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FACTORS INFLUENCING CAPITAL ADEQUACY IN BUSINESS ORGANIZATIONS: A CASE OF KENYA'S INSURANCE INDUSTRY

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FACTORS INFLUENCING CAPITAL ADEQUACY IN BUSINESS ORGANIZATIONS: A CASE OF KENYA'S INSURANCE INDUSTRY

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Abstract

Purpose: The purpose of this study was to determine the factors influencing capital adequacy in business organizations.

Methodology: A case study design was used. The study consisted of 46 insurance companies. The data is quantitative and secondary data collection method was used. The study used descriptive and regression approach in data analysis. Using Statistical Package for Social Sciences (SPSS) regression analysis model was calculated. Data was presented in tables and graphs.

Results: Regression analysis showed that ownership listing status had a beta coefficient of (-16.614) and that it was statistically insignificant (0.329). Regression analysis showed that dividend payout ratio had a beta coefficient of -0.455 and that it was statistically significant (0.000). Regression analysis showed that the profitability ratio had a beta coefficient of 0.485 and that it was statistically significant (0.000). Regression analysis showed that the liquidity ratio had a beta coefficient of 0.226 and that it was statistically significant (0.000). Regression analysis showed that the cost of capital had a beta coefficient of -0.566 and that it was statistically insignificant (0.125).

Unique contribution to theory, practice and policy: The study recommended that insurance Regulatory Authority should put in measures to make the insurance companies adhere to the recent regulations and policies which require the companies to have minimum capital requirements and hence in turn increasing capital adequacy.

Keywords: *Ownership listing, dividend policy, profitability, liquidity, capital adequacy cost of capital.*

1.1 BACKGROUND OF THE STUDY

Kane (2013) defines financial institution's capital as the difference between the value of its asset and liability positions. Onaolopa and Olufemi (2012) defines capital adequacy as a situation where the adjusted capital is sufficient to absorb all losses and fix assets of the financial institution leaving a comfortable surplus for the current operations for expansion. Functionally adequate

capital is regarded as the amount of capital that can discharge the primary function of preventing organization failures by absorbing losses.

Capital adequacy ratio in an insurance sector is the ratio that indicates the ability of financial institution to maintain equity capital sufficient to address its insurance and other risk exposures (Finance & Investment Dictionary, 2010). Lewis (1998) reveals that regulatory perspective of Capital adequacy of Insurance Company was well summarized in June 1996, by Atchinson, the president of the National Association of Insurance Commissioners (NAIC): According to him, the most important duty of insurance commissioners is to help maintain the financial stability of the industry –that is, to guard against insolvencies. Among the greatest weapons against insolvency are the risk-based capital requirements.

To begin with capital must be sufficient to cover unexpected losses while maintaining the company's credit rating. This credit rating is important for an insurance company to maintain soundness, credibility and confidence and to be able to seek opportunity that is profitable (Lewis, 1998). Following the financial crisis of the 2007-2009, stringent regulatory measures such as higher capital requirements have become more prominent as a move towards having stable and competitive financial sector (Financial Service Authority, 2009). McGraw (2003) suggests that all financial institutions subject to banking laws are required to support risk exposure with capital. Every transaction the bank executes on behalf of its clients must be supported with adequate capital.

1.2 Statement of the problem

The penetration of Insurance industry in Kenya is still below 4% despite having about 44 Insurance companies in Kenya. According to Insurance Regulatory Authority- IRA, for every Ksh10 of premium written Ksh1 should be retained as capital. Low premiums will not sufficiently contribute to the capital requirements for most insurance companies (The Insurance Survey, 2012).

However even with this regulatory provision and minimum capital requirements instituted by the government through Finance Bill 2007 and 2012 there is still a problem of capital adequacy in Kenya's insurance industry through the industry reports profits year after year. The questions we would ask are: What then are factors influencing Capital Adequacy Requirement of insurance companies in Kenya? What are the capital adequacy trends in the Insurance Industry in Kenya? What are challenges of capital adequacy requirement in the insurance industry in Kenya? How can capital adequacy in the Kenya Insurance Industry be enhanced?

Some of the studies done on Capital Adequacy in the financial institutions have focused on the banks. Limited empirical evidences exist to explain the factors influencing Capital Adequacy Requirement in the Business Organizations. In Kenya, past studies in the area of Capital Adequacy concentrated on the concept of capital adequacy requirements. Capital requirements for Kenyan life insurance companies (Mung'ara 2009) and the relationship between dividend policy and firm's performance (Murekefu & Ouma, 2010).

