EFFECT OF CORPORATE GOVERNANCE ON FINANCIAL PERFOMANCE OF INSURANCE COMPANIES IN KENYA

SUBMITTED BY:

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DECLARATION

I, the undersigned, declare that this project is my own effort which has not been submitted to any other university or institution of higher learning for any academic purpose.

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Sign: …… Date: ……

The research project has been submitted for examination with my approval as the University Supervisor

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Finally to my lecturers for impacting the desired knowledge and my classmates with whom we shared knowledge through group discussions, class presentations and other forums and my at work colleagues who from time to time have been giving me moral support.

DEDICATION

This proposal is dedicated to my loving husband Raymond Cheruiyot and our lovely children: Daughray Chepkemoi, Ryan Kipchumba and Euray Cherono.

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ACRONYMS AND ABBREVIATIONS

AKI - Association of Kenya Insurers

BOD - Board of Directors.

CEO - Chief Executive Officer

CMA -Capital Markets Authority

GDP - Gross Direct Premium

IRA - Insurance Regulatory Authority

NSE - Nairobi Securities Exchange

ROA - Return on Assets

ABSTRACT

This study looked at the relationship between corporate governance and financial performance of insurance companies in Kenya. Good corporate governance enhances ethical behavior of those that yield corporate power. Specifically, this study examined Board diversity, Board meetings, Board committee, Board size, and Board independence and their relationship with financial performance, as measured by return on assets, of insurance companies in Kenya. The study comprised of all 43 insurance companies licensed by the Insurance Regulatory Authority during the period 2012 to 2015. The study employed multiple linear regression analysis. The data collected was from secondary sources as it was obtained from the firm's financial reports. The data was cleaned for completeness, coded and analyzed by the use of Statistical Package for Social Sciences (SPSS) for analysis. The results also found that there exists a weak negative correlation between return on assets and board size with return on assets and board diversity was found to be strongly positive. The board frequency of meetings was found to have a minimal significant influence on the insurance company's financial performance with board diversity, board committee and board committee found to be statistically significant. The overall multiple linear regression models was tested using ANOVA and the resulting F-stat indicated that the model was significant at 95% significance level.The study recommends that stakeholders in Kenyan insurance industry should take into account the board diversity, board committees and board meetings when forming board of directors as they are significant determinants of financial performance. That is the board should be organized in a way that will help the insurance companies improve their overall performance. According to this study board independence and board size should not be prioritized as they are insignificant when it comes to determining listed firms' financial performance.The variables considered in the study explained 52% and 66% of the variation in firm financial performance across the four study years implying that there are other important factors not included in the model and therefore the study recommends that the management should put in to consideration such factors in order to enhance the effectiveness of corporate governance index. The study also recommends that policy makers should set an index on corporate governance to act as a reference for all insurance companies so that the efficiency of corporate governance can be enhanced

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

This chapter entails the overview of the topic under study, in it, it contains the studies background, the statement of the problem, research objective and at the same time, it looks at the value of the study .Corporate governance can be defined as that set of procedures followed, customs, policies, laws and institutions which affect the way in which the corporation is directed, administered and managed. It may be defined as the businesses' pillars which guide businesses on how tobe accountable to stakeholders, fairness, adopt transparency in business activities and exhibit independence in decision making by the board.

1.1.1 Corporate Governance

The definition of corporate governance as defined by (Julian,2005), as the system where business corporations are directed and controlled, the rights and responsibilities among different players are distributed and employees in the business, as well as corporate affairs rules and procedures for making decisions , as laid down under the corporate governance structures**.** Corporate governance as defined by Humera (2011)isthe processes, policies, customs, laws and institutions in which organizations are directed and how their operations are operated, administered and controlled. It enables organizations to achieve their goal, manages the relationship among different stakeholders who include the board of directors and the shareholders as well as dealing with employees and other stakeholders through a process by which the principal –agent problem in the organization is reduced.

According to Morin and Jarrel (2001), corporate governance is the structurethat oversees, administers and ensures the interests of different concerned players in the

market are protected. It refers to the management where the company is directed and controlled in order to strike a balance between its interests on one hand and on the other hand the interests of other related parties.

The IRA (2011) guidelines on corporate governance, summarizes principles of good governance of insurance companies as the board'sstructure and its administration that is accountable and responsible for the effective conduct and performance of the insurer. It further states that every insurer should be under a board that is effective in order to offer guidance that is strategic and policy direction, lead and control the Insurer and be accountable to its shareholdersas well as other stakeholders.

Good practices of corporate governance are those whereby the environment in which the business operates is fair, processes are transparent and companies held responsible for their actions. Weak corporate governance practices on the other hand usually leads to waste, mismanagement and higher levels of corruptions in those organizations. According to Nabil and Ziad (2014), the aim of corporate governance practices is to ensure there is a balance in power sharing among different shareholders, management as well as directors in order to shareholder value to be enhanced and ensure the interests of other shareholders is protected. Nabil and Ziad (2014), noted that investor confidence is improved by effective structures of corporate governance which ensure that the corporate entity isaccountable,reliable and quality of public financial information is enhanced and that the capital markets integrity and efficiency is enhanced.

1.1.2 Financial Performance of Insurance Companies

Financial performance is defined as the conduct and manner of performing financial activity. It can also be defined as the extent to which financial objectives is being or

has been achieved. It can also refer to the means by which the firm's policies and operations results are measured in monetary terms. The firm's overall financial health is measured over time and the obtained results are thereafter used for comparison by firms in the same industry or to compare companies in different industries or sectors, (Kwaning&Mahama, 2015)

Burca and Batrinca (2014), notes that actuaries use financial data analyzed by a company as an important tool duringthe insurance company's decision making on underwriting and investment. The insurance companies financial performance is crucial for an economy since the industry forms one of the financial system' components that foster growth and stability however internal and external factors are factors that affect the insurance' companies performance. Internal factors can be represented by specific characteristics that are mostly unique to a particular company while external factors on the other side extends beyond one company and includes those factors that affect connected institutions as well as the overall macroeconomic environment.

