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EFFECT OF PREMIUM PRICING STRATEGY ON THE PROFITABILITY OF INSURANCE FIRMS IN KENYA.

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Abstract

Purpose: The objectives of the study were to establish of premium 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 31st 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: The descriptive statistics indicated that majority of the respondents agreed that their firm positively influenced consumer's perception through fair pricing in setting premium prices, when using premium pricing our firm tried to reduce operation costs as much as possible and ensured they are controlled, their firm had successfully adopted effective premium pricing strategies in the recent years, their premium pricing strategy had led to more sales in their insurance products and their firm engaged professional expertise in implementation of their premium pricing strategy. Regression and correlation results indicated that there was a statistically significant and positive relationship between premium pricing strategies and profitability. These results implied that premium 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 premium pricing strategy to reduce product costs and thus increase profitability whenever such a strategy is used.

Keywords: *premium pricing*

1.0 INTRODUCTION

1.1 Back ground 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

In order to achieve the above objective the study was guided by the following specific objectives:

i. To establish the effect of premium 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:

AS/S = k, where S is lie stimulus, AS is the "just noticeable difference" (i.e. so that S + AS 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 empirica1 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 Premium Pricing Strategy and the Profitability of Insurance Firms

The earliest efforts to identify the relationship between pricing of risk and the profitability of insurance companies can be attributed to Bain (2001) who developed the concentration profit hypothesis. Drawing on conventional price theory, Bain hypothesizes that a concentrated market structure encouraged oligopolistic behavior by competitors. A later variant of the hypothesis submitted by Stigler (2004) came to be known as the collusion theory. It is now commonly known as the structure conduct performance.

2.3Conceptual Framework

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 31st 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: Premium Pricing Strategy and Profitability of Insurance Companies in Kenya

The study sought to establish the effect of premium pricing strategy on the profitability of insurance companies. The results were presented in Table 4.10.Seventy five percent of the respondents agreed that their firm positively influenced consumer's perception through fair pricing in setting premium prices. Above seventy eight percent (78.1%) agree that when using premium pricing their firm tried to reduce operation costs as much as possible and ensure they are controlled. Majority of the respondents (73.4%) agreed that their firm has successfully adopted effective premium pricing strategies in the recent years. Our premium pricing strategy has led to more sales in their insurance products. Above sixty percent (60.9%) agreed that their firm engages professional expertise inimplementation of their premium pricing strategy. The overall likert mean was 3.71 with a standard deviation of 1.190 and this implies that premium pricing greatly influences the profitability of insurance companies.

The findings are consistent with Baytelsmit and Bouzouita, (1998) who using premium pricing examined the market, market structure and industry profitability relationship within the non life insurance market and found a significant relationship, concluding that the pricing structure and characteristics of the market place contribute to a reduced level of competition among insurers

Table 1 Premium Pricing Strategy and Profitability of Insurance Companies

Statement	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree	Mean	Std. Deviation
Our firm positively influences consumer's perception through fair pricing in setting premium prices	4.70%	10.90%	9.40%	48.40%	26.60%	3.81	1.10
When using premium pricing our firm tries to reduce operation costs as much as possible and ensure they are controlled	6.20%	10.90%	4.70%	42.20%	35.90%	3.91	1.19

Our firm has successfully adopted effective premium pricing strategies in the recent years	4.70%	10.90%	10.90%	40.60%	32.80%	3.86	1.12
Our premium pricing strategy has led to more sales in our insurance products	7.80%	17.20%	14.10%	29.70%	31.20%	3.59	1.31
Our firm engages professional expertise in implementation of our premium pricing strategy	12.50%	10.90%	15.60%	48.40%	12.50%	3.38	1.22
Average						**3.71**	**1.19**

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 penetration, premium was 0.522.

Table 2 Pearson's Correlation Analysis

		ROA	Economy	Premium
ROA	Pearson Correlation	1.000		
	Sig. (2-tailed)			
Economy	Pearson Correlation	0.706	1.000	
	Sig. (2-tailed)	0.000		
	Sig. (2-tailed)	0.000	0.000	
Premium	Pearson Correlation	0.522	0.632	1.000
	Sig. (2-tailed)	0.000	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, penetration pricing, premium pricing, price optimization strategy and skimming 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 4indicate 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, premium pricing strategies did not significantly contributeto financial performance of insurance companies.

Table 4Analysis 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 shows that there is a positive relationship between profitability and, premium pricing whose beta coefficients is , 0.042 .The variables under study was statistically significant as they were all below the probability conventional of 0.05. The results indicate that; an increase in the; an increase in the premium pricing strategies by one unit leads to an increase in profitability by 0.042 units.

Table 5: 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
Skimming	0.051	0.0028	18.21429	0.000
Penetration	0.052	0.028	1.847	0.030
Premium	0.042	0.0018	23.33333	0.021
Optimization	0.021	0.0016	13.125	0.007

5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Premium Pricing Strategy and Profitability of Insurance Companies

The forth objective was to establish the effect of premium pricing strategies on the profitability of insurance firms in Kenya. The descriptive statistics indicated that majority of the respondents agreed that their firm positively influenced consumer's perception through fair pricing in setting premium prices, when using premium pricing our firm tried to reduce operation costs as much as

possible and ensured they are controlled, their firm had successfully adopted effective premium pricing strategies in the recent years, their premium pricing strategy had led to more sales in their insurance products and their firm engaged professional expertise in implementation of their premium pricing strategy. Regression and correlation results indicated that there was a statistically significant and positive relationship between premium pricing strategies and profitability. These results implied that premium pricing has a positive effect on the profitability of insurance companies.

5.2 Conclusion

It can be concluded thatfirms had successfully adopted effective premium pricing strategies in the recent years and strategies had yielded more sales in their insurance products.The price optimization strategies had a positive effect on profitability of insurance companies and were a key determinant of the insurance companies' performance.

5.3 Recommendations

5.3.1 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.

5.3.2 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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