It may be noted that none of the study on capital adequacy has been carried out with the passion it deserves. The intension of this study was a passionate approach to research on capital adequacy in the insurance sector from both a theoretical and empirical point of view. In the light of this problem, the study tried to find the solution to Capital Adequacy in the Kenya's Insurance Industry

and maybe helping the regulator come up with a policy what would regulate those factors which affect Capital Adequacy Requirement.

1.3 Objective of the Study

The objective of the study was to investigate the factors influencing capital adequacy in business organizations.

2.0 LITERATURE REVIEW

2.1 Theoretical Review

2.1.1 Firm's Dividend Policy

It may seem obvious that the firm would always want to give as much as possible to its shareholders by paying dividends. It may seem equally obvious that a firm can always invest the money for its shareholders instead of paying it out. The heart of dividend policy question is should the firm payout money to its shareholders or should the firm take the money and invest it for shareholders into the enterprise business. Dividend decisions are important because they determine what funds flows to investors and what funds are retained by the firm for investment (Jordan *et al.*, 2002).

Berk (2011) argues that dividend policy refers to the explicit or implicit decision of the Board of Directors regarding the amount of residual earnings (past or present) that should be distributed to the shareholders of the corporation. He argues that this is considered a financing decision because the profits of the corporation are an important source of finance available to the firm. Pandey (2000) in his contribution on dividend theories, states that dividend policy determines the amount of earning to be distributed to shareholders and the amount to be retained in the firm. Retained earnings are the most significant internal source of financing the growth of the firm. Dividend may be considered desirable from shareholders point of view as they tend to increase their current return. Dividends constitute the use of the firm's funds. Dividend policy is the decision to pay dividends versus retaining funds to reinvest in the firm. Firms will invest capital now, it will grow and can pay higher dividend in the future (Jordan, 2008).

According to Pandey (2000) paying dividend involves outflow of cash. This cash available for payment of dividend is affected by the firm's investment and financing decision. A decision to incur capital expenditure implies that less cash will be available for the payment of dividends. Given the firm's capital expenditure, and that it does not have sufficient internal funds to pay dividends, it can raise funds by issuing new shares. In this case the dividend decision is not separated from the firm's financing decision. In the absence of dividends, corporate earnings accrue to the benefits of shareholders as retained earnings and are automatically reinvested in the firm. Distribution of earnings as dividends may starve the company of funds required for growth and expansion, and this may cause the firm to seek additional external capital (Booth & Cleary, 2007)

Carter, Macdonald and Cheng (1997) believe that, the major reason for using retained earnings to finance new investments, rather than to pay higher dividends and then raise new equity for the new investments is because of floatation cost associated with issue of new equity . The management of

many companies believes that retained earnings are funds which do not cost anything, however though this is not true, it is true the use of retained earnings as a source of fund does not lead to a payment of cash. Cheng (1997) states that retained earnings are an attractive source of finance because investment projects can be taken without involving either the shareholders or any outsiders.

Companies can raise common equity indirectly, by retaining earnings. Retained earnings are preferred to new external equity because there are commissions and fees, called flotation costs, when a firm issues new equity. Few mature firms issue new shares of common stock. In fact, less than 2 percent of all new corporate funds come from the external equity market because flotation costs can be quite high. Investors perceive issuing equity as a negative signal about the true value of the company's stock. Investors believe that managers have superior knowledge about companies' future prospects, and that managers are most likely to issue new stock when they think the current stock price is higher than the true value. Therefore, if a mature company announces plans to issue additional shares, this typically causes its stock price to decline (Brigham & Daves, 2007).

2.2 Empirical Review

Ashamu, Abiola and Bdadmus (2001) carried out a study on dividend policy as a strategic tool of financing. In their study based dividend policy in an effort to explain how a firm divide retained earnings between retained earnings and dividends. The study was on all quoted companies (banks) in Nigeria. The study on dividend theories and its impacts on the corporation sources of finance. It explains that by dividend policy a corporate organization, strikes a balance between current income to the shareholders and future income. Income can be retained and reinvested into available profitable investment opportunities. Retained earnings provide the cheapest source of financing.

This study also investigated the effect of dividend policy on the value of the firm. After the investigation (Ashamuet *al.*, 2001) found the dividend policy had effect on percentage of earnings to be retained or ploughed back into the company. The secondary data obtained from Nigeria Stock exchange fact book were used for the study. Data obtained were analyzed using regression analysis with the aid of Statistical Package for Social Science (SPSS). The study found out among other things that the changes in the payout ratio of a company significantly determine the changes in the value of the firm. It was recommended that dividend policy should not be changed arbitrarily since it has a serious effect on the investor's altitude and the financial standing of the organization.

Kapoor (2009) carried out a research on impact of dividend policy on shareholders' value. A study on Indian firms looks at the issue from emerging markets perspective by focusing exclusively in Indian Information Technology, FMCG and service sector respectively. The study also observed that shareholder's wealth is represented in the market price of the company's common stock, which in turn is the function of the company's investment, financing and dividend decisions.

