Studies previously done in Kenya on the relationship between bancassurance and the financial performance of Kenyan commercial banks have shown varying outcomes. Ocholla (2005) studied the influence of weather on the insurance industry. Results showed that excessive rainfall resulted in numerous claims worth hundreds of thousands of shillings. The relationship between the rainfall and claims parameters was found to be exponential or polynomial in nature. The relationship between rainfall and premiums, however, was not linear in nature since premiums depended on a number of other factors

such as location, type of business, physical state of property etc. It was also found that most insurance companies did not always consider weather when underwriting premiums but that they were aware of the effects of rainfall on the insured. Kabue, (2003) investigated marketing communication strategies in the insurance industry: a case of firms in Nairobi. He found that the insurance firms work towards corporate advertising and apply an integrated approach in their application of the marketing tools. The government should also support the industry through teaching of insurance in schools. Some of the insurance services like life assurance should be made compulsory for all Kenyans. This is because life assurance serves as a form of saving for oneself and for his/her dependents. Kipruto (2002) investigated the pricing of conventional life insurance products by reflecting mortality risks. He noted that mortality is the main factor of determining the cost of insurance products hence we analyse the effect of varying mortality experience on the various types of mortality tables and explains how insurers incorporate benefit costs into the prices of various types of life insurance products and annuities. This study therefore seeks to bridge this gap in knowledge by investigating the impacts of the bancassurance on the financial performance of Kenyan commercial banks.

### **1.3 Research Objectives**

The main objective of this study is to determine the effect of bancassurance on financial performance of commercial banks in Kenya. Thus study specifically seeks to fulfil the following objectives.

- i) To explore the factors driving the adoption of bancassurance in Kenyan commercial banks.

- ii) To determine the challenges facing the establishment of bancassurance in Kenyan commercial banks.
- iii) To establish the impacts of bancassurance on the financial performance of the banks and insurances.

#### **1.4 Significance of the Study**

To the insurance companies: the findings of this study will provide new knowledge useful in making of insurance agreements with banks. The insurance companies will be able to establish the likely effects of such mergers and perfect the ones already established.

To the banks: The bank management will benefit from the study as more information will be obtained on the possible outcome of agreements with the insurance companies. The banks will use such results to strike profit making deals with the insurance companies.

To the government: The findings will go a long way in providing the necessary details and understanding on the bancassurance in the financial sector. The government will use the findings to limit any agreements which weaken the financial sector and put structures which support the beneficial agreements.

To the researchers and academicians: The findings of this study will add to the existing body of literature new knowledge and act as a source of reference in future to them.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter presents the literature review of the study. The chapter has the theoretical framework which has two theories i.e. efficient market theory and adaptive market theory. A review of the past studies done on bancassurance has also been reviewed. This is followed by the concept of bancassurance and financial performance measures and lastly a section of conclusion.

### **2.2 Theoretical Framework**

Bancassurance helps banks expand product offering and services to its customers under one roof, leading to improved customer satisfaction resulting in higher customer retention levels and also helps in attaining higher income stability. With the emergence of bancassurance traditional methods of distributing financial services would be challenged and innovative, customized products would emerge. Banks will bring in customer database, leverage their name recognition and reputation at both local and regional levels, make use of the personal contact with their clients, which a new entrant cannot, as they are new to the industry. From the customer point of view, a plethora of customized products would be available to him in a one-stop shop (Lasher & William, 2008).

#### **2.2.1 Efficient Market Theory**

In finance, the efficient-market hypothesis (EMH) asserts that financial markets are informational efficient. In consequence of this, one cannot consistently achieve returns in excess of average market returns on a risk-adjusted basis, given the information available at the time the investment is made (Fox & Justin 2009).

There are three major versions of the hypothesis: "weak", "semi-strong", and "strong". The weak-form EMH claims that prices on traded assets (*e.g.*, stocks, bonds, or property) already reflect all past publicly available information. The semi-strong-form EMH claims both that prices reflect all publicly available information and that prices instantly change to reflect new public information. The strong-form EMH additionally claims that prices instantly reflect even hidden or "insider" information. Critics have blamed the belief in rational markets for much of the late-2000s financial crisis. In response, proponents of the hypothesis have stated that market efficiency does not mean having no uncertainty about the future, that market efficiency is a simplification of the world which may not always hold true, and that the market is practically efficient for investment purposes for most individuals (Fox & Justin 2009).

Historically, there was a very close link between EMH and the random-walk model and then the Martingale model. The random character of stock market prices was first modelled by Jules Regnault, a French broker, in 1863 and then by Louis Bachelier, a French mathematician, in his 1900 PhD thesis, "The Theory of Speculation". His work was largely ignored until the 1950s; however beginning in the 1930s scattered, independent work corroborated his thesis. A small number of studies indicated that US stock prices and related financial series followed a random walk model. Research by Alfred Cowles in the '30s and '40s suggested that professional investors were in general unable to outperform the market (Fox & Justin 2009).

The efficient-market hypothesis was developed by Professor Eugene Fama at the University Of Chicago Booth School Of Business as an academic concept of study through his published Ph.D. thesis in the early 1960s at the same school. It was widely



accepted up until the 1990s, when behavioural finance economists, who had been a fringe element, became mainstream. Empirical analyses have consistently found problems with the efficient-market hypothesis, the most consistent being that stocks with low price to earnings (and similarly, low price to cash-flow or book value) outperform other stocks. Alternative theories have proposed that cognitive biases cause these inefficiencies, leading investors to purchase overpriced growth stocks rather than value stocks. Although the efficient-market hypothesis has become controversial because substantial and lasting inefficiencies are observed, Beechey *et al.* (2000) considers that it remains a worthwhile starting point.

The efficient-market hypothesis emerged as a prominent theory in the mid-1960s. Paul Samuelson had begun to circulate Bachelier's work among economists. In 1964 Bachelier's dissertation along with the empirical studies mentioned above were published in an anthology edited by Paul Cootner. In 1965, Eugene Fama published his dissertation arguing for the random walk hypothesis, and Samuelson published a proof for a version of the efficient-market hypothesis. In 1970 Fama published a review of both the theory and the evidence for the hypothesis. The paper extended and refined the theory, included the definitions for three forms of financial market efficiency: weak, semi-strong and strong (Beechey *et al.*, 2000).

Studies by Firth (1979 and 1980) in the United Kingdom have compared the share prices existing after a takeover announcement with the bid offer. Firth (1980) found that the share prices were fully and instantaneously adjusted to their correct levels, thus concluding that the UK stock market was semi-strong-form efficient. However, the market's ability to efficiently respond to a short term, widely publicized event such as a

takeover announcement does not necessarily prove market efficiency related to other more long term, amorphous factors. David Dreman has criticized the evidence provided by this instant "efficient" response, pointing out that an immediate response is not necessarily efficient, and that the long-term performance of the stock in response to certain movements is better indications.

### **2.2.2 Adaptive Market Theory**

The adaptive market hypothesis, as proposed by Andrew Lo, is an attempt to reconcile economic theories based on the efficient market hypothesis (which implies that markets are efficient) with behavioural economics, by applying the principles of evolution to financial interactions: competition, adaptation and natural selection.

Under this approach, the traditional models of modern financial economics can coexist with behavioural models. Lo argues that much of what behaviourists cite as counterexamples to economic rationality—loss aversion, overconfidence, overreaction, and other behavioural biases—are, in fact, consistent with an evolutionary model of individuals adapting to a changing environment using simple heuristics. According to Lo, the adaptive market hypothesis can be viewed as a new version of the efficient market hypothesis, derived from evolutionary principles:

Prices reflect as much information as dictated by the combination of environmental conditions and the number and nature of species in the economy. By species, he means distinct groups of market participants, each behaving in a common manner—pension fund managers, retail investors, market makers, hedge fund managers, etc. If multiple members of a single group are competing for rather scarce resources within a single market, then that market is likely to be highly efficient, which reflects most relevant