1.1.3 Corporate Governance and Financial Performance of Insurance Companies

Corporate governance entails ensuring there is legal compliance with legal obligations and protection of shareholders' funds against fraud or organizational failure. This involves having a board in place to direct and control managers who may at times be tempted not to manage in a manner that represents the shareholders' interests. A board comprises of inside directors who normallyare picked from among employees at the executive level of the firm and directors from outside the firm but who are affiliated to the firm by the virtue of their directorship. (Rouf, 2011).The independent director's

role is to effectively monitor and control the activities of the firm as well as to reduce managerial behaviors that may be opportunistic and thereby resulting resources of the firm being expropriated.

In a study conducted by Wanyama and Olweny (2013), on the effects of corporate governance on financial performance of listed insurance firms in Kenya,they observed that a strong relationship that exists between the corporate governance practice under study and the financial performance of the firms' under the study. They noted that board size negatively affected the financial performance of insurance companies listed at the NSE is negatively affected by board size while a positive relationship exists between board composition and firm financial performance. In regards to CEO duality, they noted that there was a positive influence on the financial performance of listed insurance firms in boards whereby the role of CEO and chair is separated.

Board size is considered as an important variable while undertaking the study of corporate governance as it is believed to influence the value of the firm in that while larger boards may have the benefit of increased monitoring, the may besurpassed by the poorer communication and decision making that results from coordinating larger groups. Mak and Kusnadi (2005), noted boards that smaller, tend to have a high firm value while on the other hand larger boards maybe less effective since the resources associated with coordinating and processing problems maybe high making decision making difficult. Small boards on the other side, reduces the problem of free riding thereby enhancing the efficiency of the firm. An optimal board as suggested by Lipton and Lorsch (1992), should consist of between seven to nine directors.

Agrawal and Knoeber (1996) assert that the number and percentage of independent directors is correlated positively to the firm's performance. Mehran (1995) noted

thatin instances wherethe number of proportion of independent directors is increased, it simultaneously increases the performance of the firm as managers are monitored effectively. However, Yermack (1996), observed that there is a negative relationship exists between the proportion of the firm and value of the firm. Hermalin and Weisbach (1991), didn't observe any relationship between the proportion of the firm and its performance

IRA in 2015 recorded an increase in Insurance fraud that has more than tripled from 88 cases involving Sh.102 million in 2015 to 93 cases involving Sh 324 million. The affected segments according to IRA were the motor and medical insurance classes which comprised of for more than half of the cases reported. The members of staff as well as loss assessors of insurance companies were found to be involved with the fraudulent activities. According to Kangethe (2015), Majority of the claims were found to come from people who pretended to have been involved in accidents. Fraudsters collude with different players in the insurance industry including garages and medical service providers. 50 percent of all paid premiums in the industry was found to be fraudulent. This has contributed to the increase of premiums.

1.1.4 Insurance Companies in Kenya

Insurance companies have a very important role for the development and growth of an economy since they provide financial services that are specialized such as underwriting of risks and mobilize large amount of funds through premiums which are later used for long term investments. Association of Kenya Insurers (AKI) under which the insurance industry operates, is an umbrella body In Kenya, which was established in the year 1987. Its aim is to encouragebusiness practices that are prudent, create public awareness as well as elevate the growth of Insurance sector in

country. There are currently 43 Insurance companies that are members of the Association of Kenya Insurers.

Kenya has been reported as the largest Insurance market within the East Africa community. According to IRA's 2014 annual report, the growth of insurance companies in Kenya can be attributed to growing middle class, discovery of oil and gas deposits, major investments in infrastructure projects as well as shifting demographics. These factors have created immense opportunities for insurance sector in Kenya which has also led to demand for quality services by the consumers. This demand has led the insurers to relook at their models in terms of innovation as well as reach. The deepening of insurance penetration in Kenya has led to a positive economic growth thereby making the future of insurance market to be promising.

The IRA is an autonomous regulator, set up in 2008 and is the industry's regulator. According to an IRA annual report that was released in the year (2014), Kenya's insurance industry has been reported as the fastest growing industry. This growth has seen the number of foreign and local investors seeking to invest in the local domestic market increase and their entry is projected to enhance the industry stability since there is a likely of core capital being injected , technical expertise as well product development innovation, distribution and global networks. Some new entrants include; Barclays Group, Prudential Life Assurance, Liberty Life Assurance, Saham Group, Leapfrog and Allianz Group.

IRA 2014 annual's report, reported that the Insurance industry witnessed increased activities in mergers, acquisitions and other restructuring such as Britam acquiring Real Insurance, Metropolitan Group acquiring Cannon Assurance, Old Mutual Group acquiring UAP Holdings and Pan Africa Holdings acquiring Gateway Insurance.

These acquisitions represented an opportunity for synergies creation and leveraging on the innovation which in the long term could result to revenue growth and profitability of the sector if well managed. However, the collapse or placement under statutory management of some of the insurance companies such as: Access Insurance, Lakestar Insurance, Kenya National Assurance, Standard Assurance, Stallion Insurance, , United Insurance and Blue Shield Insurance due to misappropriation and mismanagement of company assets, implies there are some setbacks to the growth of this industry that needs to be dealt with.

1.2 Research Problem

According to (Miller C.A., 2010), (Bourne & Franco, 2003), existing studies on firms with good corporate governance practices have been observed to have an impact that is positive to their performance. It's paramount for companies to embrace good practices of corporate governance as this helps in preventing scandals, fraud as well as enhancing the image of an organization in the eyes of the public as one that is worthy of shareholder and debt capital holder. It also becomes essential for companies to improve firm performance, ensures investor rights, enhances investment atmosphere as well as encourages economic development (Braga & Shastri, 2011). A major contribution that led to the collapse of some of the insurance companies in Kenya and the placement of some of them can be attributed to poor corporate governance. For example it was pointed out that one of the contributors of the collapse of companies such as Invesco Assurance in 2009 was as a result of high loss ratios which could have been attributed to poor corporate governance.