The study also looks at the agency problem and notes that in terms of shareholders- manager's relationships, managers whose compensation is tied to the firm's profitability and size, are interested in low dividend payout levels. A low dividend payout maximizes the size of the assets under management control, maximizes management flexibility in choosing investments, and reduces the need to turn to capital markets to finance investments. Finally looking at the pecking

order hypothesis the study states that a company which prefers retention of profits for financing the capital expenditure from internal sources distributes fewer dividends compared to a firm which finances the investment expenditure from external sources.

The objective of the research, Kapoor (2009) is to empirically examine rationale for stable dividend payments by finding the applicability of Lintner Model in Indian scenario. The present research work also seeks to examine and identify the relative importance of known determinants of dividend policy in Indian context. This research tries to unfold the relationship between shareholders' fund and the dividend policy and whether the dividend policy affect shareholders fund.

3.0 RESEARCH METHODOLOGY

A case study design was. The study consisted of 46 insurance companies. The data is quantitative and secondary data collection method was used. The study used descriptive and regression approach in data analysis. Using Statistical Package for Social Sciences (SPSS) regression analysis model was calculated. Data was presented in tables and graphs.

4.0 RESULTS AND DISCUSSIONS

4.1 Descriptive Analysis

4.1.1 Ownership Listing

The study sought to establish the listing status of the insurance companies. The findings were presented in Figure1.

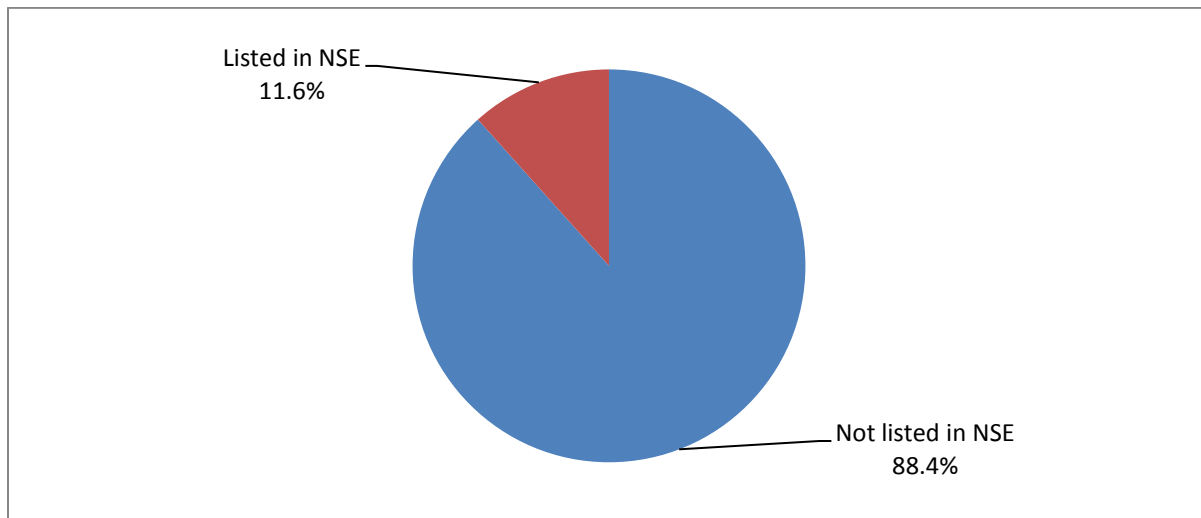


Figure 1: Ownership Listing

Above eighty eight percent (88.4%) of the companies were not listed in the Nairobi Securities Exchange while 11.6% of the companies were listed in the NSE. These results imply that majority of the companies do not engage in the trade of securities offered at the exchange market.

4.1.2 Capital Adequacy Ratio

The study sought to establish the trend of the capital adequacy ratio of insurance companies in Kenya for the years 2008-2012. The findings were presented in Figure 2

