

**FACTOR AFFECTING THE FINANCIAL PERFORMANCE OF
ETHIOPIAN INSURANCE COMPANIES**

**A RESEARCH PAPER SUBMITTED TO WOLKITE UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS DEPARTMENT OF
ACCOUNTING AND FINANCE IN PARTIAL FULFILLMENT OF THE
REQUIREMENT OF BACHELOR (BA) DEGREE IN ACCOUNTING AND
FINANCE**



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WOLKITE, ETHIOPA

August, 2021

ACKNOWLEDGEMENT

First of all, the researcher likes to be humbly grateful to his lord and shepherd Jesus and his mother virgin marry, who protected the researcher from the beginning up to the end of this research and make all things happen. Heartfelt thanks to the researcher's advisor Mitiku Melese who has a great contribution in guiding the researcher on this proposal. And finally to all peoples whose names have not been mentioned and contributed to this proposal, because this proposal will not be possible without all of your contributions.

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CHAPTER ONE

1.INTRODUCTION

1.1Background of the study

Financial institution especially insurance companies plays important role in financing and insuring economic activity and contribute to the stability of the financial system and the stability of the economy of concerned country. Insurance is the bone in managing the risk of the country (YaredWorku 2018). Risk is recognized that for some organizations, management is applied to issues predetermined to result in adverse or unwanted consequence. Therefore, most widely used method of dealing with risks is through insurance. The risk is transferred to an insurer. Insurance is a technique, which provides for collection of small amounts of premium from many individual and firms out of which losses suffered by few are reimbursed. In this method the individual insured, which is exposed to a large but uncertain loss, is able to buy protection through the payment of a small but definite cost of called premium. (TsegeredaZerou 2016).

Insurance can gives people in a society some degree of security. It allowed them to get peace of mind and relives of a great deal of financial hardship. From this point of view (Rajda 214) explain that in insurance is a polling of fortuitous loss by transfer of such risks to the insurers from such loss to provide other pecuniary benefits on their occurrence or to render services connected with the risks (Rejda 2014).

Performance of insurance companies has gained the momentum from the last couple of years, because insurance sector is not only an avenue for money saving, but also serves as a vehicle to channel funds in an appropriate way from surplus economic sectors to deficit sectors so as to support the investment activities in the economy. The financial performance measures the financial soundness and health of the organization in monetary terms and thus, can be used to compare the performance of different corporations within any particular industry or between the industries. The financial performance of the insurance companies plays a pivotal role in the growth of the industry as a whole, which ultimately contributes to the success of an economy (SeblewengelAimro, 2018).

According to (BehailuKebede 2016), profitability is one of the most important objectives of financial management since one goal of financial management is to maximize the owners“

wealth, and profitability is very important determinant of performance. A business that is not profitable cannot survive. Conversely, a business that is highly profitable has the ability to reward its owners with a large return on their investment.

Hence, the ultimate goal of a business entity is to earn profit in order to make sure the sustainability of the business in prevailing market conditions (MengistuTegegn, 2020).

The performance of any business firm not only plays the role to increase the market value of that specific firm but also leads towards the growth of the whole sector which ultimately leads towards the overall prosperity of the economy. Assessing the determinants of performance of Insurers has gained the importance in the corporate finance literature because as intermediaries, these companies are not only providing the mechanism of risk transfer, but also helps to channelize the funds in an appropriate way to support the business activities in the economy. However, it has received little attention particularly in developing economies (BehailuKebede 2016).

The important role that financial institutions such as insurance companies remain in financing and insuring economic activity and contribute to the stability of the financial system in particular and the stability of the economy of concerned country in general is part of immune and repair system of the economy. Therefore it requires empirical investigation so as to sort out what are the important factors affecting profitability of insurance companies and this are help concerned bodies to focus on the relevant factors. Hence, the efficient performance of the institutions has become important and investigations by different researchers focus on what factors determine the performance especially the financial performance of the sector (SeblewengelAimro, 2018).

Therefore, from above expression it can be inferred that, the current business world without financial institutions such as insurance companies is unsustainable because in one way, it is a normal practice that some economic units are in surplus while the others remain in deficit and in the other way risky businesses have not a capacity to retain all types of risk in current extremely uncertain environment. There have been a growing number of studies recently that test formeasures and determinants of firm profitability. Financial industry's profitability has attracted scholarly attention in recent studies due to its importance in performance measurement. However, in the context of the insurance sector particularly in developing countries or emerging markets like Ethiopia it has received little attention. Therefore it requires empirical investigation so as to sort out what are the important factors affecting financial performance of insurance

companies and this are help concerned bodies to focus on the relevant factors. To this end, this study examined factors affecting financial performance of insurance company in Ethiopia.

1.2 Background of the Ethiopian Insurance Industry

The Ethiopian insurance industry does not have a long history of development despite the counter's long history of civilization. Modern forms of insurance service which were introduced in Ethiopia by Europeans, trace their origin as far back as 1905 when the bank of Abyssinia began to transact fire and marine insurance as an agent of a foreign insurance company. The number of insurance companies increased significantly and reached 33 in 1960. At that time insurance business like any business undertaking was classified as trade and was administered by the provisions of the commercial code. This was the only legislation in force in respect of insurance except the maritime code of Ethiopia that was issued to govern the operations of maritime business and the related marine insurance. The law required an insurer to be a domestic company whose share capital (fully subscribed) to be not less than Birr 400,000 for a general insurance business and Birr 600,000 in the case of long-term insurance business and Birr one million to do both long-term & general insurance business. Non-Ethiopian nationals were not barred from participating in insurance business. However, the proclamation defined domestic company as a share company having its head office in Ethiopia and in the case of a company transacting a general insurance business at least 51% and in the case of a company transacting life insurance business, at least 30% of the paid-up capital must be held by Ethiopian national companies.

