

Determinants of Financial Performance of Insurance Companies in Ethiopia

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Abstract

The insurance sector plays important role in contributing to economic growth, efficient resource allocation, reduction of transaction costs, creation of liquidity, facilitation of economic of scale in investment, and spread of financial losses. Financial performance is the most important indicator of good financial management as the objective of financial management is to maximize organization's earnings measured by profitability. This study investigated the determinants of financial performance of insurance companies in Ethiopia based on Secondary data obtained from financial statement of nine insurance companies for eleven years, 2006 to 2016 statements and balance sheet of insurance companies from NBE. The Method of Data analysis used in this study is correlation and multiple regression analysis. The findings of the study indicate that underwriting risk have statistically significant and negative impact on insurers financial performance and also indicates that there is a positive relationship between firm size and financial performance whereas firm size has positive impact on insurers' financial performance. The study recommended that insurance companies can improve their underwriting performance through techniques like product selections; minimize claims leakages and conducting appropriate pre risk survey on the insurable interest before accepting the risk.

Keywords: *Determinants, Insurance, Financial performance*

1. INTRODUCTION

Financial institutions play pivotal role for economic development of a given nation. They interpose themselves between the deficit unit and surplus unit and bridge to provide the economy with financial resource needed to produce goods and provide services to enhance public welfare.

The role of financial institution in a country is that it creates efficient and effective financial system that facilitates economic growth through savings mobilization, risk transfer and intermediation. Financial institutions channel funds and transfers risks from one economic unit to another economic unit so as to facilitate trade and resources arrangement (Batrinca,2014).

The insurance industry plays a major role in the society as they stimulate the economy at large. This is because the sector is part of immune and repair system of an economy and successful operation of the industries and development of an economy (Yuvaraj & Abate, 2013).Indeed, the role of financial institutions and in particular well-developed insurance industry in a country's economy is undoubtedly important it provides long term fund for investors and companies and provide security for their investment. Insurance companies provide unique financial services to the growth and development of every economy. Such specialized financial services range from the underwriting of risks inherent in economic entities and the mobilization of large amount of funds through premiums for long term investments.

The performance of the businesses is very important it leads towards the growth of the whole sector where it is involved and of the overall prosperity of the economy. Discussing and analyzing the determinants of performance of insurance companies are considered important in the corporate finance literature because of their role as intermediaries (Burca & Batrinca, 2014).

According to Hailu (2007), the first significant event that the Ethiopian insurance market observation was the issuance of proclamation No. 281/1970 and this proclamation was issued to provide for the control & regulation of insurance business in Ethiopia. Consequently, it created an insurance council and an insurance controller's office, it strange impact in the sector. The controller of insurance licensed 15 domestic insurance companies, 36 agents, 7 brokers, 3 actuaries & 11 assessors in accordance with the provisions of the proclamation immediately in the year after the issuance of the law.

Ethiopia's Insurance sector has shown strong resilience to a challenging macroeconomic environment and global development. For example, according to a report by NBE (2010) the size of the country's Insurance sector in terms of assets has increased by 47.5% by the end of June 2010. The non- life insurance sector also registered a higher gross written premium of about Birr 1.38 bill thus showing a 17% increase over the previous year's premium. Moreover, the life insurance written premium has increased by 14%.

2. STATEMENT OF THE PROBLEM

The best performance of any industry in general and any firm in particular plays the role of increasing the market value of that specific firm coupled with the role of leading towards the growth of the whole industry which ultimately leads to the overall success of the economy. Measuring the performance of financial institutions has gained the relevance in the corporate

finance literature because as intermediaries, these companies in the sector are not only providing the mechanism of saving money and transferring risk but also helps to channel funds in an appropriate way from surplus economic units to deficit economic units so as to support the investment activities in the economy (Daniel & Tilahun, 2013).

Measuring the performance of financial institutions has gained the relevance in the corporate these companies in the sector are not only providing the mechanism of saving money and transferring risk but also helps to channel funds in an appropriate way from surplus economic units to deficit economic units so as to support the investment activities in the economy (Yuvaraj & Abate, 2013). Transferring funds from surplus units to deficit units is the primary function of insurance companies there for studying financial performance of the industry is important in order to know capacity of the industry.

