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FINANCIAL PERFORMANCE OF INSURANCE INDUSTRY IN ETHIOPIA

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ABSTRACT

There have not been empirical studies that address the financial performance of Ethiopian insurance companies in Ethiopia. This study was undertaken to evaluate the financial performance of non-life insurance industry in Ethiopia by using CARAMEL frame work. The researcher selected 10 insurance companies from the total of 15 based on their year of establishment. Secondary data collected from the individual insurance companies and from the National Bank of Ethiopia from the fiscal year of 2008 to 2012 was used for the completion of the study. The model employed for this study is $ROA=\alpha+\beta_1KTAit+\beta_2ONETA1it+\beta_3Rit+\beta_4Ait+\beta_5MEit+\beta_6EPR_3it+\beta_7LRit+\varepsilon$*. ROA has been used as the dependent variable explained by capital adequacy, assets quality, re-insurance, actuarial issues, management efficiency, earning and profitability and liquidity. Multiple linear regression was applied. From the multiple linear regression, it was found that assets quality and combined ratio have negative relationship whereas capital adequacy and retention ratio have positive relationship with performance (ROA) of insurance industry in Ethiopia. One of the objectives of the study is that to identify the major factors that affect the financial performance of insurance industry in Ethiopia and it was found from the regression result that the major factors are capital adequacy, assets quality, re-insurance and combined ratio. The researcher recommended that the management and regulators of Insurance companies in Ethiopia should give due attention on capital adequacy and set minimum requirement for the capital adequacy of insurance industry, assets quality and re-insurance.*

KEYWORDS

CARAMEL frame work, financial performance, nonlife insurance.

INTRODUCTION

According to Bodla, et al (2003), insurance business has emerged as one of the prominent areas of financial services during recent times particularly in developing economies where it could not grow much prior to globalization.

Insurance is a tool to spread the loss caused by a particular risk over a number of persons who are expected to it and who agree to ensure themselves against that risk.

Insurance appears simultaneously with the existence of human beings (EEA, 2011). The idea of insurance was conceptualized first in 14th century (Bodla et al, 2003). At the time it was used more as a tool for protection against financial losses of sea fearers involved in foreign trade. Since then this concept has undergone several changes. In ancient form of insurance, groups of the societies helped each other when they faced natural or unnatural catastrophic events that could lead to large financial losses. Ancient insurance service was practiced by Chinese and Babylonian traders as long as the 3rd and 2nd millennia BC. Marine insurance is the oldest form of insurance followed by life and fire insurances. The first life insurance company in the United States was established in 1759 and is still in existence (Mishkin, 2004).

In Ethiopia, insurance is dated back to ancient years when people contributed money or labor to assist other members whenever they faced financial difficulties or needed assistance. 'Idir' and 'Eqqub' are among the organizations that have played significant role in traditional insurance service in Ethiopia.

The first modern insurance company in Ethiopia can be traced back to 1905 with the establishment of Bank of Abyssinia. The bank was acting as an agent for foreign insurance companies to underwrite fire and marine policies. In 1923, the first Austrian agent of La Baloise fire insurance company came to Ethiopia and paid the first loss on warehouse and shop in 1929 (Hailu, 2007). In 1950, only foreign insurance companies - Imperial insurance company of Ethiopia was established. Thus, during 1950s and 1960s, 33 foreign and 1 domestic insurance companies were providing insurance services (EEA, 2011). The rise in the number of domestic insurance companies and the expansion of foreign insurance agents motivated the Ethiopian government to issue the first insurance proclamation to regulate the insurance business in the country.

In 1970, the first insurance proclamation, proclamation number 281/1970 was issued that prohibited foreign companies to undertake insurance business in Ethiopia either directly or through agents. Article 56 of the proclamation raised the minimum paid up capital for all insurance types. Following the 1974 revolution which followed the path of the command economy, all domestic insurance companies were nationalized through proclamation no. 26/1975. According to Hailu (2007), the Ethiopian Insurance Corporation (EIC) established in 1976 by then the government of Ethiopia monopolized the insurance business by taking over the assets and liabilities of private domestic insurance companies.