Four years after the enactment of the proclamation, the military government that came to power in 1974 put an end to all private entrepreneurship. Then all insurance companies operating werenationalized and from January 1, 1975 onwards the government took over the ownership and control of these companies & merged them into a single unit called Ethiopian Insurance Corporation. The insurance sector during the command economic system was characterized by monopoly of the sector by the government, lack of dynamism and innovation, volatile premium growth rates and reliance on a couple of classes of insurance business (motor and marine) for much of gross premium income. The nationalization of private insurance companies, the restrictions imposed on private business ventures, and management of the insurance sector had significant adverse impact on the development and growth of Ethiopian insurance industry Hailu, (2007).However, following the change in the political environment in 1991, the proclamation for

the licensing and supervision of insurance business No. 86/1994 heralded the beginning of a new era. Immediately after the enactment of the proclamation private insurance companies began to flourish. According to the directive of ISB/34/2014, any insurance company required to be a domestic company whose share capital (fully subscribed) to be not less than Ethiopian Birr 60m for a general insurance business and Ethiopian Birr 15m in the case of long term (life) insurance business and Ethiopian Birr 75m to do both long term & general insurance business.

Today the total number of insurance companies, branches and their capital increased significantly. At 2016/17, there are seventeen insurance companies in operation. Ethiopian Insurance Corporation (EIC) is state owned while the rest are private.

1.3 Statement of the problem

Insurance plays a significant role in a country's economic growth and offers financial protection to an individual or firm against monetary suffered from unforeseen circumstances. This is because the world is characterized by risks and uncertainties and insurance has evolved as a way of providing security against the risks and uncertainties (Tsegereda Zerou 2016). In this context, it is crucial to know what drives insurers' profitability. Profitability is propulsive element of any investments in different projects and relative measure of success for a business; it is the efficiency of a company or industry to generate earnings. According to (Seblewengel Aimro, 2018) insurers' profitability is determined first by underwriting performance (losses and expenses, which are affected by product pricing, risk selection, claims management, and marketing and administrative expenses); and second, by investment performance, which is a function of asset allocation and asset management as well as asset leverage.

A study of (Behailu Kebede 2016) examined the determinants of insurers' profitability indicated that size, volume of capital, leverage & loss ratio are significant determinants of profitability. Other studies conducted in the area of insurers' profitability (Mengistu Tegegn, 2020) verified that there is a direct association between profitability of insurance companies and its both internal and external determinants. Even though, all these and other researchers conducted study on this area, the determinants of profitability. Their basic internal factors are like underwriting risk, operational, technical reserve, reinsurance risks and solvency ratio that are potentially accountable for determinant of insurers' profitability. (Behailu Kebede 2016) imply that liquidity ratio had a positive and significant impact on performance of insurance companies. However, Adrian (2014) result showed that liquidity ratio negatively affected the performance of insurance

companies. In contrary, Mirie (2015) investigated that liquidity ratio had no significant effect on performance of insurance companies.

(MengistuTegegn, 2020) confirmed that underwriting risk had not significant effect on performance of insurance companies. Nevertheless, (SeblewengelAimro, 2018) a study indicates underwriting risk had a negative and statistically significant effect on performance of insurance companies. Previous Empirical results in different hemisphere of the world indicate various out comes while using the same variables to examine the effect of factor affecting financial performance of insurance companies. Prior studies conducted on determinant of profitability in Ethiopian insurance companies and studied on determinant performance in Ethiopia insurance companies.

Hence, factors which affect financial performance of insurance companies have not been adequately investigated on financial performance determinants using company specific factors variables. Therefore, this research full fill the above explained gap by providing information about the internal factors that affects financial performance of the insurance companies by examining three variables using three insurance companies operating in our country.

1.4 Research questions

1. What are the effects of liquidity ratio on financial performance of insurance companies in Ethiopia?
2. How is the company size affect financial performance of insurance companies in Ethiopia?
3. How is the effect of underwriting risk on financial performance of insurance companies in Ethiopia?

1.5 Objective of the study

1.5.1 General objective of the study

The general objective of the study was to examine factors that affect financial performance of Ethiopian insurance companies.

1.5.2 Specific objective of the study

1. To examine the effect of liquidity ratio on financial performance of insurance companies in Ethiopia.

2. To examine the effect company size on financial performance of insurance companies in Ethiopia.
3. To examine the effect underwriting risk on financial performance of insurance companies in Ethiopia.

1.6 Significance of the study

The study has ultimate significance to show factors that affect financial performance of Ethiopian insurance companies. Then, this study would help to management of Ethiopian Insurance Companies to be informed, which factors are important factors that affect financial performance of insurance companies in Ethiopia. It also helps to beginners' researchers who are interested to conduct their research in this area. It can also help the researcher to practice in large similar studies that could be performed in other organizational sectors. Furthermore, this study can promote other supplementary studies to be under taken and it was valuable in helping future research.

1.7. Limitation of the study

Everything in this world has its own limitation which restricts the usability of that thing. The same rule applies to this research work. The main limitations of this study are:

- The study is undertaken by individual researcher, therefore all the limitation of the individual researcher exists here also.
- The study is secondary data based, so the limitations of secondary data reveals with this study.

1.8. Scope of the study

The study was limited on factors that affect the performance of Ethiopian insurance companies and made the analysis using secondary source of data. The study used three variables factors that affect the performance of Ethiopian insurance company's i.e. Liquidity ratio, company size, underwriting risk, as the result, these variables explained the topic properly by referring previous empirical works. There are other variables that have been used in literatures as determinant of insurance Financial Performance. But, due to different constraints, the scope of the study had been limited to emphasize only on three variables factors that affect the performance of insurance companies.

1.9. Organization of the study

The paper would be organized in five chapters. Chapter one outlines the introduction of the study while the second chapter review the various literatures. The third chapter was about research design and methodology. Chapters four analyzes the data and present the finding. The fifth chapter includes conclusion and recommendations. Finally attach questionnaires of the study and bibliography.

CHAPTER TWO

2. LITERATURE REVIEW

2.1. Definition and Role of Insurance

Insurance is the pooling of fortuitous losses by transfer of such risks to insures, who agree to indemnify insured for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk. E.Rejda (2008) Insurance premium is the monetary consideration paid by the insured to the insurer for the cover granted by the insurance policy. The Insurer takes on a number of clients (Insured) who pay small premiums that form an aggregate fund called the premium fund (Norman, 2000).

Insurance operates on the principle of pooling risks where the people contribute to a common fund in form of premiums and where the lucky ones who do not suffer loss help the unlucky ones who suffer loss during a defined insurance period. It seems Insurance not only facilitates economic transactions through risk transfer and indemnification but it also promotes financial intermediation Ward and Zurbruegg (2000). More specifically, insurance can have effects such as promote financial stability, mobilize savings, facilitate trade and commerce, enable risk to be managed unique more efficiently, encourage loss mitigation, foster efficient capital allocation and also can be a substitute for and complement government security programs (Skipper, 2001).

