

**FINANCIAL RISK AND COST EFFICIENCY OF GENERAL INSURANCE
COMPANIES IN KENYA**

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**A RESEARCH PROJECT SUBMITTED TO THE SCHOOL OF BUSINESS IN
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DECLARATION

I declare that this research project is my original work and has not been presented to any institution for any other award.

Signature.....*SAC*..... Date.....*05/07/2022*.....

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Supervisors Declaration

This project has been submitted for defense with my approval as the university supervisor.

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ABSTRACT

Insurance companies play a key role in protecting customers from the risks that they are insured against them occurs. In order for insurance firms to meet this objective they incur costs that are related to this and so the firms should be financially sound and meet every need as it arises. Cost efficiency is the manner in which the processes and products are transformed to minimize costs in order to add value to the firm. Cost efficiency is enhanced through different strategies to make directions, drive innovation, and reduce operational costs as well as to minimize financial risk. There has been increasing inputs in the insurance industry in terms of wages for highly qualified staff, costly digital software and competition from both insurance and banking sector which may reduce the profitability. General insurance companies in Kenya have been underperforming in recent years leading to massive losses as a result of increased costs and reduced revenues leading to reduced efficiency. The study sought to ascertain the effect of financial risk on the cost efficiency of general insurance in Kenya. Specifically: credit risk, liquidity risk, interest rate risk, and foreign exchange rate risk on cost efficiency and finally to evaluate the moderating effect of capital adequacy on the relationship between financial risk and cost efficiency. This study used the Neoclassical Theory of the Firm, the Arbitrage Pricing Theory, Theory of Optimal Capital Structure and the X-efficiency Theory. Explanatory research design, and Data Envelopment Analysis model was employed to analyze general insurance companies from 2015 to 2019. DEA and panel data logit model was also adopted. The study targeted 38 general insurance companies in Kenya and formed a sample size of 38 using the census method because of the small number. The study conducted descriptive and inferential analysis. Correlation and logit regression analysis to establish the relationship between the variables. The study found that credit risk and cost efficiency were negatively and significantly related ($\beta=-5.6018$, $P=0.0123$). This means that cost efficiency would increase with a decrease in credit risk. The study also showed that liquidity risk has a negative and significant effect on cost efficiency ($\beta=-15.1983$, $P=0.001$). This implies that when liquidity gap increases then the cost efficiency of a firm decreases significantly. Moreover, interest rate risk was positively and significantly related to cost efficiency ratio ($\beta=9.277$, $P=0.004$). This implies that when liquidity gap increases then the cost efficiency of a firm decreases significantly. The study also revealed that foreign exchange risk negatively affects cost efficiency ($\beta=-0.1093$, $P=0.027$). This implies that the bigger the position an insurance firm holds in foreign markets relative to local markets, the more exposed they are to fluctuations in exchange rates. The study therefore concluded that credit risk, liquidity risk and foreign exchange risk had a negative influence on cost efficiency while interest rate risk had a positive influence on cost efficiency of general insurance companies in Kenya. Finally, it can be concluded that capital adequacy moderates the relationship between financial risk and cost efficiency among insurance firms in Kenya. The study recommends that general insurance companies should have sufficient capital reserves in order to be able to handle financial risks they are exposed to should they occur and that the IRA should set up policies that guide the industry and enable insurance companies to improve their cost efficiency and reduce their exposure to different forms of financial risk. The study also recommended that further research be conducted on other factors that may affect cost efficiency apart from those discussed in the study.