Locally, the study of Corporate governance effect's on financial performance of insurance companies in Kenya has been conducted by various researchers notably among them: Kimosop (2011), who undertook a study on therelationship between

corporate governance and financial performance of insurance companies that are listed at the NSE in Kenya, Wanyama and Olweny (2013) who studied the effect of Corporate Governance on Financial Performance of listed Insurance firms in Kenya as well as Makhokha (2014), who did a study on corporate governance and its effect on financial performance of the insurance companies in Kenya.

Kimosop (2011) noted there exists a relationship that is significant between board size, on-executive directorships, insider shareholding and board meeting frequency with both Return on Asset and Return on Equity. His study dwelled on the Insurance companies that are listed in Kenya. (Makhokha, 2014) concluded that good governance practices provide the basis for setting performance measures and enabling environment to facilitate performance that is superior as the risk of performance that is poor is lowered. Makhokha (2014) reviewed the following variables in his study; board composition, board size, risk committee and leverage and how they affect performance. However, my study will entail looking at how corporate governance practices on financial performance of insurance companies in Kenya by having a look at the following variables which were not reviewed by either Makokha (2014) or Kimosop (2011): Board diversity, Board independence, the number of meetings as well as the number of committees and how these variables affect financial performance of insurance companies in Kenya.

IRA in 2015 recorded an increase in Insurance fraud that has more than tripled from 88 cases involving Sh.102 million in 2015 to 93 cases involving Sh 324 million. The affected segments according to IRA were the motor and medical insurance classes which were found to have been more than half of the cases reported. Employees and agents have been found to have participated in some of these scandals where it was reported that there were 6 cases of Sh 14.5 million involving employees and 21 cases

worth Sh 17.8 million involving agents. Notably, in the cases of agents, it was found that some agents who received premiums would at times fail to remit premiums paid through them. Lack of sharing data among insurance companies has contributed to cases where similar claims are made from different insurers by the fraudsters. Other reported cases were those that involved fake insurance covers for motor vehicles and in other instances, these covers would be issued in the names of collapsed firms for example Blu Shield. (Ngigi, 2015)

1.3 Research Objective

The objective of the study was to determine the effect of corporate governance on financial performance of insurance companies in Kenya.

1.4 Value of the study

This study is importantfor the following reasons:-

The results of this research may be useful for regulators i.e. IRA and AKI in Kenya as they continue to deliberate the appropriate additional corporate governance requirements suitable for Insurance companies in Kenya. This study will also be useful in providing direction to stakeholders in the insurance sector as it will form basis for critical thinking which eventually aids in decision making. This may necessitate the need for further training of insurance companies' staff on the need to embrace, adopt and observe good corporate governance practices in their organizations.

This study will add more knowledge that exists about the relationship that exists between corporate governance and how these have an impact on the overall financial performance in the insurance industry and also fill the gap on the relationship between these variables for future reference by other researchers. Future researchers will also

benefit from this research as it will enable them to have a look at what has been researched before and identify gaps that have not yet been researched on.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter gives a theoretical conceptual framework on what Corporate governance entails, the theories that explain more about corporate governance, an overview of board structure, board committee, the co-existing relationship between executive compensation and financial performance of organizations. It also reviews empirical literature on past studies in this area of corporate governance and how this relationship affects the performance of insurance companies as well as identifying the research gaps to be filled.

2.2 Review of Theories

In corporate governance, there are fundamental theories which include; agency theory which has been expanded further into stewardship theory as well as stakeholder theory. These have led to development of further related theories such as resource dependency, transaction cost theory, political theory and ethics related theories. These theories mainly entail looking at the structure of the board, its size, the various committees, independent directors as well as top management's role and their social relationships. For effective and good governance practice, a combination of various theories is advisable as opposed to theorizing corporate governance based on only one theory.

2.2.1 Agency Theory

Agency theory refers to that relationship that is there between the principals who include the shareholders and their agents who include managers and executives in a company. The shareholders are usually the ones that owns the company or founders of the company who recruit managers and executives to work and oversee the operations

of their companies. The origin of this theory is from the notion that the managers and executives of an organization is working on behalf of, and in the shareholders of the firm who on most occasions are absent. (Ray W. Atchinson, II, 2007) (Berle and Means, 1932) states that the firm's managers and executives will more often than not be required to act in their own self-interest which conflicts with the interests of the owners.

Jensen and Meckling(1976) observed that the interests between shareholders and the executive maybe misaligned resulting to agency problems such as managers engaging in activities for their own benefit rather than for the benefits of the firm's owners. He portrays employees in agency theory as those who are self-interested, individualistic and bounded rationally where their priority is on rewards rather than punishments. To minimize the potential agency problem between shareholders and management and shareholders, management incentive compensation plans can be implemented such that firm's value is added by aligning the management incentives with shareholders interest.

2.2.2 Stewardship Theory

Davis and Donaldson (1997) define a steward as one whose aim is to shield and maximizes shareholders wealth through the efficient running of the firm. By doing so, the steward's value are enhanced in an organization, stewards are the managers and executives working for shareholders. They guard and make profits on behalf of the shareholders and are therefore gratified and motivated with the achievement of organizational success.

Stewardship theory stresses on the top management's role of being stewards thereby integrating these roles to be part of the organization. This theory recognizes the

structures are important in that they empower the stewards thereby giving them maximum control which builds the stewards trust and eventually minimizes monitoring costs. Executives and directors will work in such a manner as to maximize financial performance by increasing the wealth and profits of the shareholders so as to ensure their reputation is protected as organizations decision makers of (Daily et al, 2003). In doing this, they aim at being seen as stewards who are effective of their organization thereby protecting their careers (Fama, 1980).

