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**AN ANALYSIS OF THE EFFECT OF PRICING STRATEGIES  
ON PROFITABILITY OF INSURANCE FIRMS IN KENYA**

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## **EFFECT OF ECONOMY PRICING STRATEGY ON THE PROFITABILITY OF INSURANCE FIRMS IN KENYA.**

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### **Abstract**

**Purpose:** The objectives of the study were to establish the effect of economy pricing strategy on the profitability of insurance firms in Kenya

**Methodology:** The descriptive research design was preferred to other research designs because it reports the status of study variables. The population of study was the 45 insurance companies operating in Kenya as at 31<sup>st</sup> December 2012. Data was drawn from a period of five (5) years that is 2008-2012. The sample of this study was 10% of the sales workforce which comprised of 900 employees from the 45 insurance companies. The sample was generated by purposively sampling two employees from each insurance company. The researcher collected primary data with the help of a questionnaire. The primary data obtained from the questionnaires was summarized and analyzed by use of descriptive and inferential statistical techniques.

**Results:** Regression and correlation results indicated that there was a statistically significant and positive relationship between economy pricing strategies and profitability. These results implied that economy pricing has a positive effect on the profitability of insurance companies

**Policy recommendation:** The study recommends that insurance companies put in place measures assess the most effective pricing strategy to reduce product costs and thus increase profitability whenever such a strategy is used.

**Keywords:** *economy pricing strategy,profitability*

## **1.0 INTRODUCTION**

### **1.1 Background of the study.**

Insurance industry, the world over forms an integral part of the financial services sector and plays a pivotal role in the economic growth of an economy. A well developed insurance market paves way for efficient resource allocation through transfer of risk and mobilization of savings. Insurance industry is well developed in economies such as the US, Europe, Japan, and South Korea. Emerging markets are found throughout Asia, specifically in India and China, and are also in Latin America. In 2012, the global insurance market is forecast to have a value of \$4,608.5 billion, an increase of 24.9% since 2007. Life insurance dominates the global insurance market, accounting for 59.7% of the market's value (Andersen, 2008).

Insurance pricing, involves the calculation of each policy owner's fair share of losses and expenses. The price paid for insurance, called the premium, is the rate per unit or coverage multiplied by the number of unit purchased. Unit of insurance are measured differently according to the type of coverage. The rates are established before the exposure period to which they apply so that a forecast of the future must be made. The probable number and value of claims are forecast from historical loss experience with consideration given to trends and new developments. Insurers cannot set rates arbitrarily; rates are subject to state control (Andersen, 2008).

### **1.2 Statement of the Problem**

Every firm is most concerned with its profitability. One of the most frequently used tools of financial ratio analysis is profitability ratios which are used to determine the company's bottom line. Profitability measures are important to company managers and owners alike. If a small business has outside investors who have put their own money into the company, the primary owner certainly has to show profitability to those equity investors. There has been a growing number of studies recently that test for measures and determinants of firm profitability. Financial industry's profitability has attracted scholarly attention in recent studies due to its importance in performance measurement (Kallhoefer& Salem, 2008)

According to a study conducted by Ahmed et al (2011) on the determinants of performance, it indicated that size, risk and leverage are important determinants of performance of life insurance companies of Pakistan. According to Wright (1992) due to the unique accounting system used by life insurance companies, profitability of the industry has always been difficult to measure as compared with other financial institutions or corporations. Kasturi (2006) argued that the performance of insurance company in financial terms is normally expressed in net premium earned, profitability from underwriting activities, annual turnover, return on investment and return on equity. However, none of these studies focused on the effects of pricing strategies on the productivity of insurance companies in insurance firms in Kenya. If not properly implemented, pricing strategies adopted by the insurance industry are prone to fail and the more the reason for the study.

### **1.3 Research Objectives**

- i. To establish the effect of economy pricing strategy on the profitability of insurance firms in Kenya.

## **2.0 LITERATURE REVIEW**

### **2.1 Theoretical Orientation**

#### **2.1.1 The Weber-Fechner Law**

This law relates changes in a stimulus to the evolved response as follows:

$\Delta S/S = k$ , where  $S$  is the stimulus,  $\Delta S$  is the "just noticeable difference" (i.e. so that  $S + \Delta S$  is perceived to be different from  $S$ ), and  $k$  is constant for each sensory stimulus. Fechner analyzed subjective sensations using differential increments and derived the Weber-Fechner law (Monroe, 1971).