Studying the financial performance of financial institution is important in particular insurance companies since they transfer risk. Relevant empirical studies of Yuvaraj & Abate (2013), Getahun, (2016) and Daniel & Tilahun (2013) emphasized on the financial performance of Ethiopian insurance companies. The first literatures focused on 9 listed insurance companies in the country and have one dependent variable that is return on asset study the performance of insurance company in Ethiopia. While the second focused on capital structure impact on the on financial performance of insurance industry by using a nine-year data and one dependent variable which is return on asset. While the last literature focused on only nine insurance companies in the country and used return on asset as the main indicator of insurance performance. This study used to fill that research gap. This study uses the listed nine insurance companies while others in the country and use two dependent variables that are return on asset (ROA) and return on equity (ROE) with eleven years' data that determine financial performance of insurance industry in Ethiopia.

3. OBJECTIVES OF THE STUDY

3.1. General Objective

The core objective of this study was to investigate determinants of financial performance of the insurance companies in Ethiopia.

3.2. Specific Objective

1. To investigate the impact of return on asset (ROA) and return on equity (ROE) on financial performance of insurance companies in Ethiopia.
2. To identify the effect of internal factor, that determine the insurance companies' financial performance in Ethiopia specially, underwriting risk, Premium growth, Leverage ratio, Liquidity ratio, Company size, Capital adequacy ratio and Firm age.
3. To rank the factor according to their degree of influence on insurance companies financial performance.

4. LITERATURE REVIEW

Insurance companies provide unique financial services to the growth and development of every economy. Such specialized financial services range from the underwriting of risks inherent in economic entities and the mobilization of large amount of funds through premiums for long term investments. The risk absorption role of insurers promotes financial stability in the financial markets and provides a sense of peace to economic entities. The insurance companies' ability to cover risk in the economy hinges on their capacity to create profit or value for their shareholders. A well developed and evolved insurance industry is a boon for economic development as it provides long- term funds for development (Charumathi, 2012).

Financial performance consists of many different methods to assess how well an organization is using its assets to generate income. Financial performance comprises of operating income, earnings before interest and taxes, and net asset value. It is of great importance to note that no single measure of financial performance should be considered on its own. Rather, a thorough evaluation of a company's performance should take into account many different measures of its performance (Joseph, 2013). Financial performance is a form of record of the financial activity and position of a business measurement of financial performances is an important part of running a business. Generally, the performance of insurance companies is an important indicator of a thriving economy that could lead to an increase in Gross Domestic Product (GDP) of a nation.

Mirie and Cyrus (2014) examine the relationship between selected factors (growth of premiums; size of insurer; retention ratio; earning assets; investment yield; loss ratio; and expense ratio) and financial performance of general insurance underwriters in Kenya. The study employed multiple linear regression analysis with data for 22, 23 and 25 underwriters for the 2010, 2011 and 2012 years respectively. The results were that financial performance was positively related to earning assets and investment yield. Financial performance was negatively related to loss ratio and expense ratio. Growth of premiums, size of underwriter and retention ratio were not significantly related to financial performance. The results emphasize the need for general insurance firms to focus on the investment operations, underwriting results and efficiency. Getahun, (2016) investigate empirically firm specific factors such as, firm leverage, growth opportunities, size, risk, tangibility and liquidity impacts on performance in Ethiopian insurance companies from 2004-2013 annual reports. The results show that firm leverage, Size, tangibility and business risk are significant impact on performance of insurance companies in Ethiopia. While firm growth and liquidity are not clear and statistical proved relationship are obtained from the regression analysis. The results provide strong evidence in support of the pecking order theory of capital structure which asserts that leverage is a significant determinant of firms' performance. A significant negative relationship is established between leverage and performance.

Malik (2011) examined the relationship between volume capital and return on asset for Pakistan insurance industry and found positive and statistically significant relationship between insurance capital and profitability. Tangibility of assets in insurance companies in most studies is measured by the ratio of fixed assets to total assets.

5. RESEARCH DESIGN AND METHODOLOGY

The study is based on quantitative research, which constructed an econometric model to identify and measure the determinants of financial performance. The population of this study is comprised all the insurance firms that are operating in the Ethiopia market from a period of 2006-2016 This study is entirely based on secondary data, secondary data of insurance companies were obtained from the respective sample insurance companies audited financial statements and their annual reports filed with NBE. Descriptive statistics, correlation and multiple regression analysis were used to analyze the data collected.

