
INTERNATIONAL JOURNAL OF SCIENCE ARTS AND COMMERCE

EFFECT OF FINANCIAL RISK ON FINANCIAL PERFORMANCE OF INSURANCE COMPANIES IN KENYA

Maureen Mbuya

Fredrick Ogilo

MBA Student University of Nairobi

Lecturer University of Nairobi Faculty of Business and Management Science.

ABSTRACT

This study sought to establish the effect of financial risk on financial performance of insurance companies in Kenya. A descriptive research design was adopted. Target population was 56 insurance companies licensed in Kenya. Analysis was done using correlation and regression analysis. The study established that there exists a moderate negative correlation between financial performance and operational risk. The correlation between financial performance and counterparty default risk was negative and weak. Financial performance and solvency risk returned a significant weak negative correlation. Correlation coefficient between financial performance and size of firm was positive and strong. The study concluded that increasing exposure to liquidity risk, operating risk and solvency risk significantly reduced financial performance of insurance companies. On the effect of counterparty default risk, it was concluded that it lowered financial performance insignificantly. Lastly, the study concluded that size of the firm had the effect of significantly increasing financial performance of insurance companies in Kenya. The study recommends that regulatory bodies and policymakers, should formulate policies that incentivize insurance firms to adopt effective risk management strategies for enhanced financial performance and the need to constantly monitoring risk taking by insurance companies to ensure industry stability. The study underscores the necessity for insurers to institute robust risk management strategies as internal controls measures to mitigate counterparty defaults, liquidity challenges, operational issues and solvency risks thereby fortifying financial performance. Further research can focus on external risk analysis to assess

the risks that insurers in Kenya are exposed to from external sources, such as economic, regulatory, or external environmental factors.

Key words: Financial risk; Financial Performance; Insurance companies.

1.0 INTRODUCTION

Financial risk is one of the threats in the business world today due to environmental changes that have put pressure on firms' efforts to maximize profits. Recurring worldwide financial meltdowns have underlined the necessity for the management of risks by enterprises (Coskun, 2013). Financial risks are brought on by an organization's exposure to the financial markets, interactions with other parties, and reliance on its systems, processes, and workforce. Today, risks are more often seen as potential opportunities than as threats with negative financial effects. Financial risk includes all risks connected to financing and investing activities. Pablo et al., (2020) defines financial risk as the unexpected variation in returns. Muriithi (2016) posited that, financial institutions frequently underperform as a result of improper financial risk management.

The concept of financial risk is increasingly gaining prominence in today's business landscape. According to Fali, Mustapha and Nyor (2020), financial risk is the unanticipated unpredictability of returns. Financial risk as defined by Mutuku (2018), is the danger that arises when corporate institutions lack the funds necessary to meet their own obligations. Financial risk is a company's failure to create enough cash flow to fulfill both planned and unforeseen cash demands (Panigrahi, 2013). According to Pablo et al., (2020) the five primary categories of risks related to the financial aspect of businesses are operational, legal, market, credit, and liquidity risks. Financial risks related to underwriting, operational, market, credit, liquidity, strategic in the form of reputational and compliance are only a few of potential pitfalls affecting performance of businesses (Ahmad, 2020).

This study operationalized financial risk in terms of liquidity, operational, solvency and counter-party default as explanatory factors. When external financing is too expensive or unavailable, an organization can finance its activities using its liquid assets (Wani & Dar, 2015). Examining liquidity is necessary since it demonstrates the proficiency of the firm in maintaining normal working capital levels and aptly converting assets to cash. Liquidity risk was measured using current ratio. Operational risk measures the vulnerability triggered by ineffective policies and processes including system failure, fraud, and personnel mistakes and mishaps (Basel II committee, 2017). This was measured using cost to income ratio. Solvency risk is pertinent in determining if a company is able to fulfill its long-term commitments while also supporting ongoing growth (Menna, 2020). Solvency ratio was employed as a metric for risk of solvency. Examining counter party default risk is important as insurers obtain payments from third parties like reinsurers and investment partners (IRA, 2013). This was measured using debt to net assets ratio. Financial performance quantifies the degree to which business objectives are being achieved (Ahmad, 2020). In addition to increasing the market value of individual businesses,

corporate performance also supports the expansion of the industrial sector which in turn helps the economy expand and prosper (Sharma, 2018). The financial performance of a company hinges on its adeptness in utilizing its resources to achieve the desired outcomes (Fatma, 2020). Bashaija (2022) opined that a corporate's proficiency in creating income from its primary mode of business can be measured by examining its financial performance.