2.2.3 Stakeholder Theory

Freeman (1999) defines stakeholders as group of individuals or individuals who affect or are affected when the organization achieves its objectives. This group includes stakeholders such as employees, suppliers and partners in the business. Sundaram and Inkpen (2004), concludethe aim of this theory is to address the group of stakeholders who deserve and require the attention of the management. It focuses on decision making by the management and interests of the stakeholder assuming that no sets of interests dominates the others (Donaldson& Preston, 1995)

This theory is mainly interested in the way these relationships are in terms of both processes and outcomes from the firms and the firm's stakeholders as these groups can affect decision making processes. Wanyama and Olweny (2003), define this theory as that person or group of people who are affected or can affect the achievement of the objectives in the organizations. Managers oftenoperate in a network of relationships which they serve that include employees, suppliers, and business partners.

2.2.4 Resource Dependency Theory

According to Pfeffer (1973), this theory entails looking at the role that the board of directors' play in ensuring there is provision of the resources that the organization needs. In this case, the directors' role is to provide all resources required by an organization through their links to the external environments. The resources in this case include; information, skills, and access to key stakeholders who include the suppliers, buyers, makers of public policy and social groups. It provides focus in ensuring that independent organizations have representatives who are appointed to enable the firm gain access to resources that are critical to its success. For example, the B.O.D may appoint a lawyer to provide legal advice particularly during board meetings or in instances where there is private communication with the executives of the firm which may have been expensive for the firm to secure.

Daily et al, (2003), argued that by providing the required resources, the functioning and performance as well as its survival of the organization are enhanced. The directors are categorized into four different namely; insiders, support specialists, business experts and community influential. The insiders are usually selected from the current and or former executives of the firm whose role is to provide expertise in areas such as general strategy as well as direction. Business experts usually include current, former senior executives and/or directors of large profit making firms. Their role is to provide expertise on strategy of the business, assist in decision making as well as aid in solving problems. The support specialists include professionals such as bankers, lawyers, representatives from the insurance company and public relations experts. Their role is to provide support and guidance in the fields they have specialized in. The community influential includes the political leaders, members of clergy, university faculty, leaders of social or community organizations.

2.3 Determinants of Financial Performance of the Firms

Bhoelje (1999), asserts that financial performance of firms can be measured in terms of profitability, liquidity, financial efficiency, solvency and capacity in debt repayment. In a study conducted on the Bermuda Insurance market, by Adams and Buckle (2003), it was observed that companies whose leverage is high and liquidity low and reinsurance have a better operational performance compared to companies whose lowly leverage is low and liquidity high and direct insurers.

2.3.1 Age and Financial performance

According to Sorensen and Stuart (2000), company's age may have an effect on firms' performance. They further noted that older firms may have organizational inertia which tends to make them inflexible which may result to their inability to appreciate the changes that occurring in changing environment. However, Liargovas and Skandalis (2008), noted that older firms may have more skillsbecause they have been in operation longer thus have more experience having enjoyed the benefits that come from learning and aren't prone easily to the liabilities that result from newness therefore they tend to have performance that is superior as compared to newer firms.

According to Loderer and Waelchli (2009), the relationship that exists between the age of a company and profitability is positive. However it has also been observed that firms performance may at times decline as companies grow older due to the fact that old age may lead to knowledge, abilities and skills being obsolete thereby resulting to decay in organizations. Agarwal and Gort, 2002) this may explain why some older companies are usually taken over.

2.3.2 Level of Liquidity and Financial Performance

Liquidity is defined as the degree in which an entity is able to honor debt obligations falling due in the next twelve months through cash or cash equivalents for example assets that are short term can be quickly converted into cash. Liquidity results from the managers' ability to fulfill their commitments that fall due to policy holders as well as other creditors without having to increase profits from activities such as underwriting and investment and as well as their ability to liquidate financial assets. (Adam and Buckle, 2003)

According to Liargovas and Skandalis (2008), liquid assets can be used by firms for purposes offinancing their activities and investments in instances where the external finance is not forthcoming.).Firms with higher liquidity are able to deal with unexpected or unforeseen contingencies as well as cope with its obligations that fall due in periods of low earnings. Almajali et al. (2012) noted that firm's liquidity may have significant effect on financial performance of insurance companies; therefore he suggested that insurance companies should aim at increasing their current assets while decreasing their current liabilities. However, Jovanic (1982), noted that an abundance of liquidity may at times result to more harm. He therefore concludes that the effect of liquidity on financial performance of firms is ambiguous.

2.3.3 Size of the firm and Financial Performance

Burca and Batrinca (2014), asserts that the relationship existing between size and financial performance is positive in the sense that more resources are available in larger firms, better risk diversification strategies, complex information systems and are able to manage expenses well compared to small firms. This may have an impact on the financial performance of insurance companies in different ways for example

large firms may be advantaged compared to smaller firms as they can be able to exploit economies of scale and scope and as such they are more efficient in their operations and as a result reap higher level of profits..

According to Almajali et al (2012), the firm's size may have an impact on its financial performance. The relationship between performance and size is positive due to the fact that there are efficiencies in operating cost that result to increased output and economies of scale. Insurers of large companies are able to diversify their risks hence are able to quickly respond to any changes that may occur in the market. Yuqi (2007) noted that in firms that are exceptionally large, there could be a negative performance in relation to its size due to bureaucratic and other costs implications.