Insurance provides economic protection from identified risks occurring or discovered within a specified period. Insurance is a product in that the ultimate cost is often unknown until long after the coverage period, while the revenue premium payments by policyholders are received before or during the coverage period. Substitute for and complement government security programs. Insurance provides economic protection from identified risks occurring or

discovered within a specified period. Insurance is a unique product in that the ultimate cost is often unknown until long after the coverage period, while the revenue premium payments by policyholders are received before or during the coverage period (Skipper, 2001).

Insurance is an important growing part of the financial sector in virtually all the developed and developing countries. A resilient and well regulated insurance industry can significantly contribute to economic growth and efficient resource allocation through transfer of risk and mobilization of savings. In addition, it can enhance financial system efficiency by reducing transaction costs, creating liquidity and facilitating economies of scale in investment.

Insurance business is usually divided into two main classes namely:

a) General insurance business - This is a contract between an insurer and the insured where by the insurer undertakes to indemnify the assured against losses, which may result from the occurrence of specified events within specified periods. General insurance business can be subdivided into: motor, fire, accident, oil and gas, contractors' all risks and engineering risks; marine and credit insurance, bond and surety ship etc.

This is a contract between the assurer and the assured whereby the assurer undertakes to pay benefits to the policy holder on the attainment of a specified event.

b) Life assurance business: comprises individual life business, group life insurance and pension business, health insurance business and annuities.

2.2. Factors affecting insurance companies' performance

2.2.1. Credit risk

It is the risk that a borrower will not perform in accordance with its obligations. Credit risk may arise from either an inability or unwillingness on the part of the borrower to perform in the pre-committed contracted manner. In addition to this credit risk basically means the risks that counterparty cannot meet its liabilities. Even if counterparty does manage to meet its liabilities, the value of a given item may decline if its rating is downgraded. Consequently, the insurance company will be subject to credit risk whenever changes in the economic policy framework entail adverse changes in the creditworthiness of invested assets. Mortgages as well are subject to credit risk, which must be adequately assessed by means of internal ratings. When managing credit risk, insurance

companies must primarily look to avoid concentration risk (e.g. concentration of investments in a particular investment category, low degree of portfolio diversification) and strive to achieve as much diversification in their investments as possible.

As per NBE (2010) risk management guide line credit risk is the risk of financial loss, despite realization of collateral security or property, resulting from the failure of a debtor to honor its obligations to the company. The area of credit risk includes default risks related to an insurer's portfolio of bonds (credit through investment) and other fixed income investments, counter party risk on derivative contracts and the risk of default on loans or insured debts and trade debtors. The major risk that arises from a weakening of the credit portfolio is the impairment of capital or liquidity. For most companies, extending credit through investment and lending activities comprises an important portion of their business. Therefore, the quality of an institution's credit portfolio contributes to the risks borne by policyholders (liquidity) and shareholders (capital impairment).

Typical areas of concentration for credit risk

These are the following points that NBE (2010) risk management guide line has located the areas which focus on credit risk.

Investing/lending activities: Where credit is extended, almost always with collateral (e.g. Bond). Of course when making investments in any bonds, debentures or other evidences of indebtedness, the insurer is taking on a credit risk. Clearly, such investment area is a major source of credit risk for insurers.

Trade debtors/Financing of premiums: There is the credit risk arising from the fact that policyholders may not remit premiums on a timely basis, whether or not there is a premium financing program in place and whether or not the business is written through an intermediary.

Reinsurance: Insurers, especially general insurers, often rely heavily on their reinsurers for claim reimbursement. The credit risk arising in the reinsurance area can be very significant, making it critically important for insurers to establish formal policies with regard to the selection of reinsurers.

2.2.2. Credit Risk Management

Accordingly NBE (2010) referred that managing credit risk is a fundamental component in the safe and sound management of companies. Sound credit risk management involves establishing credit:

- ✓ Identifying existing or potential credit risks to which the company is exposed, on or off balance sheet, in conducting its investment and lending activities and developing and implementing sound and prudent credit policies to effectively manage and control these risks;
- ✓ Developing and implementing effective credit granting, documentation and collection procedures;
- ✓ Developing and implementing procedures to effectively monitor and control the nature, characteristics, and quality of the credit portfolio; and developing processes for managing problem accounts.

2.2.3. Liquidity ratio

Liquidity refers to the degree to which debt obligations coming due in the next 12 month can be paid from cash or assets that will be turned into cash. It is usually measured by the current assets to current liabilities (current ratio). It shows the ability to convert an asset to cash quickly and reflects the ability of the firm to manage working capital when kept abnormal levels. A firm can use liquid assets to finance its activities and investments when external finance is not available or it is too costly. On the other hand, higher liquidity would allow a firm to deal with unexpected contingencies and to cope with its obligations during periods of low earnings Liargovas, and Skandalis, (2008) Maintaining high liquidity can reduce management's discipline as regards both underwriting and investment operations.

Moreover, according to the theory of agency costs, high liquidity of assets could increase agency costs for owners because managers might take advantage of the benefits of liquid assets. In addition, liquid assets imply high reinvestment risk since the proceeds from liquid assets would have to be reinvested after a relatively short period of time. Undoubtedly, reinvestment risk would put a strain on the performance of a company. In this case, it is, therefore, likely that

insurance companies with less liquid assets outperform those with more liquid assets. Nevertheless, agency costs and reinvestment risk can be effectively minimized if proper actions are taken (Adams and Buckle, 2000).

2.3. Reinsurance dependence

According to Munich (2010) reinsurance is a transaction whereby one insurance company (the “reinsurer”) agrees to indemnify another insurance company (the “reinsured, “cedent” or “primary” company) against all or part of the loss that the latter sustains under a policy or policies that it has issued. For this service, the ceding company pays the reinsurer a premium. In addition, the purpose of reinsurance is the same as that of insurance: to spread risk. Reinsurance helps protect insurers against unforeseen or extraordinary losses by allowing them to spread their risks. For example, a catastrophic fire at an industrial enterprise could financially devastate its insurer. With reinsurance, no single insurer finds itself saddled with a financial burden beyond its ability to pay.