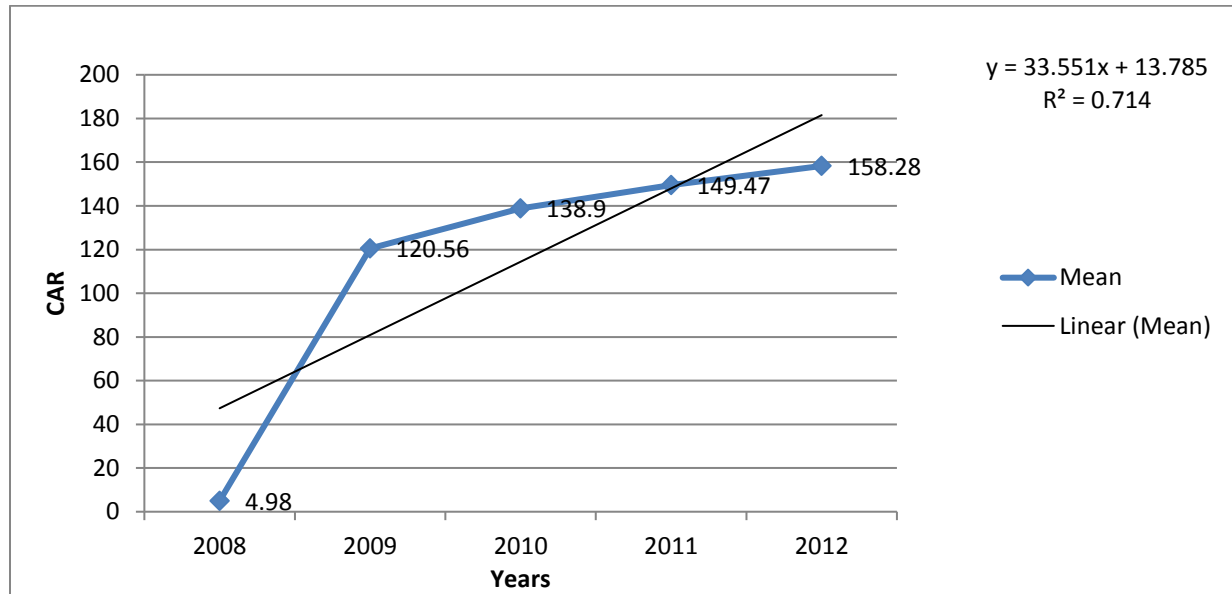


Figure 2: Capital adequacy ratio

Results indicate that the mean for CAR for 2008 was 4.98%. The CAR rose up to 120.56% in 2009 and further to 138.9% in 2010. The CAR rose again to 149.47% in 2011 and in 2012 it further rose to 158.58%. Overall, the trend in capital adequacy ratio has been consistent for the period under study. The findings imply that the majority of Insurance firms are complying with the regulation requiring insurance firms to increase their capital base.

4.1.3 Dividend Payout Ratio

The study sought to establish the trend of the dividend payout ratio of insurance companies in Kenya for the years 2008-2012. The findings were presented in Figure 3.

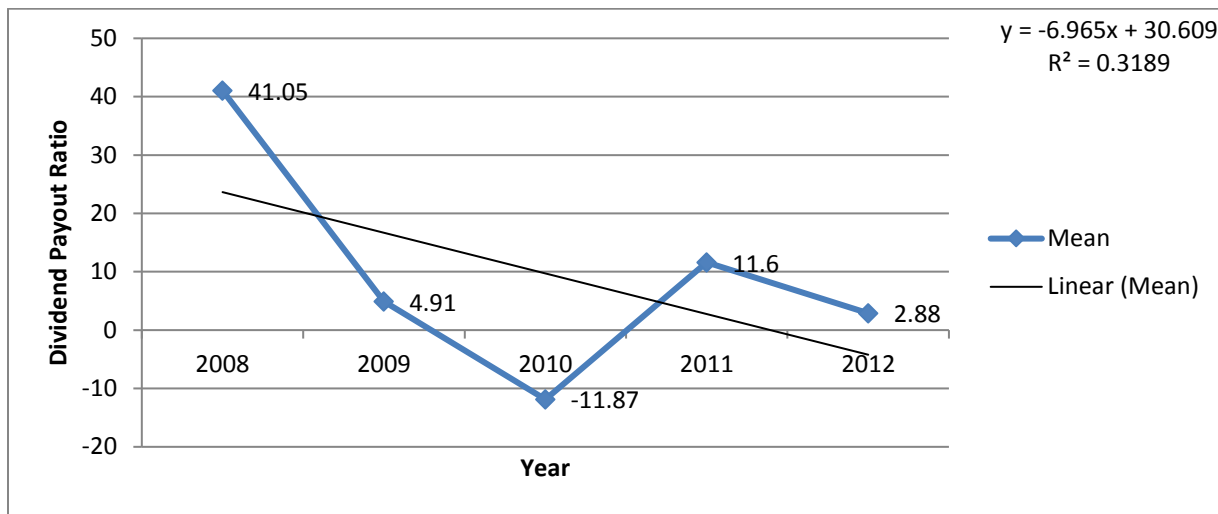


Figure 3: Dividend payout ratio

Results indicate that the mean for dividend payout ratio for 2008 was 41.05%. The dividend payout ratio dropped sharply to 4.91% in 2009 and further to -11.87% in 2010. The dividend payout ratio however rose again to 11.6% in 2011 but in 2012 it dropped to 2.88%. Overall, the trend in dividend payout ratio has been inconsistent for the period under study. The results imply that the trend could be as a result of the insurance companies retaining funds in accordance with the Perking Order theory which states that firms prefer to finance their activities with internal source such as net profit less dividends, depreciation allowance and revenue from sale of short-term securities. In case when it is necessary to finance activities with debt capital, debt securities are issues first, followed by new shares.

