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Claims Management Practices on Financial Performance of Insurance Companies in Kenya

Ephraith Kerubo Omweri
Post Graduate Student, Department of Finance & Accounting, Multimedia University, Kenya
Dr. Nyaga Njagi Gilbert
Lecturer, Department of Finance and Accounting, Mount Kenya University, Kenya
Dr. Cynthia Ikamari
Senior Lecturer, Department of Finance & Accounting, Multimedia University, Kenya

Abstract:
The insurance sector plays a crucial role in Kenya's economic development by supporting businesses and promoting financial market stability. However, the Insurance Regulatory Authority of Kenya has noted a concerning decline in the industry's overall claims ratio, primarily due to inadequate risk management. This failure in risk management has led to substantial financial losses and the collapse of several insurance companies in Kenya. Specifically, it aims to determine the effects of claims management on these companies' financial performance. The study adopted a descriptive research design, targeting all 56 insurance companies registered in Kenya as of January 31, 2023. Primary data was collected using questionnaires, while secondary data was gathered from existing sources and systematically recorded on data collection sheets for the independent variables. This secondary data was sourced from the Insurance Regulatory Authority for the period between 2013 and 2022. Quantitative data was analyzed using descriptive and inferential statistics with SPSS. Descriptive statistics included measures of central tendencies such as means, frequency distribution, and standard deviations, while inferential statistics comprised correlation and regression analysis to determine the relationships between research variables. Data findings were presented using tables and graphs. The study found that claims management had a significant positive effect on the financial performance of insurance companies in Kenya. Claims risk management had a greater impact on financial performance when measured by ROE compared to ROA. In conclusion, the study indicates that claims risk management positively and significantly affects the financial performance of insurance companies in Kenya. Therefore, it recommends that the management of these companies continuously improve their risk management practices to reduce claim rates, enhance financial performance, and increase shareholders' wealth. Further research is suggested to explore other factors beyond risk management practices that may contribute to the reduced return on equity among insurance firms in Kenya.

Keywords: *Claims management practices, financial performance, insurance companies*

1. Introduction

1.1. Background of the Study

The global insurance industry plays a crucial role in economic growth by facilitating business operations through security provision, funding development initiatives, and capital formation (Jorion, 2021). However, achieving this essential role has been challenged by global performance issues over the years. Recent financial scandals have led to massive losses and eroded public trust in financial institutions (Jorion, 2021).

Similarly, Mishkin (2018) describes financial risk management as a crucial aspect of financial management, involving the identification of potential risks, evaluation of their potential impact, and implementation of measures to mitigate or avoid them. This process employs various techniques such as diversification, hedging, insurance, and financial derivatives.

Hedging, a fundamental aspect of risk management, involves using financial instruments like derivatives to offset potential losses from adverse price movements. Empirical studies consistently highlight the positive impact of hedging on financial performance, showing that firms engaging in hedging activities often exhibit greater resilience and stability (Smith & Walters, 2021).

Recent technological advancements have revolutionized financial risk management, presenting both opportunities and challenges for firms seeking to enhance their capabilities. The rise of big data analytics, machine learning, and artificial intelligence has enabled companies to improve risk assessment and develop sophisticated risk management strategies (Liu & Kim, 2021).

In Africa, insurance companies encounter a range of financial risks from both internal and external sources. These risks include underwriting, investment, liquidity, and regulatory risks (Osei et al., 2021). Effective risk management starts with robust underwriting practices, where insurers carefully assess and price risks to ensure premiums cover potential claims.

In Kenya, insurance firms play a significant role in economic growth, although their financial performance is hindered by high claim ratios. In the first quarter of 2023, general insurance premiums amounted to KES 62.52 billion, with a claims incurred loss ratio of 72 percent, compared to 67.7 percent by the end of 2023 (IRA, 2023). A large portion of the Kenyan population operates without insurance coverage, with market penetration lagging behind the rapid increase in premiums and revenues. This suggests that focusing on basic risks affecting insurance operations could improve the sector's performance (AKI, 2021).

1.2. Research Problem

Effective financial risk management can assist insurance companies in improving their financial performance despite the losses incurred (Goh & Yong, 2018). Without proper management of financial risks, insurance companies can suffer substantially from the negative impact of risks on their financial performance, leading to fraudulent claims and enhancing financial losses due to such claims (Ulucan & Özkan, 2019). Particularly, the insurance industry continues to be dominated by instances of subpar risk management procedures resulting in substantial losses. According to the Insurance Regulatory Authority (IRA) of Kenya, the industry's overall claims ratio increased from 61.5% in 2017 to 65.6% in 2019, indicating deterioration in the industry's underwriting performance (IRA, 2020).

Empirically, the studies have no consensus on the relationship between risk management practices and performance. Jokipii and Milne (2018) found that effective financial risk management practices can enhance the financial performance of banks. Onyango (2021) found that risk monitoring and control, risk reduction, and risk identification had a strong positive relationship with performance. Similarly, a study by Goh and Yong (2018) showed a positive relationship between financial risk management and financial performance in Malaysian public-listed firms. However, some studies have produced mixed results, such as Öztekin and Flannery (2021), who showed that while financial risk management can enhance financial performance in stable economic conditions, it can have a negative impact during economic crises.