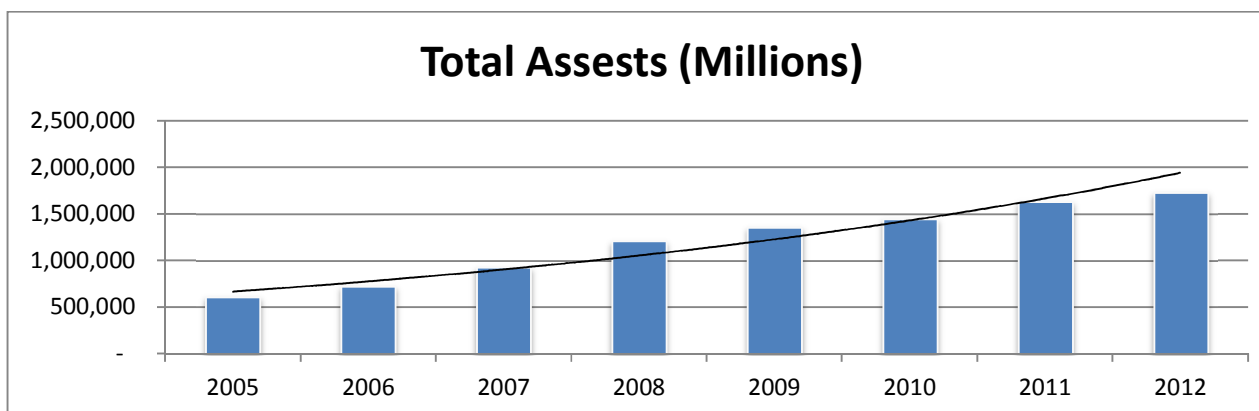
information very quickly indeed). On the other hand, if a small number of species are competing for rather abundant resources, then that market will be less efficient. Market efficiency cannot be evaluated in a vacuum, but is highly context-dependent and dynamic. Shortly stated, the degree of market efficiency is related to environmental factors characterizing market ecology, such as the number of competitors in the market, the magnitude of profit opportunities available, and the adaptability of the market participants.

### **Implications**

The adaptive market hypothesis has several implications that differentiate it from the efficient market hypothesis: 1. To the extent that a relation between risk and reward exists, it is unlikely to be stable over time, 2. There are opportunities for arbitrage, 3. Investment strategies—including quantitatively, fundamentally and technically based methods—will perform well in certain environments and poorly in others 4. The primary objective is survival; profit and utility maximization are secondary 5. The key to survival is innovation: as the risk/reward relation varies, the better way of achieving a consistent level of expected returns is to adapt to changing market conditions.

## **2.3 Situational Analysis of the Kenyan Banking Sector**

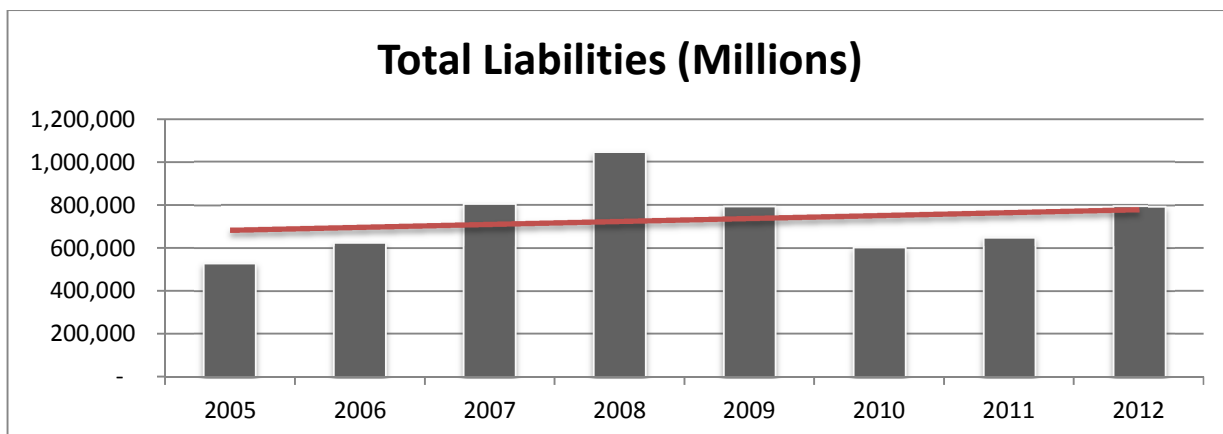
The analysis of the financial performance in the Kenyan Banking Sector brought out the following outcomes. The banking sector in Kenya has undergone tremendous growth in the recent past owing to emergence of new technology, widening of networks and creation of new services which has seen the customer base burst into a wider span than there was. The figure below shows how this growth has impacted on its asset base.



**Figure 2.1: Total Assets in Kenyan Banking Sector**

**Source: Researcher analysis**

The banking industry has over the last 8 years grown its asset base at a rate of 106%, from a value of 607,653million in 2005 to 1,729,937 million in 2012. An exponential line predicts a future further increase in the banking asset base in the coming years. This is despite the prevailing global economic downturn which mainly affected the financial sector. This is much related to the observed scenario where the liabilities are observed to be increasing at a decreasing rate as shown in the figure below.

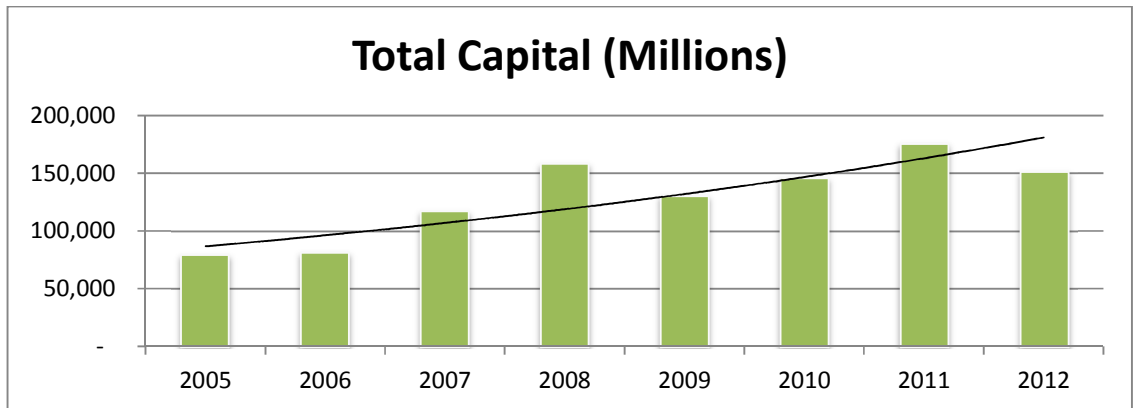


**Figure 2.2: Liabilities**

**Source: Researcher analysis**

The overall observation is that the gap between the assets and the liabilities is very small and the bankers have been widening it though at a low pace. The total liabilities have

grown at a rate of 51% to peak at Ksh. 1,045,700 million in 2008 and troughed in 2010 at Ksh. 603,996 million with an expected gradual increase. The study also looked at the capital base of the banking sector and came up with the following observations.



**Figure 2.3: Capital Base in Kenyan banking sector: Source: Research Analysis**

The banking industry is very capital intensive and hence high capital required has to be available for the investments in the banking sector to be successful. The capital base in Kenyan banking sector is relatively high with a high of Ksh. 175,379 million in 2011 and a low of Ksh. 79,155 million in 2005. The capital base was observed to increase at a rate of 82%, a bit higher than the increase in liabilities but a bit lower than increase in assets. This shows that the industry do have the potential to improve in the future at a higher rate than the observed rate. Other performance measures identified during the study period are shown below.

**Table 2.1: Financial performance of the Banking Industry in Kenya**

YEAR	Annual Income Gain (Million)	Total annual expenditure (Million)	Annual Profits (Before Tax) (Million)	Loss on Advances and Loans (Million)	Net Profits (Million)	Profit margins (Million)
2005	74,252	49,005	25,247	8,170	18,427	-
2006	88,014	52,445	35,569	12,590	25,772	7,345
2007	112,912	73,193	39,719	5,518	34,392	8,620
2008	156,961	102,222	54,739	10,543	44,198	9,806
2009	169,518	111,411	58,107	8,957	49,154	4,956
2010	183,079	121,427	61,652	7,615	54,037	4,883
2011	197,726	132,347	65,379	6,478	58,901	4,864
2012	213,544	144,250	69,294	5,506	63,799	4,898
Overall Change	113%	111%	147%	-88%	141%	-89%

Source: Research Data Analysis

The Banking sector registered 113% average increase in its annual income gains in the last 8 years. This is a high rate considering the prevailing economic conditions at the global level. The expenditures also rose at an average rate of 111% from a low of 49,005 million in 2005 to a high of 144,250 million in 2012. This rate of increase in expenditure may explain the negative profit margins acquired within this period at -89% level, with a low of 4,898 million in 2011/2012 and high of 9,806 million in 2007/2008. This means that as the banks increase their spending by diversification or expansion of their businesses, their profitability reduces by a huge margin. The losses arising from advances and loans services were observed to decrease significantly at an average rate of 88%.