4.1.4 Profitability Ratio

The study sought to establish the trend of the profitability ratio of insurance companies in Kenya for the years 2008-2012. The findings were presented in Figure 4.

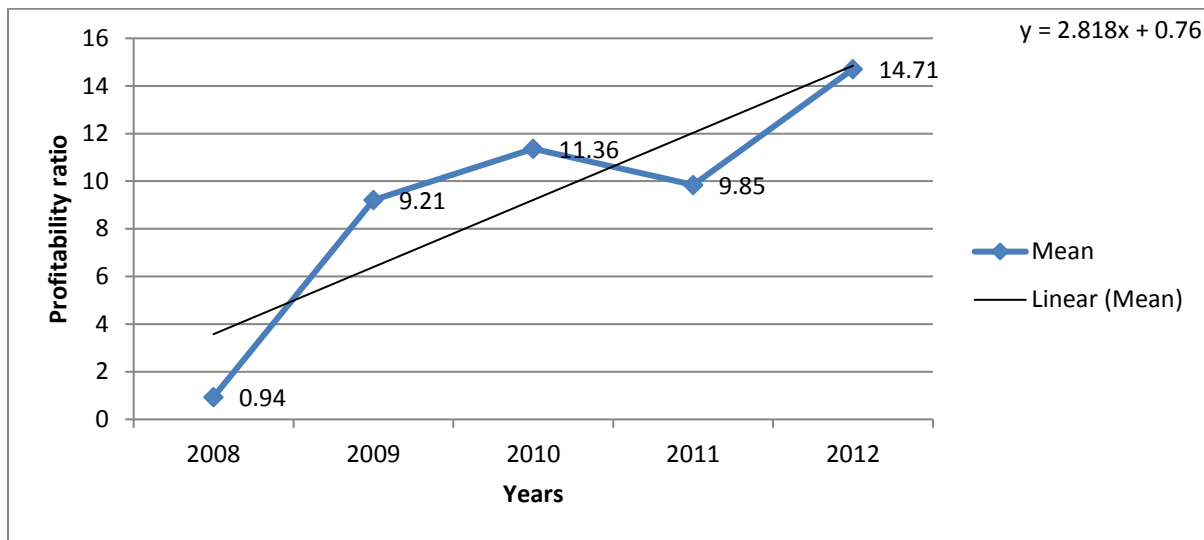


Figure 4: Profitability ratio

Results indicate that the mean for profitability ratio for 2008 was 0.94 %.The profitability rose to 9.21% in 2009 and further to 11.36 % in 2010.The profitability ratio however dropped to 9.85 % in 2011 but in 2012 it rose sharply to 14.71 %. Overall, the trend in the profitability ratio has been inconsistent for the period under study.

4.1.5 Liquidity Ratio

The study sought to establish the trend of the liquidity ratio of insurance companies in Kenya for the years 2008-2012.The findings were presented in Figure 5.