Several authors have applied the Weber-Fechner law in the investigation of price thresholds Adam (1970), Gabor and Granger,(1966) and Monroe, (1973). The empirical evidence reported in these papers supports the hypothesis of upper and lower price thresholds and thus a range of prices which is considered acceptable. The Weber-Fechner law provides a means of experimentally determining such thresholds. Prices below the lower threshold are considered too low (quality is suspect) and prices above the upper threshold are considered too high. This was empirically demonstrated by Adam (Monroe, 1973).

The theory is relevant in this study as it is used to explain how perception of prices by consumers affects them in purchasing insurance products. The more the consumers perceive those prices positively the more sales they make hence aiding in making the pricing decisions of the firms specially understanding the threshold of prices of such strategies.

### **2.2 Empirical Literature Review**

#### **2.2.1 Economy Pricing Strategy and Profitability of Insurance Firms**

Ekundayo, (2012) found that in order to meet specific objectives, and within the content of factors that influence pricing decision, firms have to adopt some type of economy pricing strategy. For example, a construction firm that is targeting a particular construction market could do this by tendering for such jobs at a low price level. Fellows and Langford, (2000) suggest that firms may adopt low profit level pricing in times of economic recession in order to maintain market share or to penetrate a new market. Skitmore, (2007) also has investigated economy oriented pricing strategies of construction firms submitting bid prices aimed at what the market will bear.

### 2.3. Conceptual Framework

#### Independent variables

#### Dependent Variable



Source: Figure 1: Conceptual Model Researcher (2013)

### 3.0 METHODOLOGY

The descriptive research design was preferred to other research designs because it reports the status of study variables. The population of study was the 45 insurance companies operating in Kenya as at 31<sup>st</sup> December 2012. Data was drawn from a period of five (5) years that is 2008-2012. The sample of this study was 10% of the sales workforce which comprised of 900 employees from the 45 insurance companies. The sample was generated by purposively sampling two employees from each insurance company. The researcher collected primary data with the help of a questionnaire. The primary data obtained from the questionnaires was summarized and analyzed by use of descriptive and inferential statistical techniques.

### 4.0 RESULTS FINDINGS

#### 4.1 Quantitative Data Analysis

This section presented the variables and their effect on profitability of insurance companies.

##### 4.1.1 Economy Pricing Strategy and Profitability of Insurance Companies in Kenya

The study sought to establish the effect of economy pricing strategy on the profitability of insurance companies. The results were presented in Table 4.7. Seventy five percent of the respondents agreed that there had been an increase in use of the economy pricing strategy in their firm in the recent years. Above eighty two percent (82.8%) agreed that there had been an increase in sales of their products as a result of economy pricing strategy. Ninety two point two percent of the respondents agreed on the statement that their company has been in a position to reduce product costs whenever economy pricing of its products was used. Eighty six percent agreed that most of their competitor firms have failed to effectively adopt economy pricing strategies giving them a competitive edge over them. Above seventy nine percent (79.7%) agreed that the measures put in place to implement our economy pricing strategies were better compared to competitor firms. The overall likert mean was 3.88 with a standard deviation of 0.86 and this implies that economy pricing greatly influences the profitability of insurance companies.

These findings agree with those of Irwin and Klenow, (2004) who found that the potential detrimental effects to both firms when the firm's economy product pricing rating improves are a direct result of both firms' complete flexibility in adjusting their prices in response to changes to product ratings. They also agree with those of Flanagan and Norman (2006) who examined the economy pricing strategies adopted manufacturing firms and concluded that they resulted in significant effect on profitability.

**Table 1: Economy Pricing Strategy and Profitability of Insurance Companies**

Statement	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	Mean	Std. Deviation
There has been an increase in use of the economy pricing strategy in our firm in the recent years	1.60%	14.10%	9.40%	62.50%	12.50%	3.7	0.92
There has been an increase in sales of our products as a result of economy pricing strategy	3.10%	3.10%	10.90%	67.20%	15.60%	3.89	0.82
Our company has been in a position to reduce product costs whenever economy pricing of its products is used	4.70%	3.10%	0.00%	75.00%	17.20%	3.97	0.85
Most of the competitor firms have failed to effectively adopt economy pricing strategies giving us a competitive edge over them	4.70%	4.70%	4.70%	67.20%	18.80%	3.91	0.92
The measures put in place to implement our economy pricing strategies are better compared to competitor firms	0.00%	7.80%	12.50%	60.90%	18.80%	3.91	0.79
<b>Average</b>						<b>3.88</b>	<b>0.86</b>

#### 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. The correlation between profitability and economy pricing strategy was strong and positive (0.706) and was statistically significant (0.000). The correlation between profitability and skimming was also strong and positive (0.693) and was statistically significant (0.000). The correlation between profitability and penetration, premium and price optimization strategies was strong and positive (0.688, 0.522, and 0.644 respectively). All the three variables were statistically significant as they each had a significance level of 0.000.