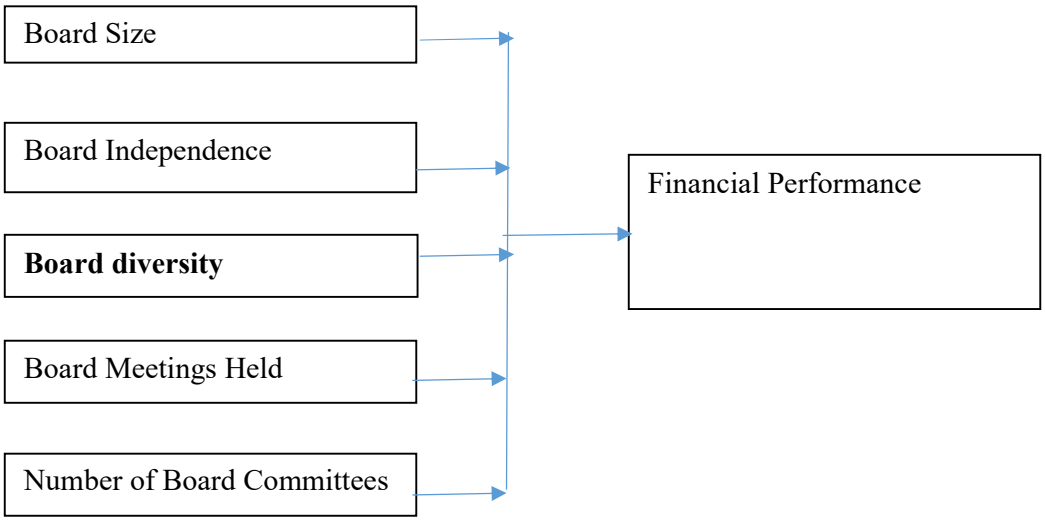
2.4 Empirical Review

In a study conducted by Wanyama and Olweny (2013) on effects of Corporate Governance on Financial Performance of Insurance Firms listed at the NSE in Kenya, He noted that a strong relationship exists between the corporate governance variables under study (board size, CEO duality, board composition, and leverage) and the firm's financial performance. It was observed that a negative relationship existed between board size and impact on the financial performance of the insurance companies listed at the NSE. Wanyama and Olweny (2013) also noted that there exists a positive relationship that existed between board composition and financial performance of firms.

Wang *et al* (2007), did a study to establish the relationship that exists e among several elements of corporate governance and the efficiency performance of insurance firms in the Taiwan Insurance industry. In regards to the BoD, the following variables were considered: the number of outside directors, board size and CEO duality. He took a

sample that consisted of 19 life insurers and 16 non-life insurers over a period of three years. ROA was used to measure firm performance. It was noted that the board structure played a critical role in that firms that had smaller boards achieved performance that was better in terms of both ROA as well as the overall cost efficiency. He observed that on one hand, the percentage of outside directors was positively related to allocative overall cost efficiency while on the other hand CEO duality decreased allocative efficiency.

2.5 Conceptual Framework



2.6 Summary of Literature Review

This chapter entails providing a review of the literature on corporate governance. The literature review reviews the theories of corporate governance which include: Agency theory (Jensen and Mackling, 1976) Stakeholder theory (Maher and Anderson, 1999), Stewardship theory (Donaldson and Davis, 1991), as well as the Resource dependence theory (Pfeiffer, 1973). This chapter has also looked at the determinants of financial performance of firms. It has also looked at the results obtained by other researchers

who studied these are of corporate governance and its impact on firm's financial performance.

Locally, this study has been conducted by many researchers notably among them Kimosop (2011) and Makhokha (2014). The study by Kimosop (2011), relates to the relationship between corporate governance and financial performance of insurance companies listed at the NSE in Kenya. Makhokha (2014) on the other side looked at the effect of corporate governance and how it affects the financial performance of insurance companies in Kenya. This study looked at the outcome of corporate governance and its effect on insurance companies' financial performance of in Kenya where I reviewed some of the variables which were not looked at by either Kimosop (2011) or Makokha (2014) .The variables that will be different in this case include Board diversity, attended number of board meetings held annually and number of board committees existing in different companies

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter contains information about the design of the research, population and sample that will be selected for the study. Data collection, data analysis and presentation techniques that were used in the study were highlighted in this chapter.

3.2 Research Design

Khumar (2005) defined research design as that method that is procedurally acquired by the researcher and that which enables the researcher to be able to answers questions accurately, validly, objectively, and economically. According to Wanyama & Olweny (2013), a research design aims at improving the ability of the research in conceptualizing an operational plan in order to be able to embark on the various techniques available and tasks that are required in order to complete the study while at the same time ensuring that that the procedures used are sufficient enough to acquire valid, objective and precise responses to the research questions.

This study adopted a descriptive research design. Mugenda and Mugenda (2003) defined this research design as that process of collecting data in order to test hypothesis to answer questions regarding the current status of the subjects in the study. The design was adopted as the researcher had interest in the actual state of affairs existing in the field and the variables were not expected not to be tampered or manipulated. The study was both qualitative and quantitative.

3.3 Population

The definition of population by Mugenda and Mugenda (2003), is the whole group of events, objects or individuals having similar observable characteristics. According to Ngechu (2004), population can be defined as a set of people, households, services,

events and group of things that are under investigation. This study looked at the 43 insurance (Appendix1) companies in Kenya who are registered members of AKI.

3.4 Data Collection

The required data was got from financial statements of the companies for the period of 2012-2015 of the selected insurance companies. These statements shall be obtained from the websites of the selected companies or from their respective administrative offices as the case may be.

3.5 Data Analysis

Multiple Regressions analysis was used to analyze whether there was a relationship that exists between one dependent variable and one or more independent variables. The firm performance shall be the independent variable while the dependent variables will be: board size, board diversity, and independence of the B.O.D, number of committees and number of meetings held annually. The multiple regression mode used is as represented below.