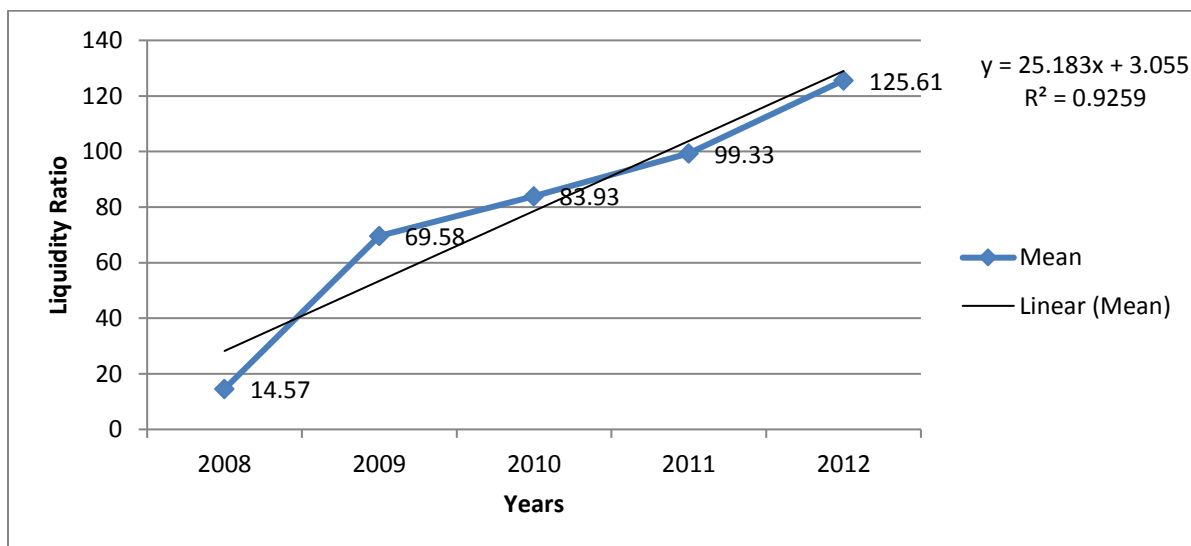


Figure 5: Liquidity ratio

Results indicate that the mean for liquidity ratio for 2008 was 14.57%.The liquidity ratio rose to 69.58% in 2009 and further to 83.93% in 2010.The liquidity ratio continued to rise to 99.33% in

2011 and went up further to 125.61% in 2012. Overall, the trend in the liquidity ratio has been consistent for the period under study.

4.1.6 Cost of Capital

The study sought to establish the trend of the cost of capital of insurance companies in Kenya for the years 2008-2012. The findings were presented in Figure 6.

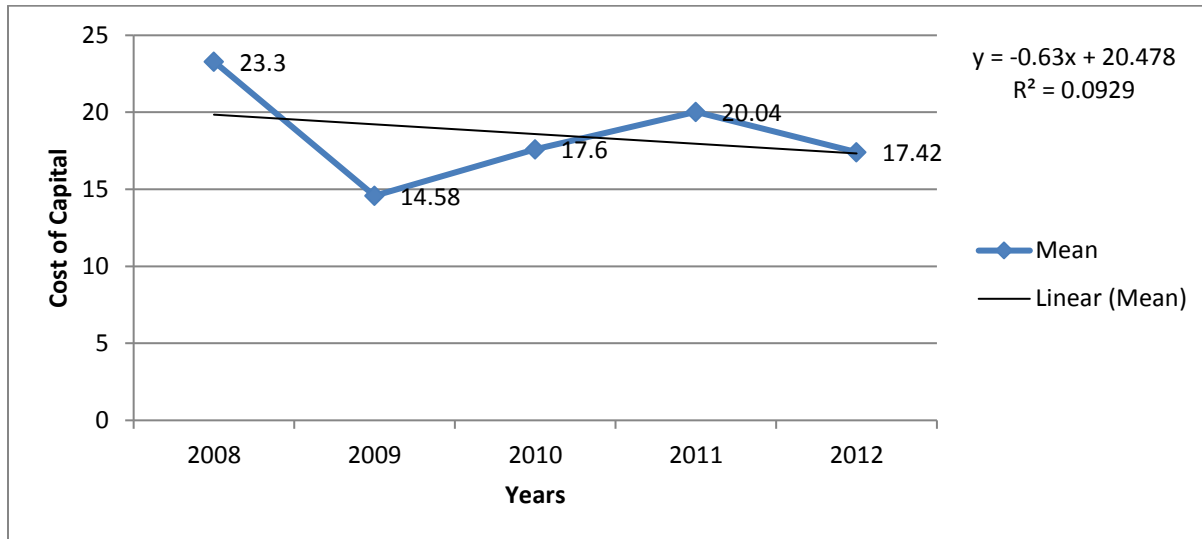


Figure 6: Cost of capital

Results indicate that the mean for the cost of capital for 2008 was 23.3%. The cost of capital dropped to 14.58% in 2009 but rose to 17.6% in 2010. The cost of capital further rose to 20.04% in 2011 but dropped to 17.42% in 2012. Overall, the trend in the cost of capital has been inconsistent for the period under study.

4.2 Pearson's Correlation Analysis

Bivariate correlation indicates the relationship between two variables. It ranges from 1 to -1 where 1 indicates a strong positive correlation and a -1 indicates a strong negative correlation and a zero indicates lack of relationship between the two variables. The closer the correlation tends to zero the weaker it becomes.