## 2.4 Bancassurance

Selling insurance products over the bank counter has been called *bancassurance* in France and has been an essential part of *Allfinanz* in Germany. This movement is an effect of the hardening competition in banking. Several theories lay behind the expansion of *bancassurance*. The most important ones are: Insurance sales costs are substantially

reduced when policies are cross-sold to a bank customer base (see, for example, Nicholson, 1990). Selling insurance products implies that the own customer base of each bank will be better protected against competition from other banks (see, for example, OECD, 1993). Certain bank and insurance services are joint products and cannot be obtained separately. In other words they form “tie-in sales” (OECD, 1992). However, to be sold in banks, most insurance products have to have their own advantages. They have to be standardized and thus at low costs. They may be produced by a subsidiary to the bank and thus treated as an in-house product. This makes it easier for them to be sold through ordinary distribution channels (OECD, 1992).

Wever (2000) refers to bancassurance as the distribution of insurance products through banking networks; in other words, as the collaboration between banks and insurers to distribute insurance products to bank customers. Staikouras (2006) and Staikouras and Nurullah (2008) find that banking and insurance entities have more similarities than differences, characteristics that may favor joint production and business synergies. Through diversification, the bancassurance approach reduces the resources required to manage risk, which in turn results in lower costs (Hughes *et al.*, 1999). Korhonen and Voutilainen (2006) applied the expert panels and the analytical hierarchy process (AHP) to explore the most preferred alternative alliances between banks and insurance companies from executive management perspectives, supervisory authorities, and customers, respectively.

With bancassurance, banks enjoy several advantages compared to insurance companies that make them ideal vehicles to carry the message of insurance to the masses, across a wide cross section of society, and in the process increase their business and improve their

bottom-line. By marketing a whole range of insurance products in the life and non life sectors, Banks, not only spread awareness of these products and facilities among the people, but also make a handsome amount of money by extending this service. Banks get an additional source of income from commissions and fees from their insurance business. Especially the excessive competition for interest based products has affected the bottom-line of the Banks who are trying to build up alternative sources of income, through provision of non banking products and services.

#### **2.4.1 Bancassurance Models**

There are several forms of Bancassurance, more or less successful depending on institutional and economic framework, type of business mix and objectives of the firms involved. Following existing literature (Van der Berghe and Verweire, 2001; Voutilainen, 2005; Staikouras, 2006) we can distinguish between various models as follows:

The first model is the cross selling agreement: this takes the form of a simple partnership; banks sell insurance products through their branches, on behalf of a single company or several companies. This kind of agreement has many advantages: it is simple and reversible, not implying any change in the ownership structure or in the organizational model of the firms involved that remain absolutely independent. On the other hand, we have to consider the existence of some drawbacks: for example, conflicts of interest between banking and insurance products sharing the same distribution channel are more likely in absence of coordination between two different managements. It is also important to notice that banks can only offer simple and standardized insurance products, not requiring consulting services by highly specialized resources (Van der Berghe and Verweire, 2001).



The second model is the cooperation between two independent partners, realized through strategic alliances (often reinforced by cross ownerships in the form of minority stakes) or joint ventures. Surely, a joint venture is a stronger form of cooperation, aiming to exploit in the best way the skills of every participant, enforcing their specializations: generally insurance companies take care of product design, while banks realize distribution. These alliances can reach significant synergies concerning know how, human capital, cross selling and scope (Voutilainen, 2005; Staikouras, 2006). Banks have an important incentive to market insurance products through their branches. Such sales income, particularly in environments where competitive pressures continue to erode margins from spread income on interest. Furthermore, the advantages that bank distribution of insurance products offer over more traditional distribution methods can lead to increased productivity. Insurers have an incentive to distribute their products through banks. The banks provide a wider client base than is normally available to insurance companies.

According to Nicholson (1990), for Bancassurance to work, the key parties to the transaction - the insurer, the bank and the customer - must obtain certain benefits. For example, the *insurer* often seeks to: align itself with the public image of the bank using the bank's reputation; establish a relationship sooner in a customer's life (e.g., individuals open bank accounts at a much earlier age than they purchase insurance); gain access to a client base that is normally not available to it through other means; and obtain business at a lower acquisition cost than usual, thanks to the bank's easy access to its client base and the strong relationships it normally maintains with its clients.

The *bank* often expects to: increase the overall productivity of its client relationship, including its branch network profitability; better leverage its positive image *financial services*; position itself as a one-stop purchasing source for the client, increasing customer loyalty and retention; and diversify its product base by making insurance products available to its client base (OECD, 1993). According to Nicholson (1990), the *customer* hopes to: pay a lower price because acquisition costs are lower; have the convenience of one-stop shopping for financial services products and an easier way to make payments (through the bank); and enjoy better client services because of the bank's expanded relationship with the customer.

## **2.5 Key factors for success with bancassurance**

For a *bancassurance* strategy to become profitable, it has to generate positive net benefits (NB). This means that formulation demonstrates that such a strategy is based on a combination of: small set-up costs; a rapid growth in sales commissions; acceptable outlays for sales promotion; and small administrative costs. A research by Göran (1995) in Krediet bank in Belgium and the Deutsche Bank in Germany showed that bancassurance responded to these costs and benefits in the following ways:

*Set-up costs:* A subsidiary has been established in order to produce life insurance services. The banks sell these services on a commission basis. However, both banks have had to give financial support to their insurance daughters. Consequently, the set-up costs for insurance distribution should be small in relation to the number of customers.

*The growth in sales commissions:* The premiums are supposed to be somewhat lower for insurance distribution via their bank branches than for direct distribution from ordinary insurance firms. This profile is supposed to be attractive for most private customers.

Therefore, a rapid growth in revenues must not be obtained through high prices but in terms of large volumes. Thus, a key to success when entering the insurance market will be to establish a substantial market share as early as possible. Cross-selling ratios have to become at least 10-15 per cent.

*Acceptable outlays for sales promotion:* The services are marketed primarily to the customers of the banks. Life insurance is chosen as the primary insurance product. The sales are performed by bank officers. As a consequence, the sales promotion must not be very large for life insurance.

*Small administration costs:* The administration costs per contract have to be much lower for bank distribution than for direct distribution. Both banks have introduced standardized products and computerized systems in order to keep these costs on a low level: A key factor for an insurance firm is that old customers generate half as many claims as new ones. The focus on low administrative costs is the most successful strategy for bancassurance.

## **2.6 Empirical Review**

The appearance of more complex and integrated models has not determined the disappearance of the previous ones: we can currently observe several forms of bancassurance, more or less successful depending on institutional and economic framework, type of business mix and objectives of the firms involved. Following existing literature (Hoschka, 1994; Van der Berghe and Verweire, 2001; Voutilainen, 2005; Staikouras, 2006) we can distinguish between various models. The first model is the cross selling agreement: thanks to a simple partnership, banks sell insurance products through their branches, on behalf of a single company or several companies. This kind of

agreement has many advantages: it is simple and reversible, not implying any change in the ownership structure or in the organisational model of the firms involved that remain absolutely independent.

On the other hand, we have to consider the existence of some drawbacks: for example, conflicts of interest between banking and insurance products sharing the same distribution channel are more likely in absence of coordination between two different managements. It is also important to notice that banks can only offer simple and standardised insurance products, not requiring consulting services by highly specialised resources. The second model is the cooperation between two independent partners, realised through strategic alliances (often reinforced by cross ownerships in the form of minority stakes) or joint ventures. Surely, a joint venture is a stronger form of cooperation, aiming to exploit in the best way the skills of every participants, enforcing their specialisations: generally insurance companies take care of product design, while banks realise distribution. These alliances can reach significant synergies concerning know how, human capital, cross selling and scope economies, but it is necessary that the two partners share the same strategy and the same engagement in resources. The third model is the control by ownership: the banking and the insurance activities are managed as completely integrated, under the direction of the same ultimate owner. The bank establishes subsidiaries completely dedicated to the insurance business, or buy an insurance company already operating on the market. This “captive” model allows the bank to use information at its disposal, designing products suitable for well known customers’ needs and avoiding the danger of “cannibalization” (Berghendal, 1995), but it appears as the less flexible and reversible.