Insurers with higher reinsurance dependence tend to have a lower level of firm profitability. It is possible that an insurer that cedes more business to reinsurer and keeps lower retention more or less operates like a reinsurance broker who only transfers risk without underwriting risk and is likely to report less profit for a relatively high percentage of the premium received is ceded to reinsurers (Lee, 2012). Cummins, et al. (2008) analyzed that the costs and the benefits of reinsurance for a sample of US property-liability insurers. The results show that reinsurance purchase increases significantly the insurer’s costs but reduces significantly the volatility of the loss ratio. With purchasing reinsurance, insurers accept to pay higher costs of insurance production to reduce their underwriting risk.

As per Suheyli (2015) illustration, insurance companies usually take out reinsurance cover to stabilize earnings, increase underwriting capacity and provide protection against catastrophic losses. Nevertheless, there is a cost for reinsurance. As a result, determining an appropriate ceding level is important for insurance companies, and they have to try to strike a balance between decreasing insolvency risk and reducing potential profitability. Although it increases operational stability, increasing reinsurance dependence, i.e. lowering the retention level, reduces the potential profitability. Purchasing reinsurance reduces insurers’ insolvency risk by stabilizing

loss experience, increasing capacity, limiting liability on specific risks, and/or protecting against catastrophes. However, transferring risk to reinsurers is expensive. The cost of reinsurance for an insurer can be much larger than the actuarial price of the risk transferred.

Insurers, especially general insurers, often rely heavily on their reinsurers for claim reimbursement. Among others, the credit risk arising in the reinsurance area can be very significant, making it critically important for insurers to establish formal policies with regard to the selection of reinsurers. The use of reinsurance in capital management, the timing of payments of reinsurance premiums and claims in liquidity management the relationship between the reinsurance program and pricing and underwriting management, are among the factor to be considered in the reinsurance risk management process (NBE, 2010).

2.3.1. Functions of Reinsurance

As stated by Munich (2010) the most common reasons for purchasing reinsurance include:

Capacity Relief- allows the reinsured to write larger amounts of insurance.

Catastrophe Protection- protects the reinsured against a large single, catastrophic loss or multiple large losses.

Stabilization- helps smooth the reinsured overall operating results from year to year.

Surplus Relief- eases the strain on the reinsured surplus during rapid premium growth.

Market Withdrawal- provides a means for the reinsured to withdraw from a line of business or geographic area or production source.

Market Entrance- helps the reinsured spread the risk on new lines of business until premium volume reaches a certain point of maturity; can add confidence when in unfamiliar coverage areas.

Expertise/Experience- provides the reinsured with a source of underwriting information when developing a new product and/or entering a new line of insurance or a new market.

Insurance companies purchase reinsurance to provide financial security, to increase their own capacity to underwrite insurance business, and to stabilize their underwriting results. Adherence to sound reinsurance risk management policies and procedures go hand in hand with financial soundness. Failure to adhere to such policies and procedures may lead to an

increased risk level assessment. The major risks that arise from weakness in a company's reinsurance risk management program are the impairment of capital or liquidity (NBE, 2010).

2.3.2. Reinsurance risk management

As stated by NBE (2010) each company should develop a comprehensive reinsurance program to address the objectives of its reinsurance risk management policy. In developing the reinsurance program, the company should identify its tolerance to risks in its underwriting book and consider which reinsurance arrangements (e.g., the use of quota share reinsurance, surplus treaties, excess of loss coverage or stop loss policies) are most appropriate to limiting risks above its tolerance level.

The reinsurance program should be documented and approved by Insurance Supervision Directorate (ISD). Although the particulars of reinsurance risk management will differ among companies depending upon the nature and the complexity of their underwriting books, a comprehensive reinsurance risk management program requires:

- Identifying when reinsurance is required to limit a company's risk;
- Selecting appropriate reinsurance counterparties and intermediaries to facilitate risk transfer;
- Selecting appropriate reinsurance agreements;
- Developing, documenting and recording effective processes for reinsurance activities;
- Developing and implementing comprehensive procedures to effectively monitor and control the reinsurance activities (NBE, 2010).

2.5. Underwriting risk

Underwriting risk is the risk that the premiums collected will not be sufficient to cover the cost of coverage. Insurance prices are established based on estimates of expected claim costs and the costs to issue and administer the policy. The estimates and assumptions used to develop policy pricing may prove to ultimately be inaccurate. This may be due to poor assumptions, changing legal environments, increased longevity, higher than expected weather catastrophes (Ernst, 2010).

Underwriting risk emphasizes the efficiency of the insurers underwriting activity and is measured through the loss ratio, which is computed as a ratio of gross claims to gross written premium. Underwriting risk reflects the adequacy or otherwise of insurers' underwriting performance.

As mentioned by Arif, (2015) underwriting guidelines are pivotal to an insurers' financial performance. The underwriting risk depends on the risk appetite of the life insurers. For instance, organizations that engage in risky activities are likely to have more volatile cash flows than entities whose management is more averse to risk taking. Therefore, a negative connection between the underwriting risk and the insurers' financial performance is expected, since taking an excessive underwriting risk can affect the company's stability through higher expenses.

Underwriting is the function of evaluating the subject of insurance, whether a person, property, profession, business, or other entity, and determining whether to insure it. Underwriting is the foundation of the insurance transaction process. Underwriting is the process of determining whether an insured is an acceptable risk, and if so, at what rate the insured will be accepted. Insurers cannot accept every applicant. An insurer has a responsibility to its current policyholders to make sure that it will be able to meet all the contractual obligations of its existing policies. If the insurance company issues policies on applicants that represent risks that are uninsurable or risks that require premiums higher than the insurer may charge can cover, the insurer's ability to meet its contractual obligations is jeopardized (Temecula, 2001). On the other hand, a for-profit insurer wants to make money and to increase its number of policyholders. No insurer wants to reject applicants unnecessarily. All these factors must be taken into consideration in the underwriting process. Insurers are not always the "victim" in the underwriting process, sometimes they are the problem. Years ago, for example, insurers sometimes approved policies on a post claims underwriting basis (now illegal). The company accepted applicants with little or no real underwriting, but when individuals attempted to file claims, the company engaged in vigorous investigations of the individual's application in an attempt to demonstrate that he or she did not adequately disclose a certain condition. The company would then cancel the policy instead of paying the claim alleging misrepresentation of a condition on the part of the applicant (Temecula, 2001). Underwriting involves the risk of determining the premium (pricing risk) and occurrence risk. Pricing risk is present before the insured event occurs because there is a risk that the costs and claims will be higher than the premiums received.