Table 1: Pearson’s Correlation Analysis

Correlation		CAR	Ownership listing	Dividend Payout	Profitability Ratio	Liquidity Ratio	Cost of Capital
CAR	Pearson Correlation	1					
	Sig. (2-tailed)						
Ownership listing	Pearson Correlation	-0.090	1				
	Sig. (2-tailed)	0.190					
Dividend Payout	Pearson Correlation	-0.429	0.124	1			
	Sig. (2-tailed)	0.000	0.069				
Profitability Ratio	Pearson Correlation	0.644	-0.033	-0.233	1		
	Sig. (2-tailed)	0.000	0.631	0.001			
Liquidity Ratio	Pearson Correlation	0.546	0.027	-0.272	0.638	1	
	Sig. (2-tailed)	0.000	0.694	0.000	0.000		
Cost of Capital	Pearson Correlation	-0.203	0.018	0.218	-0.142	-0.035	1
	Sig. (2-tailed)	0.003	0.796	0.001	0.037	0.615	

The correlation between ownership listing and capital adequacy ratio was weak and negative (-0.090) and was statistically insignificant. The correlation between capital adequacy ratio and dividend payout ratio was weak and negative (-0.429) and was statistically significant (0.000). The correlation between capital adequacy ratio and profitability ratio was strong and positive (0.644) and was statistically significant (0.000). Liquidity ratio also had a strong and positive correlation with capital adequacy ratio (0.546) and was statistically significant (0.000). However, cost of capital had a weak and negative correlation (-0.203) but was statistically significant.

4.3 Regression Analysis

Table 2 below shows the fitness of the regression model in explaining the variables under study.

Table 2: Model Fitness

Model	Coefficient
R	0.722
R Square	0.522
Adjusted R Square	0.510
Std. Error of the Estimate	78.825

The results indicate that the variables; dividend payout ratio, profitability ratio, liquidity ratio and cost of capital were satisfactory in capital adequacy ratio. This conclusion is supported by the R square of 0.522. This further means that the independent variables can explain 52.2 % of the variation of the dependent variable (CAR).

Table 3: Analysis of variance

	Sum of Squares	Df	Mean Square	F	Sig.
Regression	1417273	5	283454.5	45.62	0.000
Residual	1298583	209	6213.315		
Total	2715856	214			

ANOVA statistics presented on Table 3 indicate that the overall model was statistically significant. This was supported by a probability (p) value of 0.000. The reported p value was less than the conventional probability of 0.05 significance levels thus its significance in the study. These results indicate that the independent variables are good predictors of capital adequacy ratio.

Table 4: Regression of coefficients

Variable	B	Std. Error	T	Sig.
(Constant)	85.5	21.465		0.000
Ownership listing	-16.614	16.964	-0.047	0.329
Dividend Payout	-0.455	0.094	-0.250	0.000
Profitability Ratio	0.485	0.067	0.455	0.000
Liquidity Ratio	0.226	0.077	0.187	0.004
Cost of Capital	-0.566	0.368	-0.076	0.125

Regression of coefficients results in Table 4 shows that there is a negative relationship between ownership listing and capital adequacy whose beta coefficient is -16.416 and that it is statistically insignificant. There is a positive relationship between capital adequacy ratio and profitability ratio and liquidity ratio and whose beta coefficients are 0.485 and 0.226 respectively. There is a negative

relationship between capital adequacy ratio and dividend payout ratio and cost of capital of -0.455 and -0.566 respectively. Statistically significant variables in the study were dividend payout ratio, profitability ratio and liquidity ratio had p values of 0.000, 0.000, and 0.005 which is lower than the probability conventional of 0.05. These results indicate that capital adequacy ratio in insurance companies is determined by dividend payout ratio, profitability ratio and liquidity ratio, whereas the cost of capital is not significant to influencing CAR. This implies that an increase in unit change of dividend payout ratio, profitability ratio and liquidity ratio of the company's results to a unit change in capital adequacy ratio. However cost of capital is not statistically significant (0.130) in explaining capital adequacy ratio and they were negatively related CAR of insurance companies.

The regression equation was as follows;

Capital Adequacy Ratio= 85.5- 16.614Ownership listing- 0.455 Dividend payout ratio +0.485 Profitability ratio+ 0.226 Liquidity ratio - 0.566 Cost of Capital.

5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings

5.1.1 Ownership Listing Status

The findings indicate that above eighty eight percent (88.4%) of the companies were not listed in the Nairobi Securities Exchange while 11.6% of the companies were listed in the NSE. The correlation between ownership listing status and capital adequacy ratio was weak and negative (-0.009) and was statistically insignificant (0.190). Regression analysis showed that ownership listing status had a beta coefficient of (-16.614) and that it was statistically insignificant (0.329). Both correlation and regression analysis show a negative relationship and both are statistically insignificant.

5.1.2 Dividend Payout Ratio and Capital Adequacy Ratio

Results indicate that the mean for dividend payout ratio for 2008 was 41.05%. The dividend payout ratio dropped sharply to 4.91% in 2009 and further to -11.87% in 2010. The dividend payout ratio however rose again to 11.6% in 2011 but in 2012 it dropped to 2.88%. Overall, the trend in dividend payout ratio has been inconsistent for the period under study. The correlation between capital adequacy ratio and dividend payout ratio was weak and negative (-0.429) and was statistically significant (0.000). Regression analysis showed that dividend payout ratio had a beta coefficient of -0.455 and that it was statistically significant (0.000). Both correlation and regression analysis show a negative relationship but both are statistically significant.