1.3. Model Specification

$$ROA_i = \alpha_0 + \alpha_1 CS_i + \alpha_2 PG_i + \alpha_3 LVR_i + \alpha_4 LQR_i + \alpha_5 FA_i + \alpha_6 UR_i + e_i$$

$$ROE_i = \alpha_0 + \alpha_1 CS_i + \alpha_2 PG_i + \alpha_3 LVR_i + \alpha_4 LQR_i + \alpha_5 FA_i + \alpha_6 UR_i + e_i$$

Where:

$\alpha_0, \alpha_1, \alpha_2, \alpha_3, \alpha_4, \alpha_5, \alpha_6$ are parameters to be estimated with a priori expectation.

ROA = Return on asset, indicated by the ratio of net income to total assets

ROE= Return on equity, measured by the ratio of net income to total equity

CZ = Company size

FA= Firm age

LQR =Liquidity ratio

LVR = Leverage ratio

PG = Premium growth

UR=Underwriter risk

α_0 = Constant

E = Error term.

6. RESULTS AND DISCUSSION

6.1 Descriptive Statistics

Table1 presents the outcomes of the descriptive statistics for main variables involved in the model of this study. The mean, standard deviation, minimum and maximum value were reported.

Table 1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	99	.04405	.56745	.173639	.0840476
ROE	99	.14452	1.7538	.558450	.2812202
Leverage ratio	99	.03869	1.0019	.648300	.1804419
Liquidity ratio	99	.04671	2.3061	.990883	.3858744
Underwriter risk (Loss ratio)	99	.13	.88	.6538	.13936
Firm age	99	.0	1.00	.37	.486
Premium growth	99	.03425	.592	.25906	.14104
Company size	99	4.128	9.561	8.4029	.67136
Valid N (listwise)	99				

Source: - Author construct from survey Stata data, 2018

The minimum and maximum values also indicated that there is vary between the most financial stable firms and the least financial stable firms in the industry. The standard deviation indicates that there is approximately very good experience in financial management practice. The mean value of leverage ratio is .648300 while the standard deviation is .1804419 implies that there were moderate differences among the values of leverage as measured by debt to equity ratio across the sample insurance companies under this study.

The liquidity ratio measures the firm's ability to use its near cash or quick assets to retire its liabilities. The current ratio was 99% that was far below the NBE requirement of 150% which showed the sector was operating at a low current ratio position during the study period. The average value .990 indicates that for each one-birr current liability there was 0.990-birr current asset to meet obligation. The maximum value and the minimum value was 230% and 46% respectively for the study period. The value of standard deviation 38.5% indicates high dispersion from the mean value of liquidity ratio in the case of Ethiopia insurance companies. It indicates that, there is significant variation among the companies.

Underwriting risk variable is measured by losses incurred divided by annual premium earned. The mean of underwriter risk is 65 percent which is the incurred claims to earned premium ratio that implies on average, most insurance companies from the sample paid 65% loss incurred out of the total premium earned per year with Standard deviation of 0.13936 is significant variation among the companies. In respect of firm age of the mean value is 3 with a standard deviation of 4 this implies that there is a slight variation among the value of age due to the standard deviation with a maximum of 1 it indicates insurance companies that were in operation before 2008 and a minimum of 0 which indicates insurance companies that were in operation after 2007 means a difference in a year of their operation among insurance companies have a slight difference in their financial stability.

Premium growth of insurance companies in Ethiopia shows a mean value of 0.2590 with standard 0.14104 which implies that there is a moderate variation of premium growth among companies. Premium growth range were between the maximum 59% and minimum 3%. This high increase and decrease in premium growth for a company in a particular year indicates that unstable premium underwritings with a standard deviation of 14.1 %. The mean value of Company size 8.4029 with a standard deviation of 0.67136 were there is a moderate variation with a maximum and minimum value of 9.56 and 4.13 respectively the value of total asset between companies have a large variation. Based on the descriptive statistics, company size and liquidity ratio indicated disparity on financial stability.