It may be called the risk of insufficiency/inadequacy of insurance premiums, since it implies that the rate of loss occurrence has changed contrary to predictions at the time of determining the premiums. Therefore, it is also called premium risk since it is likely that the insurer will not collect revenue from premiums that would be sufficient to cover the claims. Property and liability pricing risk also includes the catastrophes risks that are arising from extraordinary events that are not sufficiently covered by the premium or reserve risk. Life insurance pricing risk includes biometric risk (including mortality, longevity, morbidity and disability) and the risk of withdrawal Jakovcevic, et al. (2014).

In addition to the above, Jakovcevic, et al. (2014) mentioned that the business activity of the insurance company exposes to underwriting risks. The risk of any insurance contract is that an insured event and an unexpected amount of consequential losses will occur. By the nature of insurance contracts, underwriting risk is random and therefore unpredictable and refers to the uncertainty of insurance. The insurance contract is a legal transaction in which the policyholder agrees to pay the insurance premium and the insurer assumes the obligation to pay compensation in the case of occurrence of the insured event.

2.5.1 Underwriting risk management

The following points are underwriting risk management practices that are sated by NBE (2010) risk management guideline. Managing underwriting risk is a fundamental component in the management of safety and soundness of an insurer. Sound underwriting and risk management involves understanding the risk and prudently managing the company's risk/reward relationship. Although the particulars of underwriting will differ among companies depending upon the nature and the complexity of their products and the manner in which they are marketed and serviced, a comprehensive underwriting and risk management program is required as a basic component and processes designed to quantify the risk exposure at various points in time over the insurance cycle, such as when:

- ✓ The Company accepts insurance risks;
- ✓ Material changes occur in insurance exposures for which underwriting, or limitation of risk is required;
- ✓ Claims arise requiring approval;
- ✓ Ongoing claim assessment is required; and
- ✓ The company's capacity to accept insurance risk changes in a material manner.

Companies must develop policies to effectively manage and control liability at these critical points in the insurance cycle. Good risk management with regard to underwriting management also requires:

- Developing, documenting and implementing effective processes for underwriting, for management of product options, and for adjudication of claims; and
- Developing and implementing comprehensive procedures to effectively monitor and control the nature and characteristics of the insurance risks assumed, or claims approved.

2.6. Company size

The company size can be expressed by many variables such as number of employees, number of branches, or total assets. Most researchers of the field use total assets to express the size of the company. The size of the company is considered as an influential factor because it shows that larger companies are better positioned in the market, operate with economies of scale, and thus enjoy higher benefits Schumacher, (2015).

2.7. Deposit Interest rate

Interest rate risk is the risk to an institutions net interest margin. The net interest margin is the difference between the amount of interest earned on assets (i.e., interest income from lending activity) and the amount of interest paid on liabilities (i.e., interest expenses paid on deposits and borrowings). An interest rate is the cost of borrowing money. Since insurance companies make their promises or commitments to the insured at the time of the sale of policies to the latter, they are not free to adjust the rates fixed or agreed in the sale subsequently depending on circumstance. This feature of insurance exposes them directly to the risks associated with changes in interest rates. Insurance companies invest much of the collected premiums, so the income generated through investing activities is highly dependent on interest rates. Declining interest rates usually equate to slower investment income growth impacting on the insurance.

2.8. Financial Performance of insurance companies

Measuring the performance of insurance companies has gained the momentum from the last couple of years, because insurance sector is not only an avenue for money saving, but also serves as a vehicle to channel funds in an appropriate way from surplus economic sectors to deficit sectors so as to support the investment activities in the economy. Technically, performance is defined as a subjective measure which determines how well the organizations use their available resources to generate more revenues. Performance measures the financial soundness and health of the organization in monetary terms and thus, can be used to compare the performance of different corporations within any particular industry or between the industries.

The performance of the insurance companies plays a pivotal role in the growth of the industry as a whole, which ultimately contributes to the success of an economy. The insurance companies endanger their

performance by assuming different types of risks. In order to have full and fuller understanding of the impact of financial risk on the profitability of insurance companies the present study will take into consideration various ratios like solvency, liquidity, profitability Arif (2015).

Yuvaraj (2013) as cited in suggested that although there are different ways to measure profitability it is better to use ROA. In addition to this, performance of insurance companies in financial terms is normally expressed in net premium earned, profitability from underwriting activities, annual turnover, return on investment and return on equity. These measures could be classified as profit performance measures and investment performance measures. However, most researchers in the field of insurance and their profitability stated that the key indicator of a firm's performance is ROA defined as before tax profit divided by total assets.

CHAPTER THREE

3. RESEARCH METHODOLOGY

This chapter covers the methodology used in this research paper. The selection of methodology was based on the stated research problem and research questions. The choice of methodology approaches was explained and justified in order to answer the research questions posed.

3.1. Research design

This study was used both a quantitative descriptive and qualitative research design. A descriptive research is a research for which to produce an accurate representation of persons, events or situations (Bayou Tsegaw 2017). In this regard several researchers had employed descriptive technique and this study was also employing this research technique. The research questions and objective stated are applicable for this type of study.

3.2. Methods of data collection

Primary data can be collected through interview, surveys, observation and questioners. Secondary data can be collected through previous research, publication, and journals. So, this study was used primary data collection method through questionnaire.

3.3. The target population and sampling methods

The total populations of insurance companies are seventeen but for the study purpose the researcher used sample of three insurance companies. The samples of insurance companies are Ethiopian insurance corporation, Awash insurance S.C and Nyala insurance S.C. Hence, the researcher employed purposive sampling method to draw the sample from the population and meet the study objective.

3.4. Data analyzing methods

According to research scholars, the appropriate method of data analysis for the study was based on the collecting data. Categorization or separations of data set is also a form of analysis to make the data easily manageable. Organizing, editing, ordering and manipulating the data providing information that is used to answering the research problem defined (GebeyehuTadesse, 2013). The study has attempted to describe consistency in the analysis of data. The type of data collection method is a great value to interpret the data properly. Data analysis has two prominent methods qualitative and quantitative each method are their own technique. Data analysis is the process of systematically Applying statically or logical technique to describe and illustrate,

condense and recap and evaluate data. The researcher uses Quantitative data analysis taken in a form creatively produced Statistical analysis was conducted based on Ratio, Percentages and Tables. In case of descriptive statistics, a quantitative method of data analysis was adopted.