$OP= \alpha+\beta_1X_1+\beta_2X_2+\beta_3X_3+\beta_4X_4+\beta_5X_5+e$

Where;

OP= The Financial performance of Insurance companies in Kenya measured by ROA

α = Constant Term (Total Assets)

β_i = Beta Coefficient of variable i which measures whether there is responsiveness of Y to change in i

X_1 =Board size

X_2= Board diversity

X_3= Board Independence

X_4= Number of Committees

X5=Number of meetings held annually

e=Error term

3.5.1 Board Size

This was calculated by the number of directors serving on the board. A favorable board size as suggested by Lipton and Lorsch (1992) should have between seven to nine directors. It has been noted that the size of the board has an impact on the performance of insurance companies. Lipton and Lorsch (1992) and Yermack (1996) argued that boards that were smaller were more productive and effective compared to larger boards. They attributed the lack of effective performance of large boards to free rider challenges that decreases the board's capacity to monitor effectively and efficiently. Large board sizes are also prone to larger coordinate cost which decreases their capacity and ability to monitor management. Jensen (1993) noted that a small board of less than 8 members is more effective. The size of the B.O.D was calculated using the natural logarithm of the number of directors of the board of the selected insurance companies.

3.5.2 Board diversity

This refers to the extent to which a board is constituted to comprise a broad range of backgrounds and interests for example, people from different cultural groups, minorities, gender, age, socio economic status, experience, connections, values as well as disability. Hyland & Marcellino (2002) asserts that board diversity is measured using observable characteristics that include a range in demographic such as age, gender, minorities or ethnic background.

Gender was measured by percentage of female representation at the board. (Carter *et* al.2003; Adams & Ferreira 2002).Age was measured by dispersion in age of the board members using coefficient of variation, which is the standard deviation divided by the mean. (Allison 1982; Bantel & Jackson 1989; Murray 1989)**.**Education Qualification of the directors includes differences in the levels of educational qualification such as PhD, masters degree, undergraduate degree ,diploma and certificates such as for professional courses and was calculated using the BLAU's index (1977) where p is the proportionof the board of directors in each categories of educational qualifications and Ethnicity was measured by the Blau's index (1977) of heterogeneity where p is the proportion of the directors in each of the available category of ethnic background found at the various insurance companies.

Blau's Index is computed as $1-\sum p2i$

Where p is the proportion of members from each given category and I is the number of the different categories that feature across all groups.

3.5.3 Board Independence

According to John and Senbert (1998), an independent board is one where the executive directors are fewer as compared to the non-executive members. The importance of the executive members in the board is that they are more conversant with the activities in the organization and as such they are in a better placed to advise the board. On the other hand the non-executive directors, monitor management performance, offer invaluable advice to shareholders as well as protect the interest of the shareholders. (Weisbach, 1998).This was measured by taking into consideration the extent of independent directors on the board to the board size i.e. calculating the

independent directors as a percentage of the non-executive directors in proportion to the total number of directors.

3.5.4 Board Committees

According to Laux and Laux (2006), it's important for boards to delegate board functions to smaller sub groups as this reduces free rider problem thereby enhancing the productivity of the board. It's a requirement by IRA, that boards should at least have 6 committees with different roles to make it possible for the board discharge their duties and responsibilities effectively and efficiently. Such committee mays include; audit, investment, nomination, remuneration, risk management, ethics, asset liability management as well as policyholder protection committees

3.5.5 Number of Board Meetings:

It's important for board members to meet for sufficient number of times in a given year as this enables them to keep abreast of the happenings of the organization. Very few meetings would imply that the board lacks interest on the happenings in the organization while on the other side; too many meetings would indicate trouble on the organization. (Priyanka, 2013). This was measured by the total number of board meetings held during the year.

3.5.6 Financial Performance

To order to analyze the financial performance of selected insurance companies, the study looked at two financial ratios, namely; Return on Equity (ROE) and Return on Assets (ROA) which are calculated as follows. Return on Equity =after tax profit/shareholders' Equity. Return on Assets =after tax profit + Interest (Before tax)/Shareholders Equity.

CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1 Introduction

This chapter focused on the analysis of the collected data from the insurance company's financial statements. The objective was to establish the effect of corporate governance structures on financial performance of insurance companies in Kenya. Descriptive statistics was used to analyze, tabulate and graphically present results as shown in the following sections.

4.2 Data Validity

The study looked for data that would be able to meet the objectives of the study. The data collected from insurance companies' annual financial reports was cross checked for errors to test the validity of the data sources. The research assumed a 95 percent confidence interval or 5 percent significance level (both leading to identical conclusions) for the data used. These values helped to verify the truth or the falsity of the data. Thus, the closer to 100 percent the confidence interval (and thus, the closer to 0 percent the significance level), the higher the accuracy of the data used and analyzed is assumed to be.

4.3 Descriptive Statistics

This section presents the descriptive results of this study including measures of central tendency, the trends analysis, maximum and minimum and standard deviation. From the analysis of descriptive statistics the finding clearly reveals that return on asset has a mean of 0.0498 with a maximum of .42 and minimum of .01 and standard deviation of .062, board size has a weighed mean of 7.48 maximum of 11.0 and minimum of 6, board diversity weighed mean of 1.69 maximum of 4 and minimum of 1 and standard

deviation of 0.86 and board meetings 1.88 maximum of 3 and minimum of 1 and standard deviation of 0.762.

Table 1: Descriptive statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	43	.01	.42	.0498	.06212
Board size	43	6.00	11.00	7.4884	1.31606
Board diversity	43	1.00	4.00	1.6977	.86009
Board independence	43	2.00	6.00	3.5581	1.07576
Board committee	43	4.00	6.00	4.8605	.83328
Board meetings	43	1.00	3.00	1.8837	.76249
Valid N (listwise)	43				

4.4 Correlation analysis

Correlation analysis is used to establish if there exists a relationship between two variables which lies between (-) strong negative correlation and (+) perfect positive correlation. Four variables were generated using SPSS (Board size, board diversity, board independence, Board committees and meetings).