Finance is considered as the life blood of a business. It is one of the basics of all types of economic activities. According to Walker (2001), Company's financial performance is estimated in three measurements which are company's productivity (processing inputs into outputs efficiently), profitability (the level of which company's earnings are larger than its expenses), and market premium (the level of which company's market price is exceeding its book value).

The frame work, CARAMEL (Capital adequacy, Assets quality, Reinsurance, Actuarial issues, Management efficiency, Earning and profitability, Liquidity), was used for the purpose of evaluating the financial performance of insurance industry in Ethiopia. CARAMEL was proposed by Das et al. (2003). They add Reinsurance and Actuarial issues to the CAMEL methodology routinely used for banks.

REVIEW OF LITERATURE

Simpson & Damoah (2008), conducted research on evaluation of financial health of non-life insurance companies in Ghana by using CARAMEL frame work and the objective of the study was to evaluate financial soundness of non-life insurance companies using a developing country as the context and to examine the current evaluation tools being used by the Ghanaian regulatory and supervisory body (the National Insurance Commission, NIC) on non-life insurance companies. The researchers used both primary (interview) and secondary data for the completion of the study. From 18 non-life insurers and 2 re-insurers in Ghana, the researchers purposely selected 8 insurers and 1 re-insurer for the study. The research outcomes indicated that the evaluations tools use in NIC in Ghana excludes management soundness and actuarial issues proposed under the CARAMEL. The study is mainly to examine the evaluation tools used by NIC in Ghana whereas this study is to evaluate the financial performance of non-life insurance industry in Ethiopia.

Tanveer (2011) conducted research on the financial performance of insurance industry in post liberalization era in India and the objective of the study was to analyze the financial performance of public and private sector non-life insurers on the basis of CARAMEL parameters. Both primary and secondary data sources were used for the study. The researcher collected the primary data based on personal investigation. The researcher finally concluded that the insurance industry in India, since liberalization (1999), has witnessed paradigm change in a relatively short span of time.

Noor (2004) and Mohammed et al (2013) conducted research on determinants of Capital adequacy and used secondary data. The objective of the study was to identify the determinants of the capital adequacy. The study found that profitability (ROA) and liquidity are positively related to the capital adequacy requirements.

Adams and Buckle (2012), conducted research and the objective of study is to examine the determinants of operational performance in the Bermuda Insurance Market. The researchers used panel data for 1993-97 and selected Bermuda registered 47 insurance/reinsurance companies. They found that highly leveraged, lowly liquid companies and reinsurers have better operational performance than lowly leveraged, highly liquid companies and direct insurers.

Malik (2011) conducted research on determinants of insurance companies' profitability in Pakistan. The objective of this paper was to identify and examine firm specific factors of insurance profitability in Pakistan. The researcher used secondary data and a sample of 34 insurance companies of Pakistan. The result of this paper shows that profitability proxied by ROA is affected positively by size, volume of capital and negatively by leverage and loss ratio.

Charumathi (2012), the main objective of the study is to examine the determinants of profitability of life insurance companies in India. The researcher took the total life insurance companies of India for the study and 3 years financial statements of those companies. The finding of the study revealed that profitability proxied by ROA of life insurers is positively and significantly influenced by the liquidity.

Bilal et al. *(2013)*, see the determinants of profitability of insurance sector in Pakistan. The researchers included both life and non-life insurance and panel data of 31 insurance firms was used. The outcome of the study revealed that from other determinants (leverage, size, earnings volatility and age of the firm) liquidity is not the significant determinants of profitability of insurance business in Pakistan.

Abate (2012) also conducted research on factors affecting Profitability of Insurance Companies in Ethiopia. Secondary data was used for the study. The objective of the study is to identify the factors that affect the profitability of Ethiopian insurance companies. The outcome of the study indicated that growth, leverage, volume of capital, size, and liquidity are identified as most important determinant factors of profitability of Ethiopian insurance companies.