Return on asset (ROA) was adopted as a measure for financial performance. ROA measured the managements' capacity to create money by making use of the resources at their discretion. According to Kiptoo, Kariuki and Ocharo (2021) return on asset demonstrates how adeptly the corporate management produces net income utilizing entirely existing resources. ROA was given as the net income for each of the years being examined divided by their corresponding total assets

1.1 RESEARCH PROBLEM

Insurance companies continually come across financial risks that are pervasively present in all industries. Businesses worldwide are attempting to develop appropriate risk mitigation strategies to reduce the rising financial risk. It is therefore highly unlikely or perhaps even impracticable for insurers to succeed without apt reduction of risk measures and mitigation practices. Sisay (2017) emphasized on the effect of financial and actuarial risks on companies' performance. Current empirical studies predominantly focus on financial risk management within the framework of enterprise risk management (ERM), resulting in limited data specifically addressing financial risks. Additionally, many of these studies concentrate on operational, liquidity, and market risks, often overlooking other critical financial risk factors like counterparty default and solvency risk.

Prior empirical investigations into the connection between financial risk and financial performance have yielded inconsistent and conflicting results. While some studies provide support for this link, others do not. Studies such as Wani and Dar (2015), Menna (2020), Mbinga (2022) and Kariuki and Ocharo (2021) all demonstrated that risk of liquidity is beneficially and substantially connected to financial performance, the latter also reached the conclusion that credit risk had an adverse and notable influence on financial performance. Contrarily, Nderitu (2022), Roble (2020), Obudho (2014) and Odipo (2020) concluded that liquidity risk was negatively connected to financial performance and the latter also deduced that management of credit risk positively influenced financial performance.

The above divergent findings underscore the requirement for further research in this domain. Fali, Nyor & Mustapha (2020) and Desalegn (2019) applied purposive sampling technique and explanatory design on listed insurance companies. Sisay (2017) applied a mixed research approach that entailed qualitatively and quantitatively collection of data. The current study employed a census approach using descriptive research design. Obudho (2014) and Mutuku (2018) used a study period of 5 years. The five-year period examined in these studies may not

suffice for broad generalizations. Rising inflation, and post-election political instability have significantly influenced businesses in Kenya, particularly the insurance industry. This highlights the importance of considering more current data for a comprehensive understanding of the current business environment. The filled the noted inadequacies through addressing the question: “What is the effect of financial risk on financial performance of Kenyan Insurance companies?”

1.2 RESEARCH OBJECTIVE

Establishing the effect of financial risk on financial performance of insurance companies in Kenya.

2.0 METHODS

The study utilized a descriptive research design. The population of the study were 56 licensed insurance companies operating in Kenya. The study relied on secondary data sources. The study assessed the following risks: Liquidity, Operational, Counterparty default, and Solvency. Additionally, firm size served as the control variable, and ROA was used as a proxy for financial performance. As follows;

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \beta_5X_5 + \epsilon$$

Where;

Y = Financial performance measured by Return on Assets

β_0 = The value of Y that is not affected by X

X₁= Liquidity Risk.

X₂= Operational Risk

X₃= Solvency Risk

X₄= Counter Party Default Risk

X₅= Size of the firm

$\beta_1, \beta_2, \beta_3, \beta_4$ and β_5 are coefficients of regression equation.

ϵ = error term

3.0 RESULTS

Correlation analysis looked into the relationship between study variables such as liquidity, operational risk, counter party default risk, solvency risk, firm size and their relationship with financial performance.

