Effects of Risk Management Practices on the Performance of Insurance Firms in Kenya: A Case of AIG Insurance Company Ltd

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Abstract: ***The study investigates the impact of risk management on performance of insurance companies. The research was done in Nairobi, in particular AIG insurance company where most of the respondent's work. AIG have made investments in personnel, processes and technology to help control business risk. Historically, these risk investments have focused primarily on financial controls and regulatory compliance. The objectives of this study were aimed at knowing the impact of risk management on performance of insurance companies. Random sampling was used to select fifty one respondents. The research instruments majorly used included a set of questionnaires; for the respondents. The data collected has been presented using descriptive techniques and especially frequency distribution tables, pie charts and bar graphs. The findings of the study reveal that on operational risk management the underlying causes of operational risk losses are not always initially observable. It can be difficult to uncover the exact chain of events that led to the occurrence of the loss. In addition, one cause might be linked to more than one event or one event may have multiple causes (eg cascading control failures), resulting in different types of losses that could be covered by different insurance policies. On governance risk management through training and related activities aimed at building aimed at building awareness of the importance of ERM, roles and responsibilities and value to be derived from ERM. These results point to appropriate focus on risk governance since relevant, on time information risk and responsibilities. Reduced enterprise IT support / budgets and increased ease of technology deployments has led to multiple "shadow IT" organizations within enterprises. Shadow groups tend to not follow established control procedures. On strategic risk management, boards are seeing rapid increases both in the speed with which risk events take place and the contagion with which they spread across different categories of risk. They are especially concerned about the escalating impact of 'catastrophic' risks, which can threaten an organisation's very existence and even undermine entire industries.***

Keywords: Insurance; General Insurance or non-life Insurance; Risk; Risk Management; Operational Risk Management (ORM) Practices; Financial Risk Management Practice and Governance Risk Management Practice

1. Introduction

Risk management refers to a process of identifying loss exposures faced by an organization and selecting the most appropriate techniques for treating these particular exposures effectively (Rejda, 2003). There are many techniques available for insurance companies to manage risks including; loss financing, risk avoidance and loss prevention and control. Insurance refers to a form of risk transfer where one party (the insurer) undertakes to indemnify the other (insured) in the event of an insured risk taking place in consideration of a premium (Ingram, 2006). Further, general insurance or simply non-life Insurance is the underwriting of a number of classes of insurance that is not long term in nature (usually one year) including automobile and homeowners policies. Payment or reimbursement is provided to the insured should an insured loss occur. Risk management is very important for insurance industry. Insurance means that insurance companies take over risks from customers. Insurers consider every available quantifiable factor to develop profiles of high and low insurance risk. Level of risk determines insurance premiums. Generally, insurance policies involving factors with greater risk of claims are charged at a higher rate (Gollier, 2003). With much information at hand, insurers can evaluate risk of insurance policies at much higher accuracy. To this end, insurers collect a vast amount of information about policy holders and insured objects. Statistical methods and tools based on data mining techniques can be used to analyze or to determine insurance policy risk levels (Dennis, 2005).

AIG is a world leading property-casualty and general insurance organization serving more than 70 million clients around the world. With one of the industry's most extensive ranges of products and services, deep claims expertise and excellent financial strength, AIG enables its commercial and personal insurance clients alike to manage virtually any risk with confidence. AIGis the marketing name for the worldwide property-casualty and general insurance operations of AIG Inc.At AIG, we take on our clients' challenges and goals. Whether the need is as fundamental as insuring a first home or as complex as providing environmental coverage, our priority is providing clients with the confidence they need to prosper. Behind every policy we write is our commitment to deliver what matters most to them.

These are extraordinary times, especially for Insurance companies. The last decade has been marked by a succession of disasters that have thrust the discipline of risk management into the spotlight. On the global level, just to mention a few cases, the 2004 Indian Ocean earthquake killed almost 225,000 people in various countries, while the level of terrorism has risen to all times high as witnessed in the 9/11 in New York. Closer home in Kenya, the real level of risks comprises the steady toll of fires, accidents, thefts and other similar events including terrorism, which are costly in terms of money and human pain, suffering and loss of lives. We live in a world full of dangers, hazards, risks and uncertainties as part of everyday life. This has been so from time immemorial (Irukwu, 1991). In spite of all this, something critical must be done. This is because life must go on and we cannot stop manufacturing in case people are injured, neither will we ban motor vehicles in order to stop road accidents as these would be unreasonable options. The world has to continue even in the face of risks. What we can do is try to manage our exposure to risks. All these events have called for an analysis of the role of risk management in the insurance industry.