CHAPTER FOURE

4.DATA PRESENTATION AND ANALYSIS

INTRODUCTION

As it was explained in methodology section, the information gathered from primary source through questionnaire are analyzed and interpreted. Questionnaires are distributed to the employees of three selected Insurance Corporation in Ethiopia. Among 30 questionnaires which are distributed to employees of the non-life insurance, 13.33% were not responded because of the busyness of the employees of the organizations and the remaining 26 or 87.67% were responded and used for analyzing and interpreted. The analysis and Justification of the finding from the information were presented by summarizing the question and respective response for a topic on an issue. The collected data were interpreted by using percentages and tables by using descriptive analysis method.

4.1 Background information of the respondents

Table 4.1 back ground of respondents

Question No, 1, 2, 3 \$ 4	Frequency	Percentage
Age		
20-25	6	23%
26-30	8	30%
31-40	10	39%
Above 40	2	8%
Total	26	100%
Gender		
Male	14	54%
Female	12	46%
Total	26	100%
Educational Background		
Master's Degree	6	23%
Bachelor Degree	20	77%
Diploma	0	0%

Other	0	0%
TOTAL	26	100%
Work Experience		
1- 5 Year	15	58%
6-10 Year	6	23%
11-20 Year	5	19%
Total	26	100%

Source: primary data from Questionnaire, 2021

As it can be seen from the table 4.1 the majority of the respondents 39% were found in the age range of 31-40 followed by 26-30 and 20-25 which consists 30% and 23% of the respondents respectively. The remaining groups with the age range above 40 consist of 8%. The result indicates that majority of the management and employees of the organizations are in the productive age, which can give the organization an opportunity to enhance its service by utilizing these energetic staff. In addition to this the above table shows us that 54% of the respondents are male and 46% are female.

The educational background distributions of the respondent shows that all of the respondents have educational qualification of first degree and above, which constitute 77% of the respondents have first degree and 23% of the respondents have master's degree. This result reveals that all of the respondents were well educated and this can help the accuracy of the response since they can understand the intention of the survey and respond accordingly.

The distribution of service year of the respondent are concerned 58% of employees are below 5 year of service, 23% of employees are 6-10 year and 19% of employees are above 11-20 year. The result indicates that the majority of the employees and management of the organization are well experienced; this implies that the respondents can provide quality information for the study.

4.2 Results and Discussions

4.2.1 Factors affecting the financial performance of Insurance companies

Table 4.2 Factors affecting the financial performance of Insurance companies in Ethiopia

Question No, 5\$6	Frequency	Percentage
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Yes	22	87%
No	4	13%
Total	26	100%

Source: primary data from Questionnaire, 2021

As it can be seen from the table above 4.2 87% of respondent was responded yes and 13% was responded no. From this we can conclude that there are factors that can affect financial performance of insurance companies in Ethiopia. The respondents list out that the following are factors that can affect the financial performance of insurance companies in Ethiopia.

- ✓ Credit risk (credit risk has a negative effect on financial performance of insurance companies in Ethiopia)
- ✓ Liquidity ratio (liquidity ratio has a negative effect on financial performance of insurance companies in Ethiopia)
- ✓ Reinsurance dependence (Reinsurance dependence has a negative effect on financial; performance of insurance companies in Ethiopia)
- ✓ Company size (Company size has a positive effect on financial performance of insurance companies in Ethiopia)
- ✓ Underwriting risk (Underwriting risk has a negative effect on financial performance of insurance companies in Ethiopia)
- ✓ Deposit interest rate (Deposit interest rate has positive effect on financial performance of insurance campaniles in Ethiopia)

4.2.2 Company size and its effect on financial performance of insurance companies

Table 4.3 the effect of Company size on financial performance of insurance companies.

Question No, 7\$8	Frequency	Percentage
Yes	21	81%
No	5	19%
Total	26	100%

Source: primary data from Questionnaire, 2021

As it can be seen from the table above 4.3 81% of respondent was responded yes and 19% was responded no. From this we can conclude that company size has a positive effect on financial

performance of insurance companies in Ethiopia. Majority of the respondents confirm that company size has a great contribution to the improvement of financial performance of insurance companies. The respondent's reason out that company's size has a positive effect on the improvement financial performance insurance companies because of the following reasons.

- ✓ Large insurance companies normally have greater capacity for dealing with adverse market fluctuations than small insurance companies.
- ✓ Large insurance companies usually can relatively easily recruit able employees with professional knowledge compared with small insurance companies.
- ✓ Large insurance companies have economies of scale in terms of the labor cost, which is the most significant production factor for delivering insurance services.

A positive linkage between company size and its profitability is expected, since larger firms have more resources, a better risk diversification, complex information systems and a better expenses management. So company size has positive effect on financial performance of insurance companies.

4.2.3 Underwriting risk and financial performance of insurance companies

Table 4.4 the effect of underwriting risk on financial performance of insurance companies

Question No, 9\$10	Frequency	Percentage
Yes	21	81%
No	5	19%
Total	26	100%

Source: primary data from Questionnaire, 2021

As it can be seen from the table above 4.4 81% of respondent was responded yes and 19% was responded no. From this we can conclude that underwriting risk has a negative effect on financial performance of insurance companies. Majority of the respondents confirm that underwriting risk has a negative effect on financial performance of insurance companies. The respondent's reason out that underwriting risk has a negative effect on improvement of financial performance insurance companies because of the following reasons.

- ✓ Underwriting risk measured through the losses (claims) incurred divided by premium earned and indicates that underwriting risk emphasizes the efficiency of the insurers

underwriting activity and also reflects the adequacy or otherwise of insurers' underwriting performance.