Chen and Wong (2004), the study conducted on the Determinants of Financial Health of Asian Insurance Companies. They used secondary data collected from general insurance companies from 1966 to 1999. They finally found that liquidity ratio and combined ratio are significant factors of financial health of Asian general insurance companies.

Joseph et al (2011) conducted research on the financial performance of life insurance companies in Ghana. The researchers used financial statement of 10 life insurance companies. The research examined the relationship of profitability with investment income, underwriting profit and the overall (total) net profit. The result of the paper indicated that a setting-off rather than a complementary relationship between underwriting profit and investment income towards the enhancement of the overall profitability of life insurers.

David et al (2012), the objective of the study is to see the relationship between reinsurance counterparty and firm performance in the U.S. Property-Liability Insurance Industry. Secondary data was used to the study. They analyzed the relationship between firm performance (proxied by ROA and ROE) and reinsurance utilization. They finally found that Firm performance is positively related to reinsurance utilization. Meir and Utreville (2003), titled the business cycles in insurance and re-insurance, stated that reinsurance makes primary insurers to enhance the underwriting revenue more than what would otherwise be possible.

Alexandre and João (2008), the purpose of the study was to investigate the impacts of quality management on profitability of firms and Schweiger and Friebel (2013), the objectives of the study was to find out the relationship between management quality, ownership and firm performance. They found that management quality has no significant relationship with the financial performance of the firms. Contrary, Marianne and Antoinette (2003) and Panayiotis (2013), the study investigated the effects of management quality on the performance of the firms and the result indicated that management quality is significantly and positively correlated with the financial performance of the firms.

SIGNIFICANCE OF THE STUDY

This research will help the policy makers and managers of insurance industry in Ethiopia to consider major factors and set the minimum capital requirement of the insurance business. Despite the role of insurance for the overall growth of Ethiopian economy (that is affected by the performance of the industry), only few researches are conducted on the area. As far as the researcher's knowledge is concerned, there have not been empirical studies addressed the performance of insurance industry in Ethiopia. Thus, this research is aimed at filling this gap; motivate other researches to the area and providing appropriate recommendation.

STATEMENT OF THE PROBLEM

Well-functioning financial institutions will sustain economic growth and reduce poverty (EEA, 2011). Among others, insurance industry is one of the major participants in financial markets that facilitate the protection of business from failure by indemnifying, and protection of families from exposing difficulties (after the death of the family head). These collectively lead to sustainable economic growth of a country at large. In short, Insurance industry plays the most important role for the efficient and sustainable development of economies of a particular country.

According to Naser and Mokhtar (2004), high financial performance indicates that management effectiveness and efficiency in making use of organization's resources and this in turn contributes to the country's economy at large. The insurance industry in particular is part of immune and repair system of an economy and successful operation of the industry can set energy for other industries and development of an economy. To do so the insurance industry is expected to be financially solvent and strong through being profitable in operation.

Measuring the performance of financial institutions has added the significance in the corporate finance literature because as intermediaries, these companies in the sector are not only providing the means of saving money and transferring risk but also helps to channel funds in an appropriate way from surplus economic units to deficit economic units so as to support the investment activities in the economy.

However, even if insurance industry in Ethiopia is equally old with the banking sector, it has yet to contribute more for the economic development of the country (EEA, 2011). Thus, it is essential to evaluate the financial condition or performance of insurance industry in Ethiopia. Traditionally, the financial performance of insurance industry has been measured using conventional financial ratios such as the return on equity, return on assets, and expense to premium ratios. Therefore, this study is used to evaluate the financial performance of insurance industry in Ethiopia.

As far as the knowledge of the researcher concerned, there is no research conducted on financial performance of insurance industry in Ethiopia with the help of CARAMEL frame work.

HYPOTHESIS

H1: Capital adequacy has positive effect on return on assets.
H2: Asset quality has positive effect on return on assets.
H3: Retention ratio has positive effect on return on assets
H4: Actuarial issue has a negative effect on return on assets.
H5: Management Efficiency has a negative effect on return on assets.
H6: Combined ratio has a negative effect on return on assets.
H7: Liquidity has negative effect on return on assets.