Risk management is the total process of identifying, controlling and minimizing the impact of uncertain events. Since the insurance companies carry the bigger and ultimate burden in the cost of these losses, they should therefore be at the fore front in managing the risks. Risk management if successful, avoids or mitigate costly risks while increasing the payoff by managing the risks effectively. Among the many causes of Insurance business failure are low pricing of products, poor financial management, poor corporate governance and poor underwriting (AKI Report, 2002). Poor underwriting is a source of poor risk management which if not properly managed translate into poor results. Insurance companies should therefore pay attention to and be more involved in risk management for better results (AKI Report, 2005). Despite the known advantages of having risk management practices, to the best knowledge of the researcher, no known research has been conducted in Kenya with regard to risk management practices and performance of insurance companies. There exists a knowledge gap which this study seeks to fill by establishing the effects of risk management practices on the performance of AIG Insurance Company Ltd. The general objective of this study was to establish the effects of risk management practices on the performance of insurance firms in Kenya. The specific objectives of this study were;

1. To determine the extent to which financial risk management practices influence the performance of AIG Insurance Company Ltd.
2. To establish the extent to which operational risk management practices influence the performance of AIG Insurance Company Ltd.
3. To examine the extent to which governance risk management practices influence the performance of AIG Insurance Company Ltd.
4. To examine the extent to which strategic risk management practices influence the performance of AIG Insurance Company Ltd.

2. Theoretical Review

2.1 Risk Management Theory

Risk management is the identification, assessment, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities (Wenk, 2005). Effective risk management can bring far reaching benefits to all organizations, whether large or small, public or private sector (Ranong and Phuenngam, 2009). These benefits include, superior financial performance, better basis for strategy setting, improved service delivery, greater competitive advantage, less time spent firefighting and fewer unwelcome surprises, increased likelihood of change initiative being achieved, closer internal focus on doing the right things properly, more efficient use of resources, reduced waste and fraud, and better value for money, improved innovation and better management of contingent and maintenance activities(Wenk, 2005).According to Dorfman (2007), ensuring that an organization makes cost effective use of risk management first involves creating an approach built up of well-defined risk management practices and then embedding them. These risk management practices include financial risks management practices, operational risk management practices, governance risk management practices, and strategic risk management practices.

2.2 Enterprise Risk Management Theory

According to Tseng (2007), Enterprise Risk Management (ERM) is a framework that focuses on adopting a systematic and consistent approach to managing all of the risks confronting an organization. Gordon et al. (2009) on the other hand define ERM as the overall process of managing an organization's exposure to uncertainty with particular emphasis on identifying and managing the events that could potentially prevent the organization from achieving its objective. ERM is an organizational concept that applies to all levels of the organization". In conducting ERM, the following are listed as some of the areas or aspects of the organization that a risk manager need to look into namely: the people, intellectual assets, brand values, business expertise and skills, principle source of profit stream and the regulatory environment (Searle, 2008). This will help organization to balance the two most significant business pressures; the responsibility to deliver succeed to stakeholders and the risks associated with and generated by the business itself in a commercially achievable way. By doing so, the risk manager is constantly aware of the risks it faces and therefore constantly monitors its exposure and be positioned to change strategy or direction to ensure the level of risks it takes is acceptable.

2.3 Contingency Planning Theory

Contingency planning (CP) also known as business continuity planning is a crucial element of risk management. The fundamental basis of Contingency Planning (CP) is that, since all risks cannot be totally eliminated in practice, residual risks always remain. Despite the organization's very best efforts to avoid, prevent or mitigate them, incidents will still occur. Particular situations, combinations of adverse events or unanticipated threats and vulnerabilities may conspire to bypass or overwhelm even the best information security controls designed to ensure confidentiality, integrity and availability of information assets (Hisnson and Kowalski, 2008). In the context of this study, CP is defined as the totality of activities, controls, processes, plans *etc*. relating to major incidents and disasters.