Table 1: Correlations Matrix

		Financial performance	Liquidity risk	Operational risk	Counter party default risk	Solvency risk	Firm size
Financial performance	Pearson Correlation	1					

		Sig. (2-tailed)						
	N	252						
Liquidity risk	Pearson	-.190**	1					
	Correlation							
		Sig. (2-tailed)						
	N	252	252					
Operational risk	Pearson	-.404**	-.184**	1				
	Correlation							
		Sig. (2-tailed)						
	N	252	252	252				
Counter party default risk	Pearson	-.133*	-.115	-.069	1			
	Correlation							
		Sig. (2-tailed)						
	N	252	252	252	252			
Solvency risk	Pearson	-.221**	.383**	.344**	-.314**	1		
	Correlation							
		Sig. (2-tailed)						
	N	252	252	252	252	252		
Firm size	Pearson	.660**	.204**	-.583**	.032	-.037	1	
	Correlation							
		Sig. (2-tailed)						
	N	252	252	252	252	252	252	

Source: Research findings (2023)

Table 1 above was the result of correlation between the dependent and each of the independent variables. There was a weak negative correlation between financial performance and liquidity risk. Financial Performance and liquidity risk had correlation coefficient of -0.190 with p-value $0.002 < 0.05$. The correlation was significant at 5% level. There was a moderate negative correlation between financial performance and operational risk with a correlation coefficient of -0.404 and p-value 0.000. The correlation was significant with a p-value $0.000 < 0.05$. Correlation between financial performance and counterparty default risk was negative and weak. The correlation coefficient between financial performance and counterparty default risk was -0.133 with 0.036 p-value. Based on two tailed t-test the correlation was insignificant. There was a weak negative correlation between financial performance and solvency risk with a correlation

coefficient -0.221 having p-value 0.000. Since p-value $0.000 < 0.05$, the correlation between financial performance and solvency risk was significant at 5%. Financial performance and firm size were positively correlated. Financial performance and firm size had correlation coefficient of 0.660 and p-value of 0.000 and the correlation was significant at 5% level with p-value $0.000 < 0.05$.

Regression analysis was used to determine the effect of independent variables on the dependent variable. The dependent variable was financial performance and the independent variables were liquidity risk, operational risk, counterparty default risk, solvency risk and size of firm. The significance of the coefficients was evaluated at 5% level of significance.

Table 2: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients		
	B	Std. Error	Beta	t	Sig.
(Constant)	-.048	.023		-2.088	.038
Liquidity risk	-.015	.008	-.099	-1.999	.043
Operational risk	-.029	.009	-.205	-3.330	.001
Counter party default risk	-.013	.008	-.074	-1.587	.114
Solvency risk	-.376	.065	.328	5.787	.000
Firm size	.021	.002	.576	10.397	.000

Source: Research findings (2023)

Table 2 indicated result of regression analysis. The constant value was -0.048 with p-value 0.038. The effect of liquidity risk on Financial Performance was negative with a regression coefficient of -0.015 with p-value 0.043 indicating that a unit of movement of liquidity has an effect of 0.015 on financial performance. The effect was significant at 5% level. The effect of Operational risk on FP was negative with a slope coefficient of -0.029 and p-value of 0.001. This implies that, a unit of movement of operational risk significantly affects financial performance by 0.029 units. The effect of Counterparty default risk on Financial Performance was negative with a co-efficient of -0.013 and p-value 0.114. Suggesting that, a unit of movement of counter party default risk affects financial performance by 0.013 units. The reduction was not significant at 5% level. Solvency risk negatively affected Financial Performance with a regression coefficient of -0.376 and p-value 0.000. Suggesting that a unit increase in solvency risk exposure reduced financial performance by 0.376 units. The effect of firm size on Financial Performance was positive with a regression coefficient 0.021 and p-value 0.000. Suggesting that a unit of movement of firm size has a significant effect of 0.021 on financial performance.

The resulting regression model was;

$$Y=-0.048-0.015X_1-0.029X_2-0.013X_3-0.376X_4+0.021X_5$$

4.0 CONCLUSION AND RECOMMENDATIONS

It was established that financial performance was significantly but weakly affected by financial risk. Specifically, liquidity risk had a negative and weak effect on financial performance of insurance companies in Kenya. Operational risk had a negative and weak effect on financial performance of insurance companies in Kenya. Counter party default risk negatively but weakly affected financial performance of insurance companies in Kenya, though it was found to be insignificant. Solvency risk negatively and weakly affected financial performance of insurance companies in Kenya. The size of insurance companies in Kenya had a strong effect on financial performance. This implies that, increasing exposure to liquidity risk, operating risk and solvency risk significantly reduced financial performance of insurance companies in Kenya at 5% level of significance. Counterparty default risk has an effect of reducing financial performance insignificantly at 5% level of significance. Lastly the study concludes that size of the firm has an effect of significantly increasing financial performance of insurance companies in Kenya at 5% level of significance.