The analysis of the bancassurance phenomenon can be made focussing either the banking or the insurance standpoint. Adopting the banking point of view, we can find only a handful of studies dealing specifically with efficiency gains from diversification (Allen and Rai, 1996; Vander Venet, 2002; Casu and Girardone, 2004). It is worthwhile to emphasize that all these studies adopt a definition of banking diversification different from the concept of bancassurance. Allen and Rai (1996) examine cost efficiency of banks during the period 1988-1992 for a sample of 15 different countries allowing or not the integration between traditional and investment banking. Vander Venet (2002) measures cost and profit efficiency in European banks in 1995-1996, showing that financial conglomerates, defined as combinations between commercial banking and investment banking or insurance, are more revenue efficient than specialized banks. Casu and Girardone (2004) find an increase in profit efficiency of financial conglomerates, defined as all Italian banking groups, supposing that they generally experienced a trend towards conglomeration during the observed period (1996-1999).

Focussing on the insurance standpoint, studies dealing with efficiency and bancassurance are even rarer and, as we are aware, there are no empirical analyses assessing performance differences between various models of bancassurance, even if this is probably a relevant research question, especially for practitioners. Even if it is possible to find some examples of cooperation between banks and insurance companies also in the property and casualty industry, complementariness and similarities between the banking and the insurance activities are better exploited for life products (Genetay and Molyneux, 1998), suggesting to focus on life insurance business. Efficiency in life insurance is a quite widely investigated issue: even if the number of studies is not as huge as for the

banking industry, we can find a large variety of empirical analyses, applying both parametric and non parametric frontier techniques. Many authors compare performance levels in insurance companies with a different ownership structure and organisational model, generally aiming to assess if stock companies over-perform mutual companies (Cummins, Turchetti and Weiss, 1996; Cummins and Zi, 1997; Cummins and Weiss, 1998; Cummins and Rubio Misas, 2004). More recently, insurance literature appears devoted to investigate other issues, like the influence of efficiency on profitability (e.g. Greene and Segal, 2004) or the relationship between performance and market structure, in terms of concentration and competition (Fenn et al., 2008; Bikker and Van Leuvensteijn, 2008).

Other studies analyse the impact of the industry deregulation and consolidation, adopting a single country (Cummins and Rubio Misas, 2006) or a multinational perspective (Fenn et al., 2008). Despite the existence of this quite extensive insurance literature, we can find only few efficiency studies using frontier methodologies and dealing with the bancassurance phenomenon (Hwang and Gao, 2005; Barros et al., 2006). Hwang and Gao (2005) analyse life insurance companies operating in the Irish market, measuring cost efficiency during the period 1991-2000 with a stochastic frontier approach. The obtained efficiency scores are then regressed on a set of covariates in order to detect main drivers of performance. The authors conclude that size, market share and a dummy indicating bancassurance companies are all positively related to cost efficiency, in a statistically significant way. The adopted operational definition of bancassurance is “*the distribution of insurance products by banks*”: consequently bancassurance firms are those “*centred on selling insurance through the established distribution channels of their associated banks*”.

The criterion used appears only related to the distribution system, while banks' presence in the ownership structure of insurance companies is not explicitly considered.

Barros *et al.* (2006) also use a stochastic frontier approach in order to measure cost efficiency in the Portuguese life insurance industry, during the period 1995-2003. Instead of following a two stage approach<sup>3</sup>, two dummies are directly included into the deterministic kernel of the frontier: by this way the authors distinguish between foreign and Portugal owned companies and between companies belonging to banking groups or not bank-owned. Results show the bancassurance dummy being positively related to cost efficiency, even if not statistically significant. In this case the bancassurance phenomenon is considered only by an ownership perspective, even if insurance companies do not need to be bank participated to distribute their products through bank branches. We can find other recent studies dealing with the relationship between life insurance efficiency and the use of different distribution systems, but bancassurance is completely ignored (. Klumpes, 2004) or considered as a possible marginal alternative for insurance companies using different channels (Trigo-Gamarra, 2007). This is probably due to the fact that these analyses deal with UK and Germany, countries in which bancassurance are not as common as in France or Italy (CEA, 2008).

The comparison of different structures of financial alliances between banks and insurance companies has been discussed only in studies adopting a managerial point of view (Voutilainen, 2005; Staikouras, 2006). Voutilainen (2005) reports evidence from interviews with some Finland experts discussing nine different criteria to compare the performance of alternative bancassurance models: maximize the efficiency of product development; implement the one door principle; compromise possibly conflicting

earnings as well as possible; maximize the efficiency of customer relationship management; optimize cost and revenue synergies; minimize channel conflicts; optimize required solvency capital; maximize investor power; maximize the efficiency of sales management. Results show that the most important criteria (in the managerial perspective) are those related to cost/revenue synergies and channel conflicts: control by ownership and financial conglomerates seem to be the preferred models while joint ventures, not common in Nordic countries like Finland, are not taken into consideration. Staikouras (2006) lists different drivers of success, such as flexibility in accepting and adopting each other's culture, proper corporate governance model, management initiative, corporate brand values, customer relationship management and technology.

Finally, studies dealing with the insurance industry are generally conducted on a national base, while cross country comparisons (e.g. Rai, 1996; Diacon et al., 2002) are still less frequent: this is probably due to the scarce availability of reliable data in a comparable format and to the lower level of harmonisation with respect to the banking sector. In order to use information with a reasonable level of detail and reliability we restrict our analysis to the relevant case of the Italian life insurance industry. The Italian life insurance market ranks fourth in Europe (CEA, 2008); it is much more developed than the market for P&C products with life premiums representing more than 60% in total premiums. It also presents interesting perspectives for further growth: the penetration rate (the ratio between life premiums and GDP) is still lower than in other European countries like UK or France. The bancassurance phenomenon is strongly relevant from both a distributional and ownership points of view: in 2006, nearly 60% of life premiums were collected through bank branches (ANIA, 2008); in addition to this if we look at the



ranking in terms of 2006 market share, three of the top five operators were totally or jointly owned by banks.

We can conclude that, as we are aware, there are no comprehensive studies using modern frontier methodologies to investigate efficiency effects of bancassurance on the insurance side and comparing performance among different organisational models. Overall, our paper aims to advance to the existing literature by: 1) measuring cost and profit efficiency in the life insurance industry comparing companies totally or partially owned by banks against other (independent) companies. We also avoid the potential bias due to possible sample heterogeneity by adopting the model of Battese and Coelli (1995), in which several exogenous factors, representing main differences among sample firms, are introduced as determinants of (in)efficiency; 2) dealing with bancassurance from both an ownership and a distributional perspectives: in this way we do not fail to consider that also independent companies can distribute their products through bank branches; 3) comparing the performance among different organisational models. Thanks to the introduction of some exogenous factors in the efficiency model we are able to detect also possible sources of (in) efficiency different from the pure management ability in combining production factors; 4) analysing the relevant case of the Italian life insurance industry for which, as we are aware, there are no frontier studies dealing with the potential efficiency gains of bancassurance.

According to Arena (2006), the prime reasons for a company to consider a new model like Bancassurance are; to the banks- an additional fee based income as commission, improved resource utilization, additional cash-flow through premium deposits, and potential for getting new customers by offering special deals, to insurance companies-

greater geographical reach through bank's network, financial gain through bank's database, gaining credibility in customers, introduction of co-branded products and ease of operations.

## **2.7 Conclusion**

There is a huge untapped market in Kenya, and with the emergence of bancassurance, the insurance sector will be able to increase its penetration levels. The sector will also witness the emergence of innovative products. Bancassurance if taken in a right spirit and implemented properly can be a win-win situation for all the participants: viz. banks, insurers and the customer as seen above. Success of the bancassurance would mostly depend on how well insurers and banks understand each other's businesses and seize the opportunities presented, weeding out differences that are likely to crop.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter presents research design, target population, sampling design, data collection and procedures for data analysis.

### **3.2 Research Design**

The design of this research was a census survey. A census is a survey design that collects data from all the elements in a population. A census survey seeks to obtain information that describes existing phenomena from the sample population of all commercial banks in Kenya. A census research design enables the study to access comprehensive information to enable an establishment of the link bancassurance on financial performance of commercial banks in Kenya.

### **3.3 Population and Sample size**

Sample population of the study is all the commercial banks in Kenya. The scope of the study is to examine the impact of bancassurance on financial performance of commercial banks in Kenya.

### **3.4 Data Collection.**

The study employed secondary data collection techniques in meeting its set objectives. The secondary data was obtained from the financial statements of commercial banks that have adopted bancassurance. The study got data from the financial statements which facilitated computation of financial ratios like profits before tax, ROA, ROI, current ratio and quick ratio. The researcher was restricted within the last 8 years period for the data collection. The researcher collected the data in both hard and in soft copy form.