OBJECTIVES OF THE STUDY

The **main objective** of this study is **to evaluate the financial performance of non-life insurance companies in Ethiopia by using CARAMEL frame work**.
The following are the specific objectives of the study based on the above broad objective:

1. To identify the effects of the dependent variables on the financial performance of insurance industry in Ethiopia
2. To identify major factors that affect performance of insurance industry in Ethiopia
3. To identify the effects of the dependent variables on the financial performance of non-life insurance companies in Ethiopia.

RESEARCH METHODOLOGY

In order to achieve the objectives stated in the previous section, bearing in mind the nature of research problem and the research outlook, this study mainly employed quantitative research approach on the financial performance of insurance industry in Ethiopia over the period of 2008 to 2012. In this study, the empirical methodology is adopted mainly from Mamadou (2012) with some modifications.
The Secondary data; audited annual reports of the insurance companies for the period of six years (from the period of 2007 to 2012) which was obtained from the NBE and from the selected insurance companies, was used for the completion of this study.
Currently (in the year 2013), there are 15 insurance companies in Ethiopia. From those 15 insurance companies, 10 non-life insurance companies established before 2008 were selected as the sample of the study.

MODEL SPECIFICATION

$ROA=\alpha+\beta_1 KTAit+\beta_2 ONETA1it+\beta_3 Rit+\beta_4 Ait+\beta_5 MEit+\beta_6 EPR_3 it+\beta_7 LRit +\mathcal{E}$ *adopted from* Mamadou (2012)
In this study, ROA is Return on Average assets, the dependent variable measured as net income to average total assets. KTA is the capital adequacy ratio as determined as capital to total assets, ONETA is the assets quality measured as owners' equity to total assets, R is reinsurance which is the ratio of net premium to gross premium, ME is management efficiency calculated as operating expense to gross premium, EPR, is combined ratio is the combination of loos ratio and expense ratio and LR is liquidity ratio measured as current liability to current assets. $\beta_1, \beta_2, --- \beta_7$ are coefficients and α is constant.

DATA ANALYSIS

REGRESSION ANALYSIS

ROA	Coef.	Std. Err.	T	P>|t|	[95% Conf.	Interval]
KTA	.359729	.1729322	2.08	0.044*	.7087202	.0107377
ONETA	-.5257841	.2048493	-2.57	0.014*	-.9391867	-.1123815
NPGP	.547825	.2564702	2.14	0.039*	.0302471	1.065403
NTRNC	.0439648	.0771171	0.57	0.572	-.1116638	.1995933
OEGP	-1.77791	1.179393	-1.51	0.139	-4.158022	.6022025
COMR	-2.443216	.7991895	-3.06	0.004**	-.8303862	4.056046
CACL	-.0122617	.0104894	-1.17	0.249	-.0334302	.0089068
_cons	.6051921	.1839325	3.29	0.002**	.2340013	.976383

*significant at 5% level and ** significant at 1%

Source: computed from stata 11.0

$ROA= \acute{a}+\hat{a}_1 KTAit+\hat{a}_2 ONETAit+\hat{a}_3 Rit+ \hat{a}_4 Ait+\hat{a}_5 MEit+\hat{a}_6 EPR_3 it+\hat{a}_7 LRit +\varepsilon\mathcal{E}$
$ROA= 0.61+ 0.36KTA -0.53ONETA+0.55R+0.04A -1.78ME -2.4EPR -0.01LR$
$[.184]\ [.173]\ [.205]\ [.256]\ [.077]\ [1.179]\ [.799]\ [.010]$ $adj\text{-}R^2 =.412$
The above model indicates that when asset quality and combined ratio decreased by one unit, ROA is expected to increase by 0.52 units, and 2.4 units respectively however, one unit increase in capital adequacy and in re-insurance will lead to 0.36 and 0.55 units increase in ROA. Actuarial issues, management efficiency and liquidity have no significant relationship with ROA of insurance industry in Ethiopia.
The adjusted R square indicates how well the model variance has been explained (Morgan et al 2004). It is found that the adjusted R square of this model is 41.2% (see the Appendix), meaning 41.2% of the model is explained by the independent variables collectively (the dependent variable, ROA, is explained by Capital adequacy ratio, asset quality ratio, reinsurance, actuarial issues, combined ratio and liquidity ratio) and the remaining is explained by other variables or factors. It reflects that CARAMEL frame work can be used as the measurement of financial performance of insurance industry in Ethiopia.