Table 2: Correlation analysis

		ROA	Board size	Board diversity	Board independence	Board committee	Board meetings
ROA	Pearson Correlation	1					
	Sig. (1-tailed)						
Board size	Pearson Correlation	-.124	1				
	Sig. (1-tailed)	.214					
Board diversity	Pearson Correlation	.155	-.039	1			
	Sig. (1-tailed)	.160	.403				
Board independence	Pearson Correlation	.014	.239	.003	1		
	Sig. (1-tailed)	.465	.061	.494			
Board committee	Pearson Correlation	-.044	-.232	-.275*	.207	1	
	Sig. (1-tailed)	.366	.067	.037	.092		
Board meetings	Pearson Correlation	-.136	.019	-.185	.140	.015	1
	Sig. (1-tailed)	.130	.451	.117	.185	.461	
	N						

*. Correlation is significant at the 0.05 level (1-tailed).

From the analysis of the correlation analysis, it was observed that there that there exist a weak negative correlation between return on assets and board size (p= -.124, p>0.05). This implies that the total number of directors held by insurance companies has insignificant influence on the company's performance. The relationship between

return on assets and board diversity was found to be strongly positive (p= .455, p>0.05). The study also indicate that there exist a weak negative correlation between board meeting and return on assets (p= 0.44, p>0.05). This shows that board frequency of meetings has minimal significant influence on the insurance company's financial performance. This study also found that there exist weak negative correlation between return on assets and committees (p= .136, p>0.05).

4.5 Regression Analysis and Hypothesis Testing

Table 3: Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.812[a]	.660	.064	.06409

a. Predictors: (Constant), Board meetings, Board committee, Board diversity, Board independence, Board size

Table 3 indicates that there is an R^2 value of 66%. This value indicates that the five independent variables explain 66% of the variance in the insurance company's financial performance. These independent variables contribute to a large extent to the company's level of performance. It is therefore sufficiently to conclude that these variables influence financial position of insurance companies given the unexplained variance is only 34%.

Table 4: ANOVA Analysis

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.010	5	.002	2.492	.010[a]
	Residual	.152	37	.004		
	Total	.162	42			

a. Predictors: (Constant), Board meetings, Board committee, Board diversity, Board independence, Board size

b. Dependent Variable: ROA

Given 5% level of significance, the numerator df =3 and denominator df =1, critical value 2.492, table 4.41 shows computed F value as 2.492. This confirms that overall the multiple regression model is statistically significant, in that it is a suitable prediction model for explaining how the selected independent variables affects the insurance companies financial performance.

Table 5: Regression Analysis

Model		Un-standardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.204	.200		1.016	.116
	Board size	-.699	.820	-.148	-2.082	.040
	Board diversity	.022	.045	.081	3.379	.026
	Board independence	.033	.080	.071	0.413	.682
	Board committee	-.140	.286	-.085	-2.488	.029
	Board meetings	-.034	.032	-.170	-1.046	.302

a. Dependent Variable: ROA

Using a significance level of 5%, any independent variable having a significant value greater than 5% is considered not statistically significant. This study found that board diversity, board committee and board size are statistically significant with board independence and board meetings with significance of more than 5% are not statistically significant.

4.6 Discussion of Research Findings

A total of 43 insurance companies were selected and multiple linear regression analysis conducted. The sample regression model used was $Y= \alpha+ \beta_1X_1+\beta_2X_2+\beta_3X_3+ \beta_4X_4+ \beta_5X_5+\varepsilon$ which was generated to determine the effect of corporate governance on financial performance of insurance companies in Kenya. This showed a mathematical expression of the relationship between the dependent and independent variables whereby the return on assets was considered to be responding to changes in Board meetings, Board committee, Board size, Board diversity and Board

independence. These meant that when the values were plotted on a chart, a pattern could be seen and make predictions about the financial performance of insurance companies in Kenya. A mathematical relationship however does not mean that there is an actual relationship between the two variables.

The ROA was the dependent variable while Board meetings, Board committee, Board size, Board diversity and Board independence was the explanatory variable. The constant α explained those changes occurring in the dependent variable that are not caused by changes occurring in the explanatory variable. The coefficient of change β was the change in the dependent variable in respect to a unit change in the explanatory variable.

The research study established that board diversity; board committee and board meetings are statistically significant in determining financial performance while board independence and board size with significance value of more than 5% not statistically significant in the years 2012. In the year 2013 this study found that board diversity, board committee and board meetings are statistically significant with board independence and board size not statistically significant. The results also found that there exists a weak negative correlation between return on assets and board size with return on assets and board diversity found to be strongly positive. The board frequency of meetings was found to have a minimal significant influence on the insurance company's financial performance with board diversity, board committee and board committee found to be statistically significant in 2013.

The coefficient of correlation, R-Squared, was used to further show the strength of this relationship between the dependent and independent variables. This degree of

association showed strong linearity between the two variables across the four study years. The R square computed for each of the four years indicated an increasing strength of this relationship from 52% in 2012 to 66% in 2015. This implies that the independent variables are significant predictors of financial performance of insurance companies in Kenya.

The research findings showed that the deriving model is statistically significant. This is primarily showed by the statistical parameter, the F stat. The model is fit at 95% level of confidence since the F-value is more than the critical F for the four study years. The F-stat is a ratio that evaluates the explained portion of the dependent variable in relation to the unexplained portion. The higher the F value, the more significant the deriving model is. The significance F showed this as well. At 5% significance level, the significance F (0.001) was less than the significance level (0.05) for each of the four study years implying that the model was statistically significant.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The chapter provides the findings summary from chapter four as well as gives the conclusions and recommendations of the study based on the study's objectives. The objective of the study was to determine the effect of corporate governance on financial performance of insurance companies in Kenya. The study limitations and suggestions for further research have also been presented.