### 3.5 Data Analysis and Presentation

The collected data was examined for completeness and comprehensibility. The data was then coded and keyed into the Statistical Package for Social Sciences (SPSS Version 17) for analysis. This is a computer aided tool for the analysis that helps to generate descriptive statistics such as means, standard deviations and percentages. It was used in analyzing the data.

The study also employed inferential statistics such as regression and correlation to test the relationship between processes of bancassurance and financial performance of the banks. The study came up with the following regression model that it will adopt.

$$Y = \alpha_0 + \alpha_1 X_1 + \alpha_2 X_2 + e$$

Where Y=Net profit margin (financial performance of the bank);  $\alpha_0$ =Constant term;

$\alpha_i$ =coefficients of the variables;  $X_1$ =Return on Investment (Bancassurance); and

$X_2$ =Variability in Bancassurance Profits

This model was created using insights and success from Kabajeh, AL-Nu'aimat, and Dahmash, (2012), study findings on “the Relationship between the ROA, ROE and ROI Ratios with Jordanian Insurance Public Companies Market Share Prices”, which was modified to fit the case of the analysis. They found the model to be very useful in determining performance of the insurance sector in their country.

Correlation was used to test the relationship of the ROI, ROA, current and quick ratios.

The study also used ANOVA (model goodness of fit) to test the statistical significance of the variables in satisfying the set objectives. Data presentation was done by the use of charts, graphs, percentages and frequency tables.

## CHAPTER FOUR: DATA ANALYSIS AND PRESENTATION

### 4.1 Introduction

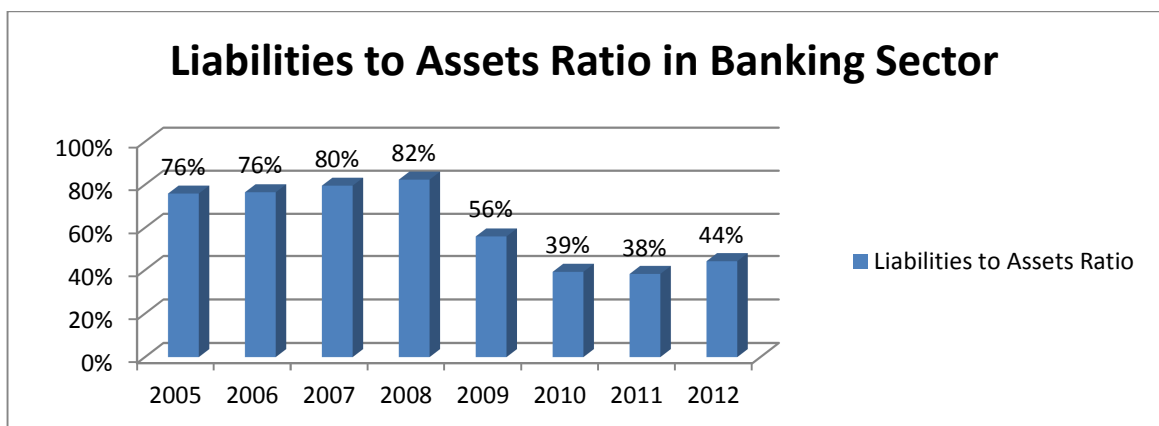
This chapter presents the findings of the study. The findings were presented using tables, charts, graphs and simplified discourse. A brief explanation accompanies each figure so as to make the findings more user-friendly and easy to understand.

### 4.2 Overall Performance Analysis of the Banking Sector

Different measures are used to show the performance of the financial sector such as liability to assets ratio, efficiency ratio,

#### 4.2.1 Liabilities to Assets Ratio

One measure of performance in financial analysis is the liability to assets ratio. It shows the capability of a firm to fund its liabilities (obligations). The following scenario in the figure below is observed in the Kenyan Banking sector.



**Figure 4.1: Liabilities to Assets ratio in the banking Sector of Kenya**

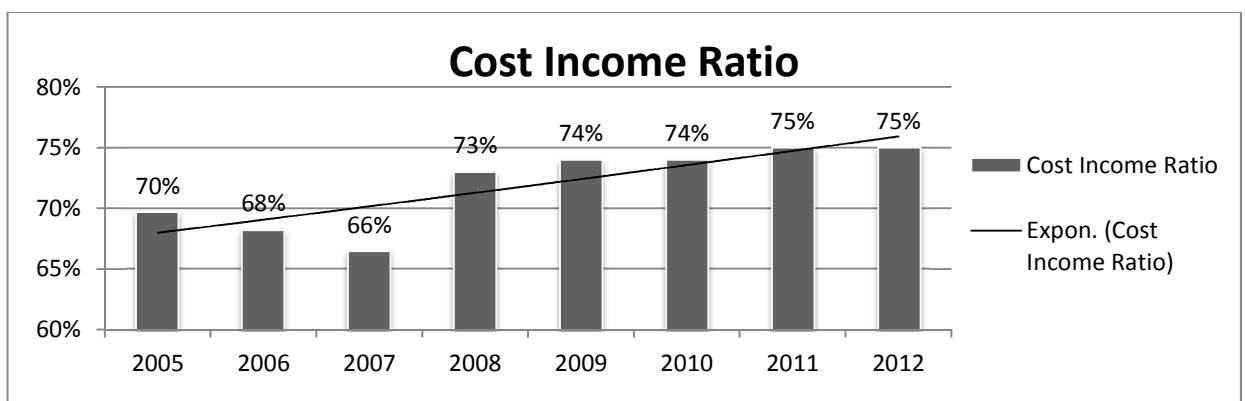
Source: Research Data Analysis

The study observed that there is a declining trend of the liabilities to Assets ratio to show that the banks are reducing their liabilities or rather increasing their assets at a higher rate. This is supported by the aforementioned observation that the liabilities are observed to

increase at a decreasing rate while the assets are increasing at an increasing rate. This shows that the banks can be able to diversify their investments further at this point therefore they have the capacity to fully implement the bancassurance and any other new investment in this sector.

#### 4.2.2 Cost Income Ratio (Efficiency)

The study also looked at the relationships between the overall costs of the sector and the income generated from the sector that shows the profitability of the investments within this sector and the abilities for an investor to break even. The Kenyan banking sector scenario is shown in the figure below, though the three start-up banks which have excessively high cost income ratios were omitted from this analysis.



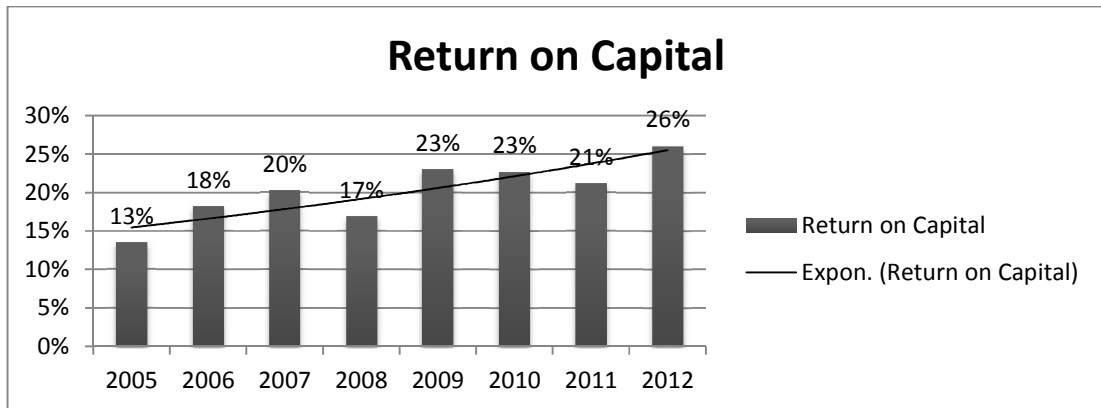
**Figure 4.2: Cost Income Ratio**

Source: Research Data Analysis

The cost income ratio was observed to be slightly increasing over the years and is projected to increase further in the coming years. It was observed to be reducing between 2005 to 2006 but changed the trend in 2008 to 2012 This shows that there is gradual increase in the cost of doing business or in the industry or that the banking sector has been intensively making new investments that are eating away on the income and increasing costs.

### 4.2.3 Return on Capital

The study analysed the relationship between the accrued profits (net profits) and the capital employed and the figure below represent the outcome of the study.