One of the key issues to be addressed in this research is the identification and evaluation of the specific financial risk management strategies employed by insurance companies in Kenya. This involves examining the range of risk management tools and techniques utilized by insurers, including asset-liability management, reinsurance, hedging, and diversification strategies. Understanding the prevalence and effectiveness of these practices is essential for gauging the resilience of insurance firms in mitigating various financial risks and navigating uncertain market conditions. By analyzing financial performance indicators such as profitability, liquidity, solvency, and market competitiveness, this study aims to assess the impact of risk management strategies on an insurer's overall financial health and sustainability. This investigation is not only crucial for insurance companies seeking to enhance their risk management frameworks but also for regulators and policymakers in formulating policies that promote stability and growth within the insurance sector.

1.3. Research Objectives

1.3.1. General Research Objective

To analyze the relationship between the claims risk management practices and financial performance of insurance companies in Kenya.

1.3.2. Specific Objective

The study was guided by the following specific objective:

- To determine the effect of claims risk management on the financial performance of insurance companies in Kenya.

1.4. Research Hypothesis

- H_{01}: There is no statistically significant relationship between claims risk management and the financial performance of insurance companies in Kenya.

2. Literature Review

2.1. Theoretical Review

2.1.1. Stakeholder Theory

Stakeholder Theory, first introduced by Edward Freeman in 1984, indicates that corporations have obligations to multiple stakeholders, including shareholders, employees, customers, suppliers, and the wider community. The theory holds that corporations should strive to create value not just for shareholders but for all stakeholders and that decisions should be made with their interests in mind. The theory is based on the assumption that corporations do not exist solely to maximize profits but to serve a broader social purpose. The relevance of stakeholder theory lies in its ability to balance the interests of various stakeholders, resulting in sustainable long-term growth (Parmar, Freeman, Harrison, Wicks, Purnell & De Colle, 2020).

Stakeholder Theory's significance lies in its ability to provide a holistic perspective on organizational management, moving beyond traditional profit-centric approaches. By recognizing the diverse stakeholders impacted by

an organization's actions, including employees, customers, suppliers, communities, and the environment, Stakeholder Theory highlights the interconnectedness of business operations with broader societal interests (Freeman, 2019). This recognition is crucial in addressing contemporary challenges such as corporate social responsibility, sustainability, and ethical decision-making (Jensen & Wicks, 2018). Consequently, Stakeholder Theory serves as a guiding principle for businesses seeking to create long-term value while balancing the interests of all stakeholders.

Furthermore, Stakeholder Theory's relevance extends beyond individual organizations to encompass entire industries and economies. In today's interconnected global marketplace, organizations operate within complex networks of stakeholders with diverse interests and expectations (Jones & Felps, 2021). Recognizing and effectively managing these stakeholder relationships are essential for organizational success and resilience in dynamic environments. Stakeholder Theory provides a framework for understanding these complex relationships and aligning organizational strategies with stakeholder interests, thereby enhancing competitiveness and sustainability (Crane et al., 2020). In essence, Stakeholder Theory offers practical insights for navigating the intricacies of stakeholder dynamics in a rapidly evolving business landscape.

2.2.2. Financial Risk Theory

Financial Risk Theory, developed by Eugene Fama and Kenneth French in 1992, indicates that investors are compensated for taking on additional financial risk and that the expected return on investment is proportional to the risk involved. The theory holds that investors can reduce risk by diversifying their portfolios across different asset classes, thereby achieving a better risk-return tradeoff. The theory assumes that financial markets are efficient and that investors have access to all relevant information. The relevance of financial risk theory lies in its ability to help investors make informed decisions about portfolio allocation and guide the pricing of financial assets based on their perceived risk (Murphy, 2018).

One of the primary significances of Financial Risk Theory lies in its ability to assist investors in making rational investment decisions by evaluating the potential risks associated with different assets or portfolios. According to Markowitz (1952), the Modern Portfolio Theory (MPT), a cornerstone of Financial Risk Theory, emphasizes the importance of diversification in reducing portfolio risk. By allocating investments across different asset classes with low correlation, investors can achieve a more efficient risk-return tradeoff. This concept remains relevant in contemporary finance, as evidenced by the widespread adoption of diversified investment strategies by institutional and individual investors (Piotrowski et al., 2020).

Furthermore, financial risk theory plays a crucial role in forming risk management practices within financial institutions and corporations. The Value-at-Risk (VaR) model, for instance, provides a quantitative measure of potential losses in a portfolio over a specified time horizon and confidence level (Jorion, 2021). Banks and financial institutions use VaR and other risk metrics to assess and monitor their exposure to market and credit risk, thereby ensuring financial stability and regulatory compliance. The relevance of risk management frameworks derived from Financial Risk Theory is evident in their integration into regulatory frameworks such as Basel III, which mandates banks to maintain adequate capital reserves based on their risk profiles (Borio et al., 2021).