5.2 Summary of Findings

The objective of this study was to establish the effect of corporate governance on financial performance of insurance companies in Kenya. The findings indicate that in the year 2012 independent variables significantly explained the variance in the financial performance of insurance companies. This study also found that board diversity; board committee and board meetings are statistically significant with board committee, board independence and board size with significance of more than 5% not statistically significant in the years 2012 while in the year 2013 this study found that board diversity, board committee and board meetings are statistically significant with board committee, board independence and board size not statistically significant.

The results also found that there exists a weak negative correlation between return on assets and board size with return on assets and board diversity was found to be strongly positive. The board frequency of meetings was found to have a minimal significant influence on the insurance company's financial performance with board diversity and board committee found to be statistically significant in 2013. This confirms that overall the multiple regression model is statistically significant, in that it

is a suitable prediction model for explaining how the selected independent variables affects the insurance companies financial performance.

5.3 Conclusion

This study concludes that the independent variables selected for this study influence to a large extent the financial performance of insurance companies in Kenya. It is therefore sufficient to conclude that these variables significantly influence financial performance movement given the unexplained variance is minimal. This confirms that overall the multiple regression model is statistically significant, in that it is a suitable prediction model for explaining how the selected independent variables affects the financial performance of insurance companies.

This study also found that board diversity.board committee and board meetings are statistically significant with board independence and board size not statistically significant. Wanyama and Olweny (2013) observed that board size affected the performance of listed insurance companies to a great extent.They also observed board size negatively affected the financial performance of listed insurance companies.

5.4 Recommendations

The study recommends that stakeholders in Kenyan insurance industry should take into account the board diversity, board committees and board meetings when forming board of directors as they are significant determinants of financial performance. That is the board should be organized in a way that will help the insurance companies improve their overall performance. According to this study board independence and board size should not be prioritized as they are insignificant when it comes to determining listed firms' financial performance.

This study concurs with Mutua (2011) that financial performance is significantly associated with board diversity. In lieu of this, it emphasizes the importance of having a diversified board especially in terms of gender, age and level of education as this will improve the financial wellbeing of insurance companies. In line with the one third rule of our current constitution, boards should be formed in such a manner that ensures women are considered for directorship positions as they have been statistically proved to have better performances while in such positions.

The variables considered in the study explained 52% and 66% of the variation in firm financial performance across the four study years implying that there are other important factors not included in the model and therefore the study recommends that the management should put in to consideration such factors in order to enhance the effectiveness of corporate governance index. The study also recommends that policy makers should set an index on corporate governance to act as a reference for all insurance companies so that the efficiency of corporate governance can be enhanced.

5.5 Limitations of the Study

The study was based on a four year study period from the year 2012 to 2015 since this is the latest period and thus availability of data that is more applicable to the current economic situation. However, if a longer duration of the study was used, it would have captured periods of various economic significances such as booms and recessions. This would have probably given a longer time focus thus a broader dimension to the problem.

This study applied secondary data in meeting its mandate. A review of the same case using primary data sources involving the experts in the insurance industry might bring

out different outcomes. The researcher decided to use secondary data because it is information from combined effort by experts to the public and is also easily obtained compared to primary data where in some cases the required data may not be easily obtained in instances where primary data is used.

For data analysis purposes, the researcher applied multiple linear regression models. Due to the shortcomings involved when using regression models such as erroneous and misleading results when the variable values change, the researcher cannot be able to generalize the findings with certainty. If more and more data is added to the functional regression model, the hypothesized relationship between two or more variables may not hold.

5.6 Suggestions for Further Research

The study concentrated on the last four years since it was the most recent data available. Future studies may use a range of many years e.g. from 1970 to date and this can be helpful to confirm or disapprove the findings of this study. Similar studies to this can also be carried out in future using both primary and secondary data to capture some pertinent information that this study was not able to capture due to the shortcomings associated with secondary data. Finally, due to the shortcomings of regression models, other models such as the Vector Error Correction Model (VECM) can be used to explain the various relationships between the variables while at the same time can used to compare research findings.

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APPENDIX 1: LIST OF INSURANCE COMPANIES IN KENYA

	Name of Insurance Company
1	AAR Insurance Company Limited
2	Allianz Insurance Company of Kenya
3	Africa Merchant Assurance Company Limited-AMACO
4	AIG Kenya Insurance Company
5	APA Insurance Company Limited and APA Life Insurance Company Limited
6	Barclays Life Assurance Kenya Limited
7	BRITAM General Insurance Company and BRITAM Life Assurance Insurance Company
8	Canon Assurance Company Limited
9	Capex Life Assurance Limited
10	CIC General Insurance Company and CIC Life Assurance Company
11	Corporate Insurance Company Limited
12	Direct Line Assurance Company Limited
13	Fidelity Shield Insurance Company
14	First Assurance Company Limited
15	GA Kenya Insurance Company Limited
16	Gateway Insurance Company Limited
17	Geminia Insurance Company Limited
18	Heritage Insurance Company Limited
19	ICEA Lion General Insurance Company and ICEA Lion Life Assurance Company
20	Intra-Africa Assurance Company Limited
21	Invesco Assurance Company Limited
22	Jubilee Insurance Company Limited

23	Kenya Orient Insurance Company Limited and Kenya Orient Life Assurance Limited
24	Kenyan Alliance Insurance Company
25	Liberty Life Assurance Company Limited
26	Madison Insurance Company Limited
27	Mayfair Insurance Company Limited
28	Metropolitan Canon Life Assurance Limited
29	The Monarch Insurance Company Limited
30	Occidental Insurance Company Limited
31	Old Mutual Life Insurance Company
32	PACIS Insurance Company Limited
33	Pan Africa Life Assurance Company
34	Phoenix Assurance Group
35	Pioneer Life Assurance Company Limited
36	Prudential Assurance Company
37	Resolution Insurance
38	Saham Assurance Company
39	Takaful Insurance of Africa Limited
40	Tausi Assurance Company Limited
41	Trident Insurance Company Limited
42	UAP Insurance Company Limited and UAP Life Assurance Company Limited
43	Xplico Insurance Company