- ✓ Organizations that engage in risky activities are likely to have more volatile cash flows than entities whose management is more averse to risk taking. Therefore, a negative connection between the underwriting risk and the insurer financial performance is expected, since taking an excessive underwriting risk can affect the company stability through higher expenses.
- ✓ Underwriting risk may be primarily generated from the inadequacy of the premiums in the form of underestimation of the premiums or insufficient diversification of insurance portfolio. Underwriting risk which is present at the time the policy is issued and before the insured event occurs. That is a risk that the costs and claims will be higher than the premiums received. When calculating the sufficient premium it may happen that the calculated premium is insufficient for the underwritten risks.
- ✓ Underwriting risk that the insurer will not raise sufficient revenues from premiums to cover claims or sum insured that represents a significant risk for the insurance company. If the contracted premium is undervalued, it means that at the time of claims liquidation paid premiums will be lower, and the insurer will face a loss on a particular insured event.
- ✓ The other extreme is overrated premium, and also the risk whereupon the insured pays a higher price than the actual value. In this case, the insurance company is uncompetitive in the market due to excessive premiums thereby reducing portfolio and the number of insured
- ✓ Underwriting risk emphasizes the efficiency of the insurer underwriting activity and the study used the same measurement. As the result, underwriting risk has a negative influence on the insurer financial performance, since taking an excessive underwriting risk can affect the company stability through higher expenses.

4.2.4 Credit risk and financial performance of insurance companies

Table 4.5 the effect of credit risk on financial performance of insurance companies

Question No, 11\$12	Frequency	Percentage
Yes	20	77%

No	6	23%
Total	26	100%

Source: primary data from Questionnaire, 2021

As it can be seen from the table above 4.5 77% of respondent was responded yes and 23% was responded no. From this we can conclude that the credit risk has a negative effect on financial performance of insurance companies. Majority of the respondents confirm that credit risk has great effect on financial performance of insurance companies. The respondent reason out that credit risk has a negative effect on financial performance of insurance companies this are the following.

- ✓ Credit risk measured by using the ratio of premium debtors plus due from reinsurer and other receivable to net asset of insurance company (premium debtors + due from reinsurer + other receivable / net asset). Currently, Ethiopian insurance companies have employed this ratio to grading their credit risk NBE (2010). In accordance with NBE (2010), area of credit risk includes counter party risk on derivative contracts and the risk of default on insured debts and trade debtors.
- ✓ Credit risk basically means the risks that counterparty cannot meet its liabilities. It is the risk that a borrower will not perform in accordance with its obligations. Credit risk may arise from either an inability or unwillingness on the part of the borrower to perform in the pre-committed contracted manner.
- ✓ Respondent indicated that credit risk has negative effect on performance of insurance companies. Thus, the study concludes that credit risk negatively affect the financial performance of insurance companies.

4.2.5 Liquidity Risk and financial performance of insurance companies

Table 4.6 the effect of liquidity risk on financial performance of insurance companies

Question No, 13\$14	Frequency	Percentage
Yes	22	87%
No	4	13%
Total	26	100%

Source: primary data from Questionnaire, 2021

As it can be seen from the table above 4.6 87% of respondent was responded yes and 13% was responded no. From this we can conclude that liquidity risk have a negative effect on financial performance of insurance companies in Ethiopia. Majority of the respondents confirm that liquidity risk has great effect on the financial performance of insurance companies. The respondent's reason out that liquidity risk has a negative effect on the financial perforce of insurance companies in Ethiopia the following reasons.

- ✓ Liquidity risk arises if the maturities of the two sides of balance sheet are different. This difference could be due to excessive cash or lack of cash that is needed to be financed. Liquidity measured through current asset over current liabilities that refer to the degree to which debt obligations coming due in the next 12 months can be paid from cash or assets that will be turned into cash.
- ✓ Liquidity ratio has negatively effect on financial performance of insurance companies. Hence, the study liquidity ratio has negative and statistically significant effect on financial performance of insurance companies. Liquidity ratio has negative and statistically significant effect on Ethiopia insurance companies' financial performance

4.2.6 Deposit interest rate and financial performance of insurance

Table 3.7 the effect of deposit interest rate on the financial performance of insurance companies

Question No, 15 & 16	Frequency	Percentage
YES	20	77%
NO	6	23%
Total	26	100%

Source: primary data from Questionnaire, 2021

As it can be seen from the table above 4.7 77% of respondent was responded yes and 23% was responded no. From this we can conclude that deposit interest has a positive effect on financial performance of insurance companies in Ethiopia. Majority of the respondents confirm that deposit interest rat has great effect on the financial performance of insurance companies. The respondent's reason out that deposit interest rate has a positive effect on the financial perforce of insurance companies in Ethiopia the following reasons.

- ✓ The continuing decline in market interest rates tends to make it more difficult for insurance companies to provide high interest rates for their customers or the insured and- as a result-to maintain hence high levels of profitability.
- ✓ The change in deposit interest rate has a positive effect on financial performance of insurance companies. The results suggest that the effects of changes in interest rates on insurance company profitability depend on how profits are measured, that it differs depending on the profit indicator that is employed. Deposit interest rate has positive and statistically significant effect on Ethiopia insurance companies' financial performance.

4.2.7 Reinsurance Dependency interest rate and financial performance of insurance

Table 3.8 the effect of reinsurance dependency on financial performance of insurance companies in Ethiopia

Question No, 17 & 18	Frequency	Percentage
YES	22	87%
NO	4	13%
Total	26	100%

Source: primary data from Questionnaire, 2021

As it can be seen from the table above 4.8 87% of respondent was responded yes and 13% was responded no. From this we can conclude that reinsurance dependence has a positive effect on financial performance of insurance companies in Ethiopia. Majority of the respondents confirm that reinsurance dependency has great effect on the financial performance of insurance companies. The respondent's reason out that reinsurance dependency has a positive effect on the financial perforce of insurance companies in Ethiopia the following.

- ✓ Reinsurance improves the stability of the insurance company through risk dispersion, achievement of solvency requirements, risk profile equilibration and growth of the underwriting capacity, it involves a certain cost'
- ✓ Insurance companies purchase reinsurance to provide financial security, to increase their own capacity to underwrite insurance business, and to stabilize their underwriting results. Adherence to sound reinsurance risk management policies and procedures go hand in hand with financial soundness.

- ✓ Failure to adhere to such policies and procedures may lead to an increased risk level assessment. The major risks that arise from weakness in a company's reinsurance risk management program are the impairment of capital or liquidity.
- ✓ Reinsurance has negative and significant association with performance of insurance companies. In addition, due to their limited capacity and the volatile nature of their business, most general insurers rely heavily on reinsurance, in order to avoid catastrophic losses and reduce the net drain on surplus, by passing on a portion of any risk too large to handle. Nevertheless, it should be noted that there is a cost for reinsurance. Hence, reinsurance dependency increases cost for insurance companies" which decrease the performance of insurance companies. Thus; the researcher concludes that reinsurance dependence as negative and statistically significant effect on performance.