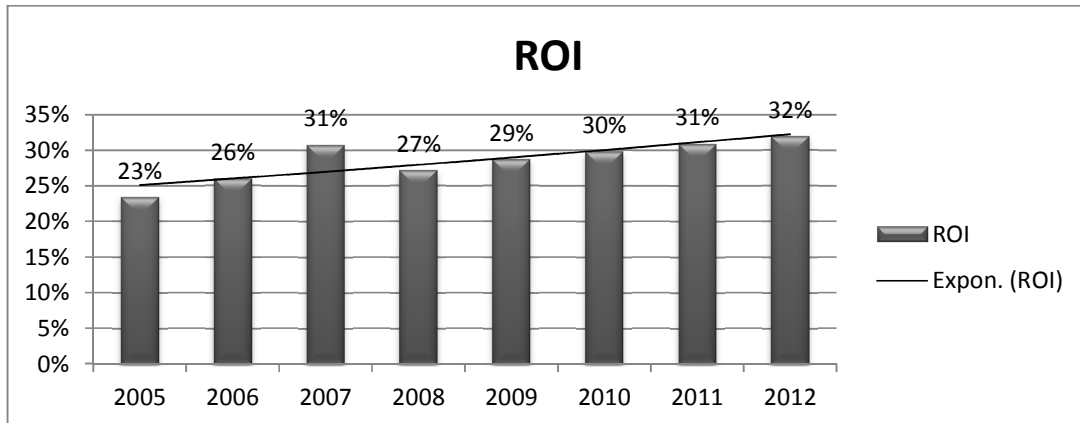
**Figure 4.3: Return on Capital**

Source: Research Data Analysis

The returns on capital were observed to be increasing steadily over time with 2012 reporting the highest value at 26%. This shows that profitability in the banking sector is increasing gradually with a prediction of a future rise in the same. Therefore, the banking sector current undertakings are observed to improve profitability or they use lesser capital to be operational.

### 4.2.4 Return on Investment

Return on investment (ROI) is a performance measure used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments. To calculate ROI, the benefit (return) of all the investments was divided by the cost of the investment; and the result was expressed in percentage as shown below.



**Figure 4.4: Return on Investment (Banking sector)**

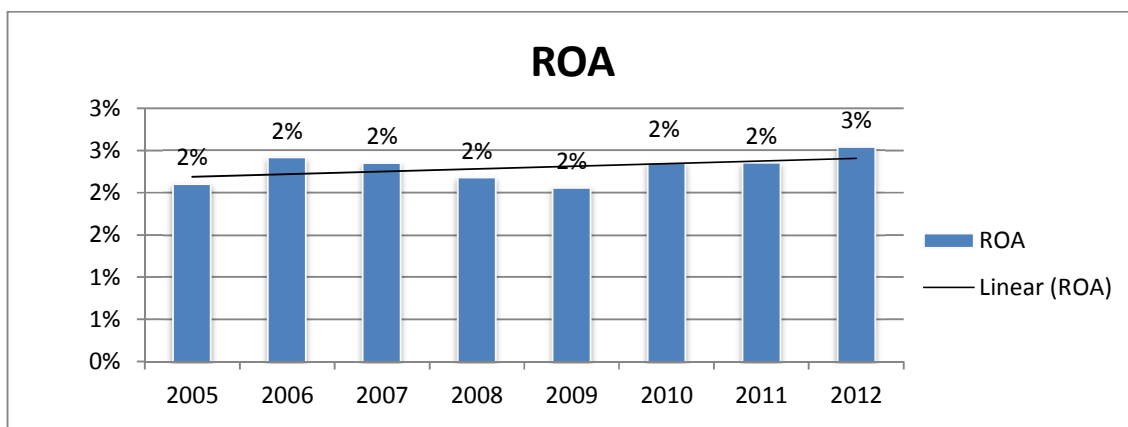
Source: Research Data Analysis

The study unearthed that the return to investment ratio is increasing though at a very low pace. Some of the banks have associated this to the reduction of losses on loans and advances as well as diversification. The average return on investment being at 29% for the 2005-2012 period is a good gesture since investments in the banking sector are bound to create a 29% profit in the current market condition. An investment of 1 Ksh will generate 29 cents profit. This shows a viable market that is attractive to investors.

#### **4.2.5 Return on Assets**

Return on assets percentage (ROA) percentage shows how profitable a company's assets are in generating revenue. The banking sector's overall return on assets is as shown in the figure below.





**Figure 4.5: Return on Assets**

Source: Research Data Analysis

It was observed that the banking sector has a very low return on assets ratio. This is because as mentioned earlier, the banking sector is capital intensive and requires a lot of assets so as to be fully functional. This may explain why the start up banks tends to be submerged in debts and losses. The study observed a very low increment rate of the ROA and is expected to increase further over the next few years.

### **4.3 Bancassurance Performance**

The study employed different measures to assess the performance level of bancassurance in the banking sector. Return on investment, return on assets and efficiency ratio were used in this case.

#### **4.3.1 General performance**

The performance indicators of bancassurance in Kenya is observed to be very promising as profitability is seen to rise steadily even though costs are still increasing in all areas as shown in the figure below.

**Table 4.1: Overall Bancassurance performance**

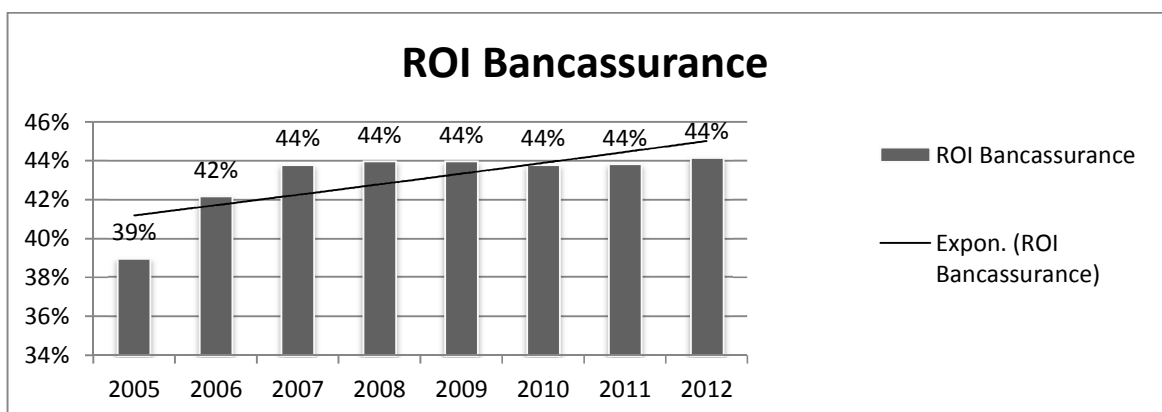
Year of Operation	Income (Bancassurance) (Millions)	Expenditures (Bancassurance)	Profit (Bancassurance)
2012	375	252	123
2011	347	231	116
2010	321	212	110
2009	298	194	103
2008	276	178	97
2007	198	128	71
2006	155	91	63
2005	130	85	45
<b>% change</b>	112%	104%	95%

Source: Research Data Analysis

Though four of the banks registered losses in their bancassurance investment, the overall banking sector income was observed to increase over time at a rate of 112%. The expenditures were increasing at a lower rate of 104%. This shows that banks were investing more into bancassurance even though it is at its start up stage. A high profitability level was also observed with an overall positive increase rate of 95%.

#### 4.3.2 Return on Investment in Bancassurance

The ROI in bancassurance investment was identified as a positive ratio at above 40%. The study observed that there is a high likelihood of an investment into bancassurance to bear in profits. This observation is presented in the figure below.



**Figure 4.6: Return on Investment (Bancassurance)**

Source: Research Data Analysis

This shows that the investments in bancassurance are highly profitable since the cost of investment is lower than the income generated hence provides positive income.

#### 4.3.3 Individual Banking Performance

Concerning profits and losses, banks performed differently over the years with some presenting losses and others presenting profit gains as shown.

**Table 4.2: Profit/loss for bancassurance investment**

<b>Bancassurance Investment situation</b>	<b>2012</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>Banks Reporting Profits</b>	40	40	40	39	39	39	38	38
<b>Banks Reporting losses</b>	3	3	3	4	3	2	1	1
<b>Banks Not investing</b>	0	0	0	0	1	2	4	4

Source: Research Data Analysis

It was observed that 93% of the banks registered profits in their bancassurance investment while only 7% registered losses in 2010, 2011, and 2012. In 2009, the profitable banks were at 91% and 9% were unprofitable while in 2008, 91% were profitable, 7% registered losses and 2% had not invested. In 2007, 91% were profitable, 5% registered losses and 4% had no investment. In 2005 and 2006, 88% of the banks were profitable, 2% registered losses and 9% had not adopted this investment. Those that registered losses had same characteristic: that they were in their start-up stage and had just adopted bancassurance. One such bank is the first community bank. Therefore, Bancassurance has a boosting impact to the overall profitability of the Banks.