These findings agree with those of Ashamu *et al.*, (2001) who found out among other things that the changes in the payout ratio of a company significantly determine the changes in the value of the firm.

5.1.3 Profitability Ratio and Capital Adequacy Ratio

Results indicate that the mean for profitability ratio for 2008 was 1.27%. Results indicate that the mean for profitability ratio for 2008 was 0.94 %. The profitability rose to 9.21% in 2009 and

further to 11.36 % in 2010. The profitability ratio however dropped to 9.85 % in 2011 but in 2012 it rose sharply to 14.71 %. Overall, the trend in profitability ratio has been inconsistent for the period under study. The correlation between capital adequacy ratio and profitability ratio was strong and positive (0.644) and was statistically significant (0.000). Regression analysis showed that the profitability ratio had a beta coefficient of 0.485 and that it was statistically significant (0.000). Both correlation and regression analysis show a positive relationship and both are statistically significant.

These findings agree with those of Uwuigbeet *al.*, (2012) found that there is a significant positive association between the firms' financing and its profitability of the sampled firms in Nigeria.

5.1.4 Liquidity Ratio and Capital Adequacy Ratio

Results indicate that the mean for capital adequacy ratio for 2008 was 14.57%. The liquidity ratio rose to 69.58% in 2009 and further to 83.93% in 2010. The liquidity ratio continued to rise to 99.33% in 2011 and went up further to 125.61% in 2012. Overall, the trend in liquidity ratio has been consistent for the period under study. Liquidity ratio also had a strong and positive correlation with capital adequacy ratio (0.546) and was statistically significant (0.005). Regression analysis showed that the liquidity ratio had a beta coefficient of 0.226 and that it was statistically significant (0.000). Both correlation and regression analysis show a positive relationship and both are statistically significant.

These findings agree with those of Amengor, (2012) who conducted a study on Importance of liquidity and capital adequacy to banks and found a strong and positive relationship between liquidity ratio and capital adequacy.

5.1.5 Cost of Capital and Capital Adequacy Ratio

Results indicate that the mean for dividend payout ratio for 2008 was 23.3%. The cost of capital dropped to 14.58% in 2009 but rose to 17.6% in 2010. The cost of capital further rose to 20.04% in 2011 but dropped to 17.42% in 2012. Overall, the trend in the cost of capital has been inconsistent for the period under study. However, cost of capital had a weak and negative correlation (-0.203) but was statistically insignificant (0.130). Regression analysis showed that the cost of capital had a beta coefficient of -0.566 and that it was statistically insignificant (0.125). Both correlation and regression analysis show a negative relationship and both are statistically insignificant.

These findings disagree with those of Murekefu and Ouma (2010) who carried out a study on the relation between cost of capital and the firm's performance among listed firms in the Nairobi Securities exchange and found a strong and positive relationship between cost of capital and firm performance.

5.2 Conclusions

The findings from the study revealed that most of the insurance companies had put in measures to ensure that capital adequacy increases over the years as implied by the consistent trend in increase in CAR. However in the recent years from the trend continues with a minimal rate. Dividend payout ratio impacts negatively on the capital adequacy ratio reflected by the decreasing and inconsistent trend over the years. It is however a key determinant of the availability of capital

adequacy. Results from the study also revealed that both profitability and liquidity are key determinants of capital adequacy where higher the profitability led to higher CAR while the higher the liquidity, the lower the capital adequacy. They were both very key determinants of capital adequacy. From the results, ownership listing status of the insurance companies and the cost of capital are not significant determinants of capital adequacy as implied by the insignificant p value and the inconsistent trend over the years.

5.3 Recommendations

The study recommended that More insurance companies should get listed in the Nairobi Securities Exchange as this increases the in that the companies which are listed have a higher capital adequacy ratio. Insurance Regulatory Authority should put in measures to make the insurance companies adhere to the recent regulations and policies which require the companies to have minimum capital requirements and hence in turn increasing capital adequacy. The study also recommended that insurance companies should ensure the put in place measures to increase the profitability ratio as the more the ratio is higher, the higher capital adequacy meaning the companies will be better positioned in access of such capital. On dividend policy, the insurance companies should adopt effective measures to determine to what extent they should to retain funds internally and their effect on divined payout in that this determines their capital adequacy. Insurance companies should ensure they put in place operational measures to ensure that the liquidity ratio does not fluctuate or decrease over a duration of time in that higher liquidity of such companies guarantee higher capital adequacy.

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