6.2 Correlation Analysis

Table 2: Correlation Analysis

	ROA	ROE	LR	LQR	UR	FA	PG	CZ
ROA	1							
ROE	.735	1						
LR	.478	.478	1					
LQR	.278	.450	.351	1				
UR	-.574	-.736	-.348	-.325	1			
FA	.066	.253	-.010	.352	.007	1		
PG	.499	.523	.394	.230	-.423	.093	1	
CZ	.468	.327	.252	.081	-.297	-.114	.258	1

Correlation is two tailed significant at 0.05

Source: -Author construct from survey Stata data, 2018

The coefficient for underwriting risk has a negative correlation with Return on asset significantly correlated at 1 percent significant level with a coefficient of -0.547. Firm age has a positive correlation with return on asset with coefficient of 0.66 but not significantly correlated at 1% and 5% significant level. Underwriter risk is significant with negative relationship is not statistically different from zero. Hence high underwriting risk in the sector ensures low ROA, while high Liquidity ratio leads us to high ROA in Ethiopian insurance companies in the last 11 years. The coefficient underwriter risk has a negative correlation with return on equity significantly correlated at 1 percent significant level with coefficient of -0.734. Firm age has a positive correlation with return on equity with coefficient of 0.235 is significantly correlated at 5% significant level. The liquidity ratio (current ratio) with correlation 0.450 has a positive relationship with return on equity at 5 percent significance level.

6.3 Analysis of Variance (ANOVA)

Table 3: Analysis of variance ROA

Model	Sum of Squares	Df	Mean Square	F-Ratio	P-Value (Sig.)
Regression	2.388	7	0.341	39.37	0.000
Residual	0.788	91	0.008		
Total	0.351	98			

Source: -Author construct from survey Stata data, 2018

In order to assess the statistical significance of the result it is necessary to look in the table 4.5 (ANOVA). Table 4.5 shows the absence of committing a statistical type I error since the p-value in the ANOVA table is less than 0.05, meaning that there is a

statistically significant relationship between the variables $F(7,91)=39.37, p=0.000$ at 95% confidence level.

Table 4 :Analysis of variance ROE

Model	Sum of Squares	Df	Mean Square	F-Ratio	P-Value (Sig.)
Regression	2.264	7	0.323	18.04	0.000
Residual	1.632	91	0.017		
Total	3.897	98			

Source: -Author construct from survey Stata data, 2018

In order to assess the statistical significance of the result it is necessary to look in the table 4.6 (ANOVA). Table 4.6 shows the absence of committing a statistical type I error since the p-value in the ANOVA table is less than 0.05, meaning that there is a statistically significant relationship between the variables with $F(7,91)=18.04, P=0.000$ at 95% Confidence level.

6.4. Regression Analysis

Table 5:Regression Analysis on ROA

	Coefficient	Std. Err	T	P	[95%Conf interval]
LEV	.3322154	.0462465	5.32	0.000*	.2082127 .4562181
LIQ	.076915	.0291366	2.64	0.010*	.190387 .1347913
UNDER	-.4772921	.0815751	-5.85	0.000*	-.6393311 -.3152531
FRMAG	.0828397	.0220268	3.76	0.000*	.0390861 .1265933
PREMG	.1684541	.0781631	2.16	0.034**	.0131927 .3237155
COMSZ	-.026	.0153314	2.9	0.0005*	.0140622 .0749699
(Constant)	-1.245874	-.1524563	8.17	0.000	-1.54871 -.9430387
R Square	0.7518				
Adj. R Square	0.7327				
Number of obs	99				

a. Dependent Variable: ROA

Source: -Author construct from survey Stata data, 2018

The R square is 75.1% variations in the dependent variable can be accounted for by the independent variables. This means 75.1% of variations in the financial performance Ethiopian insurance companies are explained by independent variable. This showed that the independent variable values have at least 75% significant influence on financial performance of the Ethiopian insurance companies. This also indicates that there are other variables that influence the variations in the level of performance of the firms. While the result of the Adjusted-R squared indicates that the changes in the independent variables explain 73.2% of the changes in the dependent variable. The coefficient of underwriter risk against ROA is negative-.4772921. This indicates that there is an inverse relationship between the independent variable and ROA. Thus the increase of this variable will lead to a decrease in ROA. On the other hand, variables like

liquidity ratio, leverage ratio, firm age, premium growth and company size had a positive relationship with return on asset since their respective coefficients were 0.3322154,0.076915, 0.0828397,0.1684541 and0.0445161.This revealed that there was a direct relationship between the above six independent variables and ROA.