It is the act of preparing for major incidents and disasters, formulating flexible plans and marshaling suitable resources that will come into play in the event, whatever actually eventuates. The very word 'contingency' implies that the activities and resources that will be required following major incidents or disasters are contingent (depend) on the exact nature of the incidents and disasters that actually unfold. In this sense, CP involves preparing for the unexpected and planning for the unknown. The basic purpose of CP is to minimize the adverse consequences or impacts of incidents and disasters.

3. Conceptual Framework

Smyth (2004) defines a conceptual framework as a framework that is structured from a set of broad ideas and theories that help a researcher to properly identify the problem they are looking at frame their questions and find suitable literature. The conceptual framework of the study will consist of independent variables; financial risk management practices, operational risk management practices, governance risk management practices, and strategic risk management and a dependent variable; the performance of insurance firms.

3.1 Independent Variables Dependent Variable

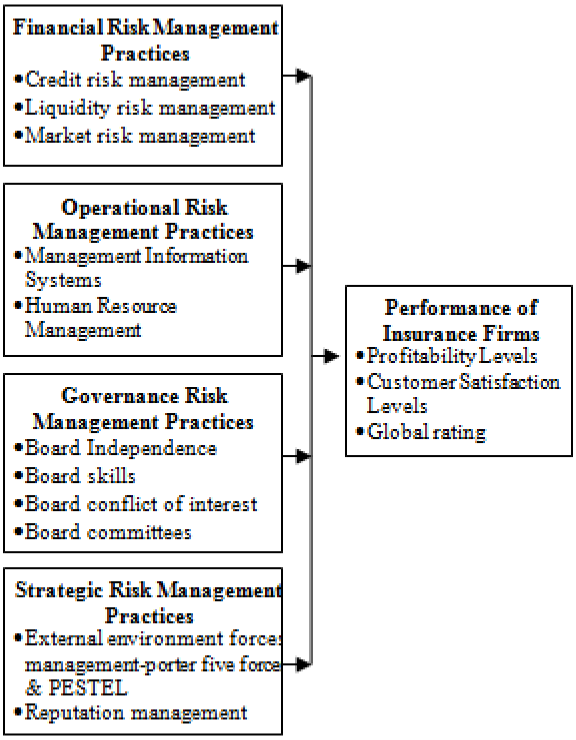

Figure 1: Conceptual Framework

3.2 Research Gaps

Research gaps exist since none of the studies address the effect of risk management practices on the financial performance of insurance firms. In addition, majority of the studies were either done in the banking sector. In addition, the majority of the studies were done in developed economies hence leaving scarce literature in developing economies.

3.3 Data Analysis and Presentation

Data analysis was done to generate a view of how the objectives were achievable. This was done using descriptive statistics, which saw the use of frequency tables, percentage and distribution tables, bar graphs and pie charts. The output for this study was presented using descriptive statistics like the mean score and standard deviation. Graphs, bar charts and pie charts were used for further representation.

4. Results and Discussion

The researcher targeted six general managers, ten assistant general managers, thirteen service/underwriting managers, and twenty two professional staff of AIG Insurance Company Ltd. The researcher managed to administer the questionnaires to all the targeted respondents. According to Mugenda (2003) above 70% response rate is very good. A summary of the response rate is as shown in table and figure below;

5. The Role of Financial Risk Management

All the respondents indicated that AIG has a risk management department with exception of two who did not understand how the risk department really worked. This implies that AIG understands the importance of identifying, assessing, and prioritizing of risks in its line of business. The company therefore has a department to assist in the coordination and economical application of resources to minimize, monitor and control the probability and/or impact of unfortunate events and maximize the realization of opportunities. Table shows a summary of the results. Further, the respondents level of agreement to a number of reasons attributed to AIG's establishment of a risk management department. Most of the respondents 88%, agreed that risk management is of great value to the company. The rest neither agreed nor disagreed with this opinion. A summary of the results is shown in table below;

6. Operational Risk Management

The respondents level of agreement to a number of reasons attributed to AIG's establishment of a risk management department and what value it adds in handling operational risk management.Most of the respondents 88%, agreed that risk management is of great value to the company. The rest neither agreed nor disagreed with this opinion. Some of the reasons given include; In the past, companies have not collected operational risk data properly (inability to connect losses resulting from a unique event) or across the full spectrum of their business activities which AIG is currently doing. Internal loss data is one fundamental method of data source used by AIG to measure operational risk. What AIG lacks in amount or quality, is that it can supplement with external data from industry sources, such as Global Operational Risk Database (ORX) and Operational Risk Consortium (ORIC). This findings agreed with Mercelo (2011) findings that found out that Financial Risk Management is crucial for sucess of any Insurance firm.