#### 4.3.4 Challenges experienced in Bancassurance

The study observed the following as the challenges that the banks are faced with in establishing bancassurance in Kenya. Some of these challenges include:

**Loses in the initial investment period:** The period prior to the initial investment is marked by losses from the bancassurance investment that hinder Banks from making the move to establish bancassurance.

**High Initial Investment Capital required:** This is linked to the experience of losses immediately after investment. Bancassurance is capital intensive and the banks need to operationalize a huge amount of their capital so as to make this investment.

**Legal framework in Kenya:** Bancassurance is guided by various legal frameworks in banking and insurance sectors, which brings about complications in its enforcement.

#### **4.3.5 Factors Driving Adoption of Bancassurance**

The study identified the following factors as the driving force in adoption of Bancassurance in Kenyan banking sector.

***Insurance products will increase productivity of banks and enhance their profitability:***

Through sale of insurance products, the banks accrue a number of financial benefits. These benefits include improved income generation, in the form of commissions and/or profits from insurance business; decreased effect of the bank fixed costs because they are spread over the life insurance relationship and employee productivity.

***Branch network by banks would increase penetration of insurance products:*** The banking sector has achieved a deeper penetration especially within the rural areas, where the insurance companies do not have branches. With increased integration of financial services and banks seeking to expand the range of services offered to clients, a perfect opportunity exists for the two sectors to enter into a bancassurance partnership hence an avenue to reach more customers.

***Diversification of banking products and services:*** The banks are able to further diversify their services hence widening their sources of revenue and hence increasing their revenues. The banks are able to sell these diversified products to their wide customer base hence ensuring that there is a wider uptake reaching new markets.

***Availability of untapped Insurance market:*** The study observed that most of the current insurance market penetration rate is approximately 2.5% of the GNP, despite the Kenyan Insurance industry accommodating in excess of over 40 insurance underwriters whose distribution strategies have not been effective in enhancing the penetration rate especially in the rural areas.

#### **4.4 Regression Analysis**

The study carried out a regression analysis between the change in profit streams from bancassurance over the study period and the net profit margins of the banking sector. The following shows the observed outcomes of the analysis.

**Table 4.3: Regression statistics output**

<i>Regression Statistics</i>	
Multiple R	0.972
R Square	0.944
Adjusted R Square	0.916
Standard Error	607.85591
Observations	6

Source: Research Data Analysis

The analysis shows that there is a high correlation (97.2%) between the actual and predicted values of the dependent variable (change in bancassurance profits) as shown by the multiple R analysis. The model is 94.4% accurate in explaining the dependent variable of the analysis and explains 91.6% of the variable. This shows that the model have a highly significant effect.

**Table 4.4: ANOVA Analysis**

ANOVA <sup>b</sup>						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	24,899,023.87	2	12,449,511.94	33.694	.003 <sup>a</sup>
	Residual	1,477,955.22	4	369,488.805		
<b>Total</b>		<b>2,376,979.09</b>	<b>6</b>			

a. Predictors: (Constant), ProfitsBancassurance, ROIbancassurance

b. Dependent Variable: NetProfitMargin

Source: Research Data Analysis

The ANOVA analysis showed that the outcomes of the analysis are reliable with a P-value of 0.03 which is less than the allowable 0.05. The analysis was also observed to have a higher explained variance of outcomes with an F value greater than 1 (33.694).

**Table 4.5: Regression Coefficients**

Coefficients <sup>a</sup>								
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B	
		B	Std. Error	Beta			Lower Bound	Upper Bound
1	(Constant)	1485.84	672.06		2.211	.042	-380.092	3351.775
	ROIbancassurance	16055.07	3225.84	.671	4.977	.008	7098.692	25011.456
	ProfitsBancassurance	304.89	37.57	1.094	8.115	.001	200.570	409.206

Source: Research Data Analysis

The regression coefficients were all significant as they have a P-value of less than 0.05 given as 0.042 (intercept), 0.008 ( $a_1$ ), and 0.001( $a_2$ ). The coefficients are both positive and able to predict the value of the profit margins. This gives the model as:

$$Y = 1,485.84 + 16055.07 X_1 + 304.89 X_2 + e$$

Where Y=Net profit margin in Banking sector;  $X_1$ =Return on Investment in Bancassurance;  $X_2$ =Variability in Overall Bancassurance Profitability; and e=standard error

The study realized a high positive coefficient ( $a_1$ ) that shows a positive contribution of bancassurance profits to the profit margin. The constant was also observed to be a bit high due to the fact that other major contributors to the profits in the sector have not been included in the model.

**Table 4.6: Coefficients Correlations**

Coefficient Correlations				
Model		ProfitsBancassurance	ROIbancassurance	
1	Correlations	ProfitsBancassurance	1.000	.479
		ROIbancassurance	.479	1.000
	Covariances	ProfitsBancassurance	1411.691	58069.234
		ROIbancassurance	58069.234	1.041E+07

Source: Research Data Analysis

A correlation analysis between the two coefficients of the variables of study brought forward a low correlation of 47.9% to show that the two coefficients have low autocorrelation. Hence the coefficients can be said to lack the problem of heteroscedasticity and hence are very much fit to explain the variability in net profit margins in this model.

**Table 4.7: Residual Statistics**

Residuals Statistics					
	Minimum	Maximum	Mean	Std. Deviation	N
<b>Predicted Value</b>	4406.6001	9573.4883	6481.7271	2037.11495	7
<b>Residual</b>	-843.45917	491.84995	.00000	496.31227	7
<b>Std. Predicted Value</b>	-1.019	1.518	.000	1.000	7
<b>Std. Residual</b>	-1.388	.809	.000	.816	7

Source: Research Data Analysis

The analysis showed that the model can be able to explain 91.6% of the net profit margin as given by the adjusted  $R^2$  of 0.916. This shows that the model is highly predictive when it comes to the said forecasts. This model can predict the profit margins as given in the table above.

## **4.5 Summary and Interpretation**

The banking sector in Kenya has undergone tremendous growth in the recent past owing to emergence of new technology, widening of networks and creation of new services which has seen the customer base burst into a wider span than there was. It has over the last 8 years grown its asset base at a rate of 106%, from a value of 607,653million in 2005 to 1,729,937 million in 2012. This is a huge growth despite the world economic problems experienced in this period such as the credit crunch. This shows that healthy financial conditions exist in Kenya.

The gap between the assets and the liabilities is very small and the bankers have been widening it though at a low pace. It was observed that the total liabilities have grown at a rate of 51% to peak at Ksh. 1,045,700 million in 2008 and troughed in 2010 at Ksh. 603,996 million with an expected gradual increase. This period (2005-2012) saw most of the banks start their investment in Bancassurance and therefore, the smaller gap may be linked to the high initial capital investment required in bancassurance.

The banking sector is capital intensive and hence high capital required has to be available for the investments in the banking sector to be successful. The study found that the capital base in Kenyan banking sector is relatively high with a high of Ksh. 175,379 million in 2011 and a low of Ksh. 79,155 million in 2005. The capital base was observed to increase at a rate of 82%, a bit higher than the increase in liabilities but a bit lower than increase in assets. The sector registered 113% average increase in its annual income gains in the last 8 years, while expenditures as well rose at an average rate of 111% from a low of 49,005 million in 2005 to a high of 144,250 million in 2012. This rate of increase in expenditure may explain the negative overall profit margins acquired within this period at



(-89%) level, with a low of 4,898 million in 2011/2012 and high of 9,806 million in 2007/2008. This means that as the banks increase their spending by diversification or expansion of their businesses, their profitability was observed to be reducing by a huge margin. The losses arising from advances and loans services were observed to decrease significantly at an average rate of 88%.

The liabilities to Assets ratio was observed to be declining to show that the banks are reducing their liabilities or rather increasing their assets at a higher rate. This is supported by the aforementioned observation that the liabilities are observed to increase at a decreasing rate while the assets are increasing at an increasing rate. This shows that the banks have capacity to diversify their investments further at this point therefore they have the capacity to fully implement the bancassurance among other investments.

The cost income ratio was observed to be reducing between 2005 to 2006 but changed the trend in 2008 to 2012 This shows that there is gradual increase in the cost of doing business in the industry or that the banking sector has been intensively making new investments that are eating away on the income and increasing costs. This may be associated with the increasing complexity of the banking sector.