2.2. Empirical Review

2.2.1. Claims Risk Management Practices and Financial Performance

Jones et al. (2021) investigated the relationship between claims risk management practices and financial performance in the insurance industry. Through a comprehensive analysis of various insurers, they found that companies implementing robust claims risk management strategies tend to experience lower claim costs and higher profitability. Their findings underscored the importance of proactive risk management in enhancing financial outcomes within the insurance sector, highlighting the potential for insurers to achieve competitive advantages through effective claims management.

A study by Smith and Brown (2019) focused on examining the impact of claims risk management practices on the financial performance of healthcare organizations. Their research revealed a significant correlation between the adoption of advanced risk management techniques and improved financial metrics, such as reduced medical malpractice claims and increased revenue streams. The study emphasized the critical role of proactive risk mitigation strategies in safeguarding financial stability and enhancing operational efficiency within the healthcare sector.

Wang et al. (2020) conducted a study to explore the relationship between claims risk management practices and financial performance in the banking industry. Through an analysis of leading banks, they discovered a clear link between the implementation of comprehensive risk management frameworks and enhanced profitability. Their findings highlighted the importance of integrating claims risk management into overall risk management strategies to mitigate losses and improve financial resilience, particularly in an increasingly volatile banking environment.

In a study by Garcia and Patel (2018), researchers examined the impact of claims risk management practices on the financial performance of manufacturing firms. Their findings revealed that companies prioritizing proactive risk identification and mitigation strategies tend to experience fewer operational disruptions and lower financial losses associated with claims. The study underscored the significance of integrating risk management into operational processes to optimize financial performance and sustain competitive advantages in the manufacturing sector.

Chen et al. (2022) conducted a study focusing on the association between claims risk management practices and financial performance in the transportation industry. Through an analysis of major transportation companies, they observed a positive correlation between effective risk management strategies and improved profitability metrics. The

study emphasized the importance of implementing comprehensive risk mitigation measures to minimize financial losses stemming from claims-related liabilities and enhance overall performance in the transportation sector.

In a recent study by Lee and Kim (2023), researchers investigated the relationship between claims risk management practices and financial performance in the technology sector. Their findings demonstrated that technology companies with robust risk management frameworks tend to achieve higher profitability and market valuation. The study underscored the strategic importance of integrating claims risk management into corporate governance structures to mitigate financial risks and sustain long-term value creation in the dynamic technology landscape.

3. Research Methodology

The study employed a descriptive research design, specifically focusing on survey research. This approach allows for a detailed examination of situations, events, and individuals, making it the most suitable method for achieving the study's objectives (Cooper, 2020). Descriptive research design involves outlining a population concerning key study variables, with the primary aim of establishing relationships between these variables (Cresswell & Cresswell, 2021). Consequently, this design often serves as a precursor to more quantitative research designs, providing valuable insights into which variables are worth quantitatively testing. Given its flexibility in describing and collecting data, the descriptive research design was selected for this study.

A multiple regression model was used to test the significance of the effect of the independent variables on the dependent variable. The multiple regression model was as follows:

$Y = \beta_0+\beta_1 X_1 + e$

Where:

Y = Performance of the Insurance companies as measured by ROA

β_i = The coefficients representing the various independent variables.

β_0 = the Y intercept

X_1 = Claims Risk Management Practices

e = the error term, which is assumed to be normally distributed with mean zero and constant variance.

4. Findings and Discussion

The study sought to determine the effect of claims risk management on the financial performance of insurance companies in Kenya. To this effect, their study found a coefficient of correlation of .697 ($p<0.05$) overall financial performance, .639 ($p<0.05$) return on assets and .808 ($p<0.05$) return on equity. This, therefore, meant that claims risk management has a significant and positive effect on financial performance as measured by return on assets and equity. Enhancing claims risk management practices will improve the performance of insurance firms in Kenya.

The findings agree with existing empirical studies. Jones et al. (2021) found that companies implementing robust claims risk management strategies tend to experience lower claim costs and higher profitability. A study by Garcia and Patel (2018) revealed that companies prioritizing proactive claims risk identification and mitigation strategies intended to experience fewer operational disruptions and lower financial losses associated with claims. Lee and Kim (2023), researchers investigated the relationship between claims risk management practices and financial performance in the technology sector. Their findings demonstrated that technology companies with robust claims risk management frameworks intended to achieve higher profitability and market evaluation. The study underscored the strategic importance of integrating claims risk management into corporate governance structures to mitigate financial risks. Gandhi sustained long-term value creation in their dynamic technology landscape.

5. Conclusions and Recommendations

5.1. Conclusions

The study found a correlation coefficient of i.697i I ($p<0.05$) overall financial performance, .639($p<0.05$) return in assets, and .808 ($p<0.05$) return in equity. This indicates that claims risk management significantly and positively affects financial performance as measured by return on assets and return on equity. Enhancing claims risk management practices improves the performance of insurance firms in Kenya.

The study concluded that claims risk management positively and significantly affects the financial performance of insurance companies in Kenya. Enhancing claims risk management practices will improve the performance of insurance firms in Kenya.

5.2. Recommendations

The study recommends that the management of insurance companies in Kenya continuously improve their claims risk management practices to reduce claim rates and enhance the financial performance of Gandhi shareholder's wealth.

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