FINDINGS AND CONCLUSION

The objective of the study is to evaluate the financial performance of insurance industry in Ethiopia. The study used secondary data for the period of 2007 to 2012 and the sample is 10 nonlife insurance companies from the total of 15 insurance companies of Ethiopia. The variables tested in this study are capital adequacy, assets quality, reinsurance, actuarial issues, management efficiency, earning and profitability and liquidity. Regression analysis was performed.
The findings of this study contribute towards the better understanding of financial performance of insurance industry in Ethiopia. The financial performance proxied by ROA and CARAMEL that represent capital adequacy, assets quality, reinsurance, actuarial issues, management efficiency, earnings and profitability and liquidity were regressed to show the effects of those dependent variables on the ROA of insurance industry in Ethiopia.
The result shows that capital adequacy and re-insurance have a positive effect on ROA whereas combined ratio and assets quality have negative effect on ROA. Actuarial issues, management efficiency and liquidity have insignificant effect on ROA of insurance industry in Ethiopia.
This result suggests that Management and regulators of Insurance companies in Ethiopia should give due attention on capital adequacy as it is vital to absorb losses arising from underwriting business and should set the minimum requirement of the capital adequacy for the insurance industry as is applicable for banks.

RECOMMENDATIONS

Based on the conclusion drawn above the researcher provided the following recommendations:

1. Management and regulators of Insurance companies in Ethiopia should give due attention on capital adequacy as it is vital to absorb losses arising from underwriting business and should set the minimum requirement of the capital adequacy for the insurance industry as is applicable for banks.
2. The insurance companies should focus on their assets quality. Inclusion of more equity will surely make the asset quality of the insurers better. Contrary, the higher the equity ratio will face the company to lose for huge portion of its earnings spent in paying interest. Hence, insurance industry should have reasonable equity in its portfolio.

3. For the improvement of reinsurance ratio, proper management of premium will help insurers to retain and manage maximum risk efficiently.
4. Other researchers should incorporate the financial and non financial performance of both non life and life insurance companies in Ethiopia.

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APPENDICES

APPENDIX 1: LIST OF INSURANCE COMPANIES IN ETHIOPIA AS OF 2013

s.no	Insurance companies	Year of Establishment
1	*Abay insurance company	2010
2	Africa Insurance Company s.c.	1994
3	Awash Insurance Company S.C	1994
4	*Berhan insurance S.c	2011
5	*Ethio-Life and General Insurance S.C.	2008
6	Ethiopian Insurance Corporation	1975
7	Global Insurance Company S.C.	1997
8	Lion Insurance Company S.C	2007
9	National Insurance Company of Ethiopia S.C.	1994
10	Nib Insurance Company	2002
11	Nile Insurance Company S.C	1995
12	Nyala Insurance Company S.C	1995
13	*Oromia Insurance Company S.C.	2009
14	*Tsehay Insurance S.C.	2012
15	The United Insurance S.C	1997

Note: * insurance companies not included in this study

Source: http://www.nbe.gov.et/financial/insurer.html

APPENDIX 2: REGRESSION ANALYSIS RESULT

FIXED EFFECTS

ROA	Coef.	Std Err.	T	P>|t|]	[95% Conf.	Interval]
KTA	.0247388	.3543825	0.07	0.945	-.6962577	.7457354
ONETA	-.4166097	.2532368	-1.65	0.109	-.9318237	.0986044
NPGP	.3586712	.2488333	1.44	0.159	-.147584	.8649264
NTRNC	-.1174367	.1758338	-0.67	0.509	-.4751732	.2402997
OEGP	-2.890061	1.325177	-2.18	0.036	-5.586155	-.1939682
COMR	-2.701793	.9783998	2.76	0.009	.7112238	4.692363
CACL	-.011687	.0107308	-1.09	0.284	-.033519	.0101449
_cons	.62395	.2586244	2.41	0.022	.0977747	1.150125
sigma_u	.12632814					
sigma_e	.11769584					
Rho	.53533061					