It's noteworthy acknowledging that this study aligns with the findings of Mutuku (2018), who analyzed the relationship between financial risk and the financial performance of Nairobi Securities Exchange-listed insurance firms in Kenya. The researcher deduced that, only reinsurance risk had a positive correlation with return on assets (ROA), while liquidity and solvency risks all had a negative and statistically insignificant effect on ROA. Obudho (2014) also demonstrated that solvency and liquidity risks negatively affected financial performance of insurers in Kenya whereas insurers' firm size was discovered to positively influence financial performance.

The study recommends that insurance companies' management and directors should focus on increasing their solvency by formulating policies aimed at enhancing assets while simultaneously reducing solvency risk, as this will directly influence financial performance. The negative relationship between financial performance and liquidity risk suggests the need for policy changes to manage liquidity effectively. Managers should monitor the ratio of current assets to current liabilities to ensure that there are sufficient current assets to cover current liabilities. Regulators and policymakers should create policies and regulations that encourage insurance firms to adopt appropriate risk management strategies to enhance their performance. Directors and managers of insurance companies should establish proper risk management strategies to control counter-party defaults, liquidity, operational, and solvency risks to boost financial performance.

REFERENCES

- Ahmad, A. W. (2020). Relationship between financial risk and financial performance: An insight of Indian insurance industry.
- Anamaria, B., & Ghiorghe, B. (2014). The Determinants of Financial Performance in the Romanian Insurance Market. *International journal of academic research in accounting, finance and management sciences*, 4 (1), 300-308.
- Banks, E. (2004). *Integrated risk management through Insurance, Re-insurance and the Capital Markets*.
- Basel II Pillar 3. (2017). CIMB Investment Bank: Berhad.
- Basel, J. A., & Oudat, S. M. (2020). "Financial Risk and the Financial Performance in listed Commercial and Investment Banks in Bahrain Bourse".
- Coşkun, Y. (2013). Financial engineering and engineering of financial regulation. Guidance for compliance and risk management departments. *Journal of Securities Operations & Custody* 6 (3).
- Ernst & Young (2023). *Global Insurance Outlook: How to drive purposeful change in uncertain times*
- Fadun, O. S., & Oye, D. (2020). Impacts of operational risk management on financial performance: a case of commercial banks in Nigeria. *International Journal of Finance & Banking Studies*, 9 (1), 22-35.
- Fali, I. M., Nyor, T., & Mustapha, L. O. (2020). Financial Risk and Financial Performance of listed Insurance Companies in Nigeria. *European Journal of Business and Management*.
- Fatma, A. M. (2020). Effect of Financial Risk on Financial Performance of Non-Financial Firms Listed at Nairobi Securities Exchange, *Unpublished MBA project*, University of Nairobi.
- Gordon, J. M. (1971). Towards a Theory of Financial Distress. *Journal of Finance*, 26 (2), 347-56.