7. Role of Governance on Risk Management

The most common action, roughly taken by 24 (47%) of organizations was to improve the process for reporting risk information to their board of directors and to their management risk committees. In additon to formation of risk management committees at both management and level was approximately undertaken by 14 (27%) respondents. An interesting finding was that approximately a third of respondents had materially recommended for there to be risk culture to improve the effectiveness of risk oversight. This could have been through training and related activities aimed at building aimed at building awareness of the importance of ERM, roles and responsibilities and value to be derived from ERM. These results point to appropriate focus on risk governance since relevant, on time information risk and responsibilities. Governance is what lacks for proper implementation and success of risk management.

8. Role of Strategic Risk Management

There was an overwhelming response in regard to what the respondents had to say about how AIG manages undertakes strategic risk management. As shown in the above table 4.5, 25 (49%) of the respondents of which many were executives are worried that the risk frameworks and processes that are currently in place in AIG are no longer giving them the level of protection they need. Secondly, boards are seeing rapid increases both in the speed with which risk events take place and the contagion with which they spread across different categories of risk. They are especially concerned about the escalating impact of 'catastrophic' risks, which can threaten an organisation's very existence and even undermine entire industries.The third shift is that boards feel they are spending too much time and money on running their current risk management processes, rather than moving quickly and flexibly to identify and tackle new risks. As a result, some are not convinced that their return on spending on ERM is fully justified by the level of protection they gain from it. These shortcomings reveal that current approaches to strategic risk management are no longer fit for purpose. It is important to develop and expand existing frameworks and tools, drawing on outside experience and knowledge wherever possible(Murton Lane, 2004). Indeed, the external viewpoint that independent directors can bring to the boardroom will play an essential part in ensuring this breadth of risk-thinking enhances the development of strategic thinking.

9. Performance of Insurance Firms

All respondents agreed that company having a department to assist in the coordination and economical application of resources to minimize, monitor and control the probability and/or impact of unfortunate events then profitability levels are bound to rise as the lesser the claims the lesser the expenditure hence higher profits. The less the payout in claims the less the premiums charged to the clients therefore increasing customer loyalty and satisfaction. Customers being the brand owners they are bound to evaluate one firms services/Products interms of fuctionality and cost. The product/services that best serves the two variables is seen to be a better brand. The findings were in agreement Mercelo (2006) findings which indicated that an Insurance Company's performance can be greately improved through prudent risk management.

10. Conclusion

In view of the findings this study established that effects of risk management practices on performance of insurance companies. Risk management has played a major role in insurance companies although it has its downfalls and thus the study brought into light some of the main effects of risk management on performance of risk insurance companies. Majority said insurance activities are broadly divided into life and non-life insurance, and firms specializing in either category face different risks. Specifically, these two types of activities require firms to hold different technical provisions, by virtue of both prudent business practices and regulatory mandates.

On operational risks, some of the reasons given include; in the past, companies have not collected operational risk data properly (inability to connect losses resulting from a unique event) or across the full spectrum of their business activities which AIG is currently doing. On governance risk management, what contributed to the ineffectiveness of the system is that the system had loopholes and that some claims paid were not genuine as well as information technology related risks which emerged due to investment across organizations and regions.i.e Loss / release of critical business data, security and identity management. There was seen to be a lot of emphasis on Strategic Risk Management policies but there wasn't a clear roadmap to implementation. Secondly we need to equip staff with the necessary skills and power to implement the various strategies. It's also necessary to embrace technology to help in forecasting Catastrophic Risk exposures that have are of low frequency but high severity.

11. Recommendations

Based on the discussions above the researcher has recommended that a transparent account of the firm's risk management objectives and resources required to implement the objective be put in place. A method for identifying, assessing, analyzing, and measuring the key business risks in an organization is available to all employees. A set of risk valuation models for various risk and budgets to finance the models. An open forum for discussing an organization's risk capabilities, such as where it stands in terms of strategy, people, processes, technology and knowledge.

All key business managers need to take part in the risk management process and assume ownership of risks. Only when the business managers have accepted the ownership of risks can we say that the risk management process has been institutionalized. They in turn can impart the risk management process to the entire organization through staff training.

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