The returns on capital were observed to be increasing steadily over time with 2012 reporting the highest value at 26%. This shows that profitability in the banking sector is increasing gradually with a prediction of a future rise in the same. The return to investment ratio is increasing though at a very low pace. Some of the banks have associated this to the reduction of losses on loans and advances as well as diversification. The average return on investment being at 29% for the 2005-2012 period is a good gesture since investments in the banking sector are bound to create a 29% profit in the

current market condition. An investment of 1 Ksh will generate 29 cents profit. This shows a viable market that is attractive to investors. It was observed that the banking sector has a very low return on assets ratio (2% average). The study observed a very low increment rate of the ROA and is expected to increase further over the next few years.

The income acquired from bancassurance was observed to increase over the period at a rate of 112%. The expenditures were increasing at a lower rate of 104%. This shows that banks were investing more into bancassurance even though it is at its start up stage. A high profitability level was also observed with an overall positive increase rate of 95%. The income generated from bancassurance in relation to the overall income is very small but important as the stream of income from bancassurance is increasing over time.

It was observed that 93% of the banks registered profits in their bancassurance investment while only 7% registered losses in 2010, 2011, and 2012. In 2009, the profitable banks were at 91% and 9% were not profitable while in 2008, 91% were profitable, 7% registered losses and 2% had not invested. In 2007, 91% were profitable, 5% registered losses and 4% had no investment. In 2005 and 2006, 88% of the banks were profitable, 2% registered losses and 9% had not adopted this investment. Those that registered losses had same characteristic: that they were in their start-up stage and had just adopted bancassurance. One such bank is the first community bank.

The ROI in bancassurance investment was identified as a positive ratio at above 40%, far higher than the overall ROI of the banking sector. This shows that the profitability from bancassurance is far higher than profitability from other investments in the banking sector. The study observed that there is a higher likelihood of an investment into

bancassurance to bear in profits and the profitability is bound to increase as more and more customers adopt bancassurance.

The study identified the following factors as the driving force in adoption of Bancassurance in Kenyan Banking sector as: Insurance products increases productivity of banks and enhance their profitability; branch network by banks would increase penetration of insurance products; diversification of banking products and services; and, availability of untapped Insurance market.

Challenges that banks are faced with in establishing bancassurance in Kenya were observed to include: High Investment Capital requirement; high loss in the initial investment period; legal framework in Kenya; lack of a single central regulatory body in Kenya is a major impediment to acceptance of Bancassurance in Kenya.

The regression analysis gave positive coefficients and a 97.2% efficiency level of the predictors explaining 91.6% of the net profit margin. The study model was observed to be significant with a P-value of the variables less than 0.05 (95% confidence level). The study came up with the following model that explains the effects of bancassurance on the net profit margin of a financial institution.

$$Y = 1,485.84 + 16055.07 X1 + 304.89 X2 + e$$

Where Y= Net profit margin in Banking sector

X1=Return on Investment in Bancassurance

X2=Variability in Overall Bancassurance Profitability

e=standard error

The study found that despite the challenges listed above, the financial institutions are bound to make profits by adopting bancassurance in their banking systems.

## **CHAPTER FIVE: CONCLUSION AND RECOMMENDATION**

### **5.1 Summary**

The study was meant to determine the effects of Bancassurance on the financial performance of financial institutions in Kenya. This study was able to achieve this by review of the existing literature on financial performance, Banking Industry in Kenya, and bancassurance singly or in unison that facilitated a realization of the research gap that the study fills. The researcher used a statistical approach to determine the effects of bancassurance on commercial banks financial performance by carrying out a model fitness analysis, correlations and regression on a time series (2005-2012) data collected from secondary sources acquired from the banks that brought out the sensitivity of bancassurance on financial performance.

### **5.2 Conclusion**

In conclusion, the study has observed that the banking sector in Kenya is very dynamic and highly profitable as an investment avenue. The sector has seen major growth in the recent past despite dwindling performance in the global financial sector. The financial figures analysed in the study has shown a sector capable of expanding further and increasing its market reach. The sector has a wide asset base that allows it to diversify products and create new innovations for its customers.

All the performance indicators show a normally functioning banking sector with high return on investment ratio and a high return on assets ratio. The banking sector is therefore fully functional and has been able to uptake bancassurance investment without affecting the usual banking services on offer. Banks have therefore expressed their ability

to implement the insurance services within their banking operations and hence ensuring more people are able to access insurance services.

The profitability of bancassurance was observed to be increasing over the period and shows a high probability of future increments which shows that more and more people are being able to access the service through the banks. The growth in profitability of bancassurance is a sure sign that with more marketing of the service, the insurance services reach to the Kenyan population will improve in future and the banking sector will be boosted further by this growth.

Bancassurance was observed to boost profitability of the banking sector by a large profit margin and its growth was observed to have significant effects on the profit gains in the banking sector. The banking sector will therefore enjoy more profits by providing more insurance services to the customers and the Kenyan public. The study proposes a model that may be used to assess the profitability of the bancassurance investment and also in forecasting profitability of such investment hence determining the profitability of an investment. This model is as shown below

$$Y = 1,485.84 + 16055.07 X_1 + 304.89 X_2 + e$$

Where Y=Net profit margin in Banking sector

X<sub>1</sub>=Return on Investment in Bancassurance

X<sub>2</sub>=Variability in Overall Bancassurance Profitability

e=standard error

The provision of the insurance services were observed to be affected by some challenges such as: High Investment Capital requirement; High loss in the initial investment period; Legal framework in Kenya; and, lack of a single central regulatory body in Kenya is a

major impediment to acceptance of Bancassurance in Kenya, which hamper the introduction and growth of the insurance products in the sector.

It was also observed that Bancassurance benefits from the fact that Insurance products will increase productivity of banks and enhance their profitability; the branch network by banks would increase penetration of insurance products (symbiotic relationship), diversification of banking products and services will be achieved through bancassurance, and, the availability of untapped insurance market in Kenya especially the rural areas may be a boost to the bancassurance services.

### **5.3 Recommendations for Policy and Practice**

The study has confirmed that the banking sector can increase profitability by a high margin by increasing its bancassurance services and by investing more into the bancassurance products. The study thus recommends that the banking sector should invest more into bancassurance by improved marketing strategy for its products such that more customers are attracted to these services.

The study also observes that there are key pull factors to investment in bancassurance which the banks need to employ and take advantage of so as to be able to fully rip the benefits of this lucrative venture. The study recommends that the banks need to embrace the fact that bancassurance is a symbiotic relationship which will benefit them as well as the insurance firms, it will diversify their income sources; and increase productivity.

High profitability of bancassurance in the banking sector will provide new revenues that are bound to make the banking sector in Kenya more attractive to investors. More assets generated will therefore help the banking sector to innovate further and improve on the bancassurance products on offer. The study recommends that the banking sector should

bring in more experts on bancassurance to help in rolling out better products that suits customer niche and embrace customer uniqueness in the Kenyan insurance market.

The banking sector regulators should also find ways to offer solutions to the challenges that were observed to hinder bancassurance investment though some have already been solved with the Kenyan government bringing onboard a new financial bill 2012.'

#### **5.4 Limitations of the Study**

The study was limited to the area of study, Kenya commercial banks and therefore couldn't venture into analysing the effects of bancassurance to the insurance sector's financial performance as well as analysing the effects on the customer financial security.

The study also used secondary data in meeting its mandate since the study could only be done on using time series data. This data was available in the banking survey, 2009, by Ochieng, Oloo for year 2005 to 2008 period. Therefore the efficiency and applicability of the recorded data was not predetermined, but later the data was adopted as a representation of the real data after cross-checking part of the figures with real figures collected in random banks. The rest of the data for the period 2009-2012 was acquired from various banking institutions in Kenya that were provided all the requisite information.

#### **5.5 Suggestions for Further Research**

Further exploratory research should be done in this area to assess the factors that caused successful implementation of bancassurance in the Kenyan banking sector. Also, researchers should assess the readiness of the Kenyan higher education institutions in providing training in bancassurance. Further research on the benefits of bancassurance to

the Kenyan insurance market should be done to assess the effects of bancassurance in the public view.

The model proposed in this study may be very much applicable in the analysis of financial performance and the forecasting of the same. Therefore it is important for policy makers and researchers to carry out further testing of the model to justify further its applicability in the financial forecasting and analysis. Further research should also be carried out to determine the effects of bank assurance on the financial performance of insurance firms in Kenya.



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