Table 6: Regression Analysis on ROE

	Coefficient	Std. Error	T	P	[95%Conf interval]
LEV	.466833	.089041	5.20	0.000*	.2884482 .6452177
LIQ	.0184726	.0419146	-3.31	0.660	-.1017309 .0647857
UNDER	-.3889085	.1173504	-3.31	0.001*	-.6220107 -.1558064
FRMAG	.0487074	.0316868	1.54	0.128.	.0142346 .1116495
PREMG	.2379061	.112442	2.12	0.037**	.0145539 .4612584
COMSZ	.091297	.022055	4.14	0.000*	.0474874 .1351066
(Constant)	-1.090386	.2193169	-4.97	0.000	-1.526032 -.654701
R Square	0.5812				
Adj Square	0.5490				
Number of obs	99				

a. Dependent Variable: ROE

Source: -Author construct from survey Stata data, 2018

The R square is 58.1% variations in the dependent variable can be accounted for by the independent variables. This means 58.1% of variations in the financial performance Ethiopian insurance companies are explained by independent variable. This showed that the independent variable values have at least 58% significant influence on financial performance of the Ethiopian insurance companies. This also indicates that there are other variables that influence the variations in the level of performance of the firms. While the result of the Adjusted-R squared indicates that the changes in the independent variables explain 54.9% of the changes in the dependent variable. The coefficient of underwriter risk against ROE is negative -.3889085. This indicates that there is an inverse relationship between the independent variable and ROE. Thus the increase of this variable will lead to a decrease in ROE. On the other hand, variables like liquidity ratio 0.0184726, leverage ratio 0.466833.The ratio demonstrates the potential impact of deficiencies in technical reserves due to occurrence of unexpected losses on the equity (Adams& Buckle, 2003). The result indicates that insurance companies in Ethiopia with high financial leverage have better performance than companies with low financial leverage.

Premium growth 0.2379061and company size 0.091297 had a positive relationship with return on asset since and firm age is 0.0487074 .According to Amal, (2012) analyze the firm performance related to firm age found evidence that firms improve with age, because ageing firms are observed to have steadily increase their levels of productivity, higher profits, larger size, lower debt ratios, and higher equity ratios. Because stock shares are the currency which commands both cash flow and control rights, the tradability of this currency plays a central role in the governance, valuation, and performance of firms. Premium growth 0.2379061 and company size 0.091297. According to Fang & Tice (2009) the result indicates that financial performance of large insurance companies is better than small size companies. Financial performance is likely to increase in size, because large insurance companies normally have greater capacity for dealing with adverse market fluctuations than small insurance companies and

have more economies of scale in terms of the unit cost, which is the most significant production factor for delivering insurance services.

7. CONCLUSIONS AND RECOMMENDATION

The results of the descriptive statistical analysis there is moderate variation between firm age, liquidity ratio and leverage ratio with financial performance and strong variation with underwriting risk, premium growth, company size, among the companies. The results of the regression analysis showed negative relationship between the ratio of underwriting risk (claims incurred to earned premium) and financial performance with strong statistical significance. This shows that as minimizing underwriting risk it will certainly improve the insurers financial performance since taking an excessive underwriting risk can affect the company's stability through higher expenses. The logarithm of total assets has a positive impact on profitability with strong significance coefficient. This indicates that as larger insurance companies of the country experience more significant increases in profitability through economies of scale. In general, all explanatory variables except that of premium growth and firm age such as underwriting risk, liquidity ratio, company size, solvency margin ratio, and leverage has a significant impact on Ethiopian insurance financial performance.

On the basis of the findings of this study, the researcher has drawn the following recommendations:

- Since underwriting is basic activity for insurance industry in Ethiopia, the insurers should reduce the impact of underwriting risk (amount of losses) by improving their underwriting performance through techniques like product selections; minimize claims leakages and conducting appropriate pre risk survey on the insurable interest before accepting the risk.
- The researcher recommends that managers shall not use excessive amount of leverage in their capital structure, they must try to finance their projects with retained earnings and use leverage as a last option. Managers must work to achieve the optimal capital structure level to maximize the firm's performance and try to maintain it as much as possible.
- The insurance companies should try as much as possible to forecast their liquidity requirements and maintain emergency standby in order to meet their customers needs and minimize the risk associated with their investments. This does not mean to leave excess funds idle or to invest in less profitable ventures. By doing this, their liquidity will be safe and the net assets value of the companies would be improved.

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