Source: computed from stata 11.0

RANDOM EFFECTS

ROA	Coef.	Std. Err.	Z	P>|z|	[95% Conf.	Interval]
KTA		.2206293	-1.00	0.315	-.6539123	.2109386
ONETA	-.4469637	.217885	-2.05	0.040	-.8740105	-.0199169
NPGP	.429386	.2384461	1.80	0.072	-.0379599	.8967318
NTRNC	.0129907	.1018466	0.13	0.899	-.1866249	.2126063
OEGP	-2.237987	1.175787	-1.90	0.057	-4.542487	.0665129
COMR	-2.494188	.8234837	3.03	0.002	.8801894	4.108186
CACL	-.0130009	.0097359	-1.34	0.182	-.0320829	.0060811
_cons	.6410682	.1901714	3.37	0.001	.2683391	1.013797
sigma_u	.08376549					
sigma_e	.11769584					
rho	.33622445					

Source: computed from stata 11.0

HAUSMAN FIXED RANDOM

	(b)	(B)	(b-B)	sqrt(diag(V_b- V_B))
	fixed	random	Difference	S.E.
KTA	.0247388	-.2214869	.2462257	.2773259
ONETA	-.4166097	-.4469637	.030354	.1290541
NPGP	.3586712	.429386	-.0707148	.0711439
NTRNC	-.1174367	.0129907	-.1304274	.1433345
OEGP	-2.890061	-2.237987	-.6520744	.6112444
COMR	-2.701793	-2.494188	. -0.207605	.5283378
CACL	-.011687	-.0130009	.0013139	.0045125
chi2(7) = 8.94				
Prob>chi2 = 0.2570				

Source: computed from stata 11.0

BREUSCH-PAGAN LAGRANGE MULTIPLIER

chi2(1) = 0.85
Prob>chi2=0.3569

Source: computed from stata 11.0

SHAPIRO-WILK TEST

Variable	Obs	W	V	Z	Prob>z
R	50	0.98755	0.585	-1.142	0.87320

Source: computed from stata 11.0

TEST FOR HETEROSKEDASTICITY

chi2(1) = 0.64
Prob> chi2 = 0.4252

Source: computed from stata 11.0

CORRELATION

	ROA	KTA	ONETA	NPGP	NTRNC	OEGP	COMR	CACL
ROA	1.0000							
KTA	-0.3013	1.0000						
ONETA	-0.2097	0.3788	1.0000					
NPGP	-0.0016	0.2720	0.1281	1.0000				
NTRNC	-0.0693	0.5061	0.1431	0.2160	1.0000			
OEGP	0.3186	0.2047	0.5372	0.2788	0.2585	1.0000		
COMR	0.4125	0.1303	0.4483	-0.1297	0.1241	0.5749	1.0000	
CACL	-0.1875	0.1811	-0.1700	-0.1465	0.0700	-0.1718	-0.0897	1.0000

Source: computed from stata 11.0

ANOVA

Sources	SS	df	MS	Number of obs =50
Model	.770899173	7	.110128453	F(7,42)=5.9
Residual	.784327374	42	.018674461	Prob>F=0.0001
				R-squared=0.4957
Total	1.55522655	49	.031739317	Adj R-squared=0.4116
				Root MSE=.13665

Source: computed from stata 11.0

SUMMARY OF STATISTICAL RESULTS

OLS test results		
ROA		
Variables	Relationship	Sign
KTA	Significant	+
ONETA	Significant	-
NPGP	Significant	+
NTRNC	Insignificant	+
OEGP	insignificant	-
COMR	significant	-
CACL	Insignificant	-

Source: computed from stata 11.0

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