CHAPTER FIVE

5 CONCLUSION AND RECOMMENDATION

5.1 Conclusions

The study specifically examines factors affecting financial performance of insurance companies in Ethiopia based on the following conclusions.

- ✓ The result indicates that credit risk has a negative effect on Ethiopian insurance companies on financial performance which implies the increase in credit risk inevitably lead to a decline in the financial performance of the insurance companies due to the likelihood of debtors failing to honor their obligation to the insurance company.
- ✓ Liquidity ratio has also negative and significant effect on financial Performance of Ethiopian insurance companies. This implies that an increase in liquidity, definitely lead to a decrease in financial performance of Ethiopian insurance companies. It refers that holding of excess cash and failed to invest on the available investment lead to the consequence of losing an opportunity of making additional revenue.
- ✓ Reinsurance dependency has positive effect on Ethiopian insurance company's financial performance. This implies that an increase in reinsurance dependency, certainly not lead to decrease or increase significantly in financial performance of Ethiopian insurance companies. Even though, reinsurers buffer insurance companies against huge losses, most of the significant claims have been covered by Ethiopian insurance companies.
- ✓ Company size has positive and significant effect on financial Performance of Ethiopian insurance companies. This implies that an increase in company size, definitely lead to increase in financial performance of Ethiopian insurance companies. It refers that large corporate size enables to effectively diversify their assumed risks and respond more quickly to changes in market conditions.
- ✓ Underwriting risk has negative effect on Ethiopian insurance companies' financial performance. This implies that an increase in underwriting risk, certainly lead to a decrease in financial performance of Ethiopian insurance companies. This entails that while the costs and claims would be higher than the premiums received, the insurer could not raise sufficient revenues from premiums to cover claims or sum insured.

- ✓ Deposit interest rate has positive effect on financial Performance of Ethiopian insurance companies. This implies that an increase in deposit interest rate, definitely lead to increase in financial performance of Ethiopian insurance companies. It refers that insurance companies invest on bank deposit much of the collected premiums, so the income generated through investing activities is highly dependent on interest rates.

In general, credit risk, liquidity ratio and underwriting risks how negative and significant association with financial performance of Ethiopian insurance companies, whereas company size and deposit interest rate have positive and significant effect on financial performance. However, reinsurance dependency has no significant effect on financial performance of Ethiopian insurance companies.

5.2 Recommendation

The findings of the study showed that credit risk, liquidity ratio, underwriting risk, company size and deposit interest rate are significant drivers of financial performance of insurance companies in Ethiopia, whereas reinsurance dependency are insignificant determinant of financial performance for Ethiopian insurance companies during the study period. Hence, based on the findings which are obtained from regression, the researcher has drawn the following recommendations.

- ✓ The analysis indicated that credit risk had negative and significant effect on Ethiopian insurance company's financial performance. Thus, Ethiopian insurance companies should manage their receivable amount properly through providing payment arrangement for their debtors which is suitable to pay their debt. By categorizing each debtor outstanding receivable balance with their period, Ethiopian insurance companies can offer different mode of repayment for debtors to pay their obligation.
- ✓ The finding explained that liquidity ratio had negative and significant effect on Ethiopian insurance company's financial performance. Hence, Ethiopian insurance companies should consider investing their idle of cash on various sectors by diversifying their investment portfolio according to NBE insurance company's investment regulation. Thus, Ethiopian insurance companies should employ this directive properly through develop and implement suitable investment portfolio management which can improve their return.
- ✓ The study revealed that underwriting risk had negative and significant effect on Ethiopian insurance company's financial performance. For this reason, Ethiopian insurance companies should consider to minimize their costs and claims through proper estimation pricing and valuation technique taking in to account risk of specific sector and catastrophic event.
- ✓ The study examined that company size has positive and significant effect with financial Performance of Ethiopian insurance companies. For this reason, Ethiopian insurance companies should maximize their total asset by investing on fixed asset and current asset.
- ✓ The study examined that deposit interest rate has positive and significant effect with financial Performance of Ethiopian insurance companies. For this reason, Ethiopian

insurance companies should invest their collected premiums on bank deposit as per NBE directive indicated about short term invest on saving and time deposit account.

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Appendix
Wolkite University University

College of Business and Economics

Department of Accounting and Finance

This is questionnaire designed to meet the objective of research project entitled “Factors affecting the financial performance of Ethiopian Insurance companies” for partial fulfillment of BA degree in accounting and finance. Your sincere and honest response is highly appreciated as it will have a great importance to the study and the industry as well.

Dear respondent: I would like to assure that the information you give will be kept confidential and hence try to express your ideas frankly as much as possible.

Thank you very much for your cooperation

Direction: - for questions with given alternative choose one of the given alternative which you think that most appropriate and put a think (√) make in the box provided. For questions with no alternative write a clear answer (either in English or Amharic) on the space provided.

Part one: - respondents profile

1. Age:

20-25 26-30

31-35 36-40

41-50 above 51

2. Gender: Male

Female

3. Your educational level (i.e at the time have for this questionnaire)?

Masters degree

Bachelor degree

Diploma

4. Your work experience in the insurance industry?

1-5 years

6-10 years

11-20 years

Part Two: - Factors affecting the financial performance of Ethiopian Insurance companies

5. Is there any factor that can affect the financial performance of insurance companies in Ethiopia?

Yes No

6. Describe what factors affect the financial performance of insurance companies in Ethiopia. _____

7. Does the company size have effect on financial performance of insurance company in Ethiopia?

Yes No

8. If your answer for question number 7 is yes explain how? _____

9. Does the underwriting risk have effect on financial performance of insurance companies in Ethiopia?

Yes No

10. If your answer for question number 9 is yes explain how? _____

11. Does credit risk have effect on financial performance of insurance companies in Ethiopia?

Yes No

12. If your answer for question number 11 is yes explain how? _____

13. Does liquidity risk have effect on financial performance of insurance companies in Ethiopia?

Yes No

14. If your answer for question number 13 is yes explain how? _____

15. Does deposit interest rate have effect on financial performance of insurance companies in Ethiopia?

Yes No

16. If your answer for question number 15 is yes explain how? _____

17. Does reinsurance dependence have effect on financial performance of insurance companies in Ethiopia?

Yes No

18. If your answer for question number 17 is yes explain how? _____