- Hirsch, P. M., Friedman, R., & Koza, M. P. (1990). Collaboration or paradigm shift? Caveat emptor and the risk of romance with economic models for strategy and policy research. *Journal of organization Science*, 1(1), 87-97.
- Ikpesu, F., Vincent, O., & Dakare, O. (2019). *Financial Distress Overview, Determinants, and Sustainable Remedial Measures*.
- Kioko, C. M., Olweny, T., & Ochieng, L. (2019). Effect of financial risk on the financial performance of commercial banks in Kenya listed on the Nairobi Stock Exchange. *The Strategic Journal of Business & Change Management*, 6 (2), 1936 –1952.
- Kiptoo, I. K., Kariuki, S. N., & Ocharo, K. N. (2021). Risk management and financial performance of insurance firms in Kenya. *Cogent Business & Management*, 8, 1-17
- Markowitz, H. (1952). Portfolio selection. *The Journal of Finance*, 7 (1), 77–91.
- Mbinga, J. W. (2022). *Effect of Financial Risk on Financial Performance of Microfinance Institutions in Kenya, Unpublished MBA project*, University of Nairobi.
- Menna, B. E. (2020). The Effect of Financial Risk on Performance of Private Insurance Companies in Ethiopia. *A Thesis Submitted to The Department of Accounting and Finance, College of Business and Economics, Addis Ababa University*.
- Mugenda, O. M., & Mugenda, A. G. (2013). *Research Methods. Quantitative and Qualitative Approaches*. Nairobi.
- Muia, J. S. (2016). The Effects of operational risk management practices on financial performance in Insurance Companies in Kenya, *Unpublished MBA project*, University of Nairobi.
- Muinde, A. M. (2018). Effect of financial risk on the financial performance of Insurance companies limited at the NSE, *Unpublished MBA project*, University of Nairobi.
- Mutuku, A. M. (2018). The effect of financial risk on performance of insurance companies listed at Nairobi Securities Exchange. *International Journal of Financial Studies*, 6 (7), 66-71.

- Muriithi, J. G. (2016). Effect of financial risk on financial performance of commercial banks in Kenya. *International Journal of Financial Studies*, 4 (5), 88-91.
- Myers, S. C. (1984). The Capital Structure Puzzle. *Journal of Finance*, 39 (3), 575–592
- Nyarangi, J. M., Ngali, R. (2021). Risk management practices and financial performance of insurance companies listed in Nairobi Securities Exchange, Kenya. *International Academic Journal of Economics and Finance*, 3(7), 176-197
- Obudho, A. R. (2014). The Relationship Between Financial Risk and Financial Performance of Insurance Companies in Kenya, *Unpublished MBA project*, University of Nairobi.
- Odipo, S. O. (2020). The Effect of Enterprise Risk Management on Financial Performance of Insurance Firms in Kenya, *Unpublished MBA project*, University of Nairobi.
- Pablo, F., Apellániz, E., & Acín, F. J. (2020) Market Risk Premium and Risk-Free Rate used for 81 countries. *IESE Business School Working Paper No. WP-1244-E*.
- Panda, B., & Leepsa, N. (2017). Agency Theory: Review of Theory and Evidence on Problems and Perspectives. *Indian Journal of Corporate Governance*, 10, 74-95.
- Panigrahi, A. K. (2013). Liquidity Management of Indian Cement Companies. *Journal of Business and Management*, 14, 49-61.
- Rahi, S. (2017). Research Design and Methods: A Systematic Review of Research Paradigms Sampling issues and Instruments Development. *International Journal of Economic and Management Sciences*, 6, 403.
- Roble, I. A. (2020). Effect of financial risk management on financial performance of state-owned commercial banks in Kenya, *Unpublished MBA project*, University of Nairobi.
- Ross, S. A. (1973). The Arbitrage Theory of Capital Asset Pricing. *Journal of Economic Theory*, 13, 341-360.
- Siedlecki, S. (2020). Understanding Descriptive Research Designs and Methods. *Clinical nurse specialist*, 34, 8-12.

- Sisay, D. (2017). The effect of financial risk on performance of insurance companies in Ethiopia. *College of Business and Economics*, 1-120.
- Sharma, A., Jadi, D. M., & Ward, D. (2018). Evaluating financial performance of insurance companies using rating transition matrices. *The Journal of Economic Asymmetries*.
- Stulz, R. M. (1984). Optimal hedging policies. *Journal of Financial and Quantitative Analysis*, 19, 127-140.
- Wani, A. A., & Dar, S. A. (2015). Relationship between financial risk and financial performance: An insight of Indian insurance industry. *International Journal of Science and Research*, 4 (11), 1424-1433.
- Whitaker, R. (1999). The early stages of financial distress. *Journal of Economics and Finance*, 23 (2), 123-132.
- Zhongming, T., Frimpong, S., Guoping, D. (2019). Impact of Financial Risk Indicators on Banks' Financial Performance in Ghana. *Business and Economic Research*, 9 (4), 23-52.