**Table 2 Pearson's Correlation Analysis**

	ROA	Economy
ROA	Pearson Correlation	1.000
	Sig. (2-tailed)	

	Pearson		
Economy	Correlation	0.706	1.000
	Sig. (2-tailed)	0.000	

### 4.3 Regression Analysis

Table 3 below shows the fitness of the regression model in explaining the variables under study. The results indicate that the variables; economy pricing, were satisfactorily explaining profitability. This conclusion is supported by the R square of 0.651. This further means that the independent variables can explain 65.1% of the independent variable (profitability).

**Table 3 Model Fitness**

Indicator	Coefficient
R	0.807
R Square	0.651
Adjusted R Square	0.620
Std. Error of the Estimate	0.0778

### 4.4 Analysis of Variance

ANOVA statistics presented on Table 4 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 performance in terms of profitability.

The findings led to rejection of null hypothesis that economy pricing, did not significantly contribute to financial performance of insurance companies.

**Table 5 Analysis of Variance**

Model	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.653	5	0.131	21.596	0.000
Residual	0.351	58	0.006		
Total	1.004	63			

Regression of coefficients results in Table 4.16 shows that there is a positive relationship between profitability and economy pricing, and whose beta coefficients are 0.069. The results indicate that; an increase in the economy pricing strategies by one unit leads to an increase in profitability by 0.069 units;

**Table 6 Regression of Coefficients**

	B	Std. Error	t	Sig.
(Constant)	-0.551	0.075	-7.390	0.000
Economy	0.069	0.017	4.018	0.000

### 4.7 Summary Equations

The summary equation was;

**ROA= -0.551 + 0.069Economy pricing**

## **5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

### **5.1 Summary of study**

This section attempted to summarize the findings that were obtained in chapter four.

#### **5.1.1 Economy Pricing Strategy and Profitability of Insurance Companies**

The descriptive statistics indicated that majority of the respondents agreed that there had been an increase in use of the economy pricing strategy in their firm in the recent years, there had been an increase in sales of their products as a result of economy pricing strategy, their company has been in a position to reduce product costs whenever economy pricing of its products was used, most of the competitor firms had failed to effectively adopt economy pricing strategies giving them a competitive edge over them and the measures put in place to implement them economy pricing strategies are better compared to competitor firms. Regression and correlation results indicated that there was a statistically significant and positive relationship between economy pricing strategies and profitability. These results implied that economy pricing has a positive effect on the profitability of insurance companies. The findings agree with those of Flanagan and Norman (2006) who examined the economy pricing strategies adopted manufacturing firms and concluded that they resulted in significant effect on profitability.

### **5.2 Conclusion**

Based on the objectives and the findings of the study the following conclusion can be made; From the study it can be concluded that the insurance companies had put in place effective economy pricing measures as firms had ensured reduction of product costs giving them a competitive edge over their rivals. It can also be concluded that economy pricing was a strong determinant of insurance company's profitability.

### **5.4 Recommendations**

#### **5.4.1 Recommendations for study findings**

The study recommends that insurance companies put in place measures assess the most effective pricing strategy to reduce product costs and thus increase profitability whenever such a strategy is used. They should also adopt ways to implement their pricing strategies better compared to competitor firms. They should also ensure that the strategies they adopt help them discourage competition and focus more on both acceptance and profits. They should also use strategies that positively influence consumer's perception through fair pricing in setting their product prices so that customers will be satisfied when paying for such services.

#### **5.4.2 Recommendations for Further Research**

This study was not exhaustive by any means and therefore it is suggested that another study be conducted in the insurance industry in probably using the same variables so as to establish whether the findings of this study will hold true for individual products since the risk rating is different from one product to another with special focus on Medical and Motor private classes which have been reported as loss making by many firms. An additional research can be done to find out exactly the reason for bad performance of these classes.



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