

# Effects of Capital Structure on Financial Performance of Insurance Companies in Nepal

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Received: April 10, 2020

Accepted: July 29, 2020

Published: September 11, 2020

doi:10.5296/ijافر.v10i3.17674

URL: <https://doi.org/10.5296/ijافر.v10i3.17674>

## Abstract

The study has examined the effects of capital structure on financial performance of insurance companies in Nepal. Data were collected from the annual report of the respective insurance companies' web site. The panel data of 14 Nepalese insurance companies from 2007/08 to 2015/16, leading to a total of 126 observations. The data were analyzed using pooled OLS model, random effect model and fixed effect model. The study has been return on assets as dependent variable whereas total debt ratio, equity to total assets, leverage, firm size, liquidity ratio and assets tangibility are independent variables. The result concluded that equity to total assets, leverage, and assets tangibility have effects the financial performance in Nepalese insurance companies' cases.

**Keywords:** Profitability, Insurance companies, Total debt ratio, Equity to total assets, Leverage, Firm size, Liquidity ratio, Assets tangibility

## 1. Introduction

In insurance company, performance is normally expressed in net premiums earned, profitability from underwriting activities, annual turnover, returns on investment and return on equity. These measures can be classified as profit performance measures and investment performance measures. The relationship between capital structure and profitability has been the subject of remarkable milestone over the past decade. Profit does not only improve upon insurers' solvency state but it also plays an essential role in persuading policyholders and shareholders to supply funds to insurance firms (Chen and Wong, 2004).

The capital structure decision is critical for the continued existence of any business organization so as to maximize returns to stakeholders (Akintoye 2008). The many studies have been carried out to investigate the relationship that exists between financial leverage and performance. Some studies revealed a positive relationship between capital structure and performance (Akintoye 2008; Dare & Sola 2010, and Tayyaba, 2013), while other reported a negative relationship between capital structure and performance (Iorpev and Kwanum 2012). Still, some studies indicated that there is no relationship between capital structure and performance (Prahlathan & Rajan 2011).

In context of Nepal, there are dozens of studies related to banks and manufacturing enterprises. These studies are: Shrestha (1993); Pradhan and Ang (1994); Baral (1996); Ghimire (1999); Pandey (2000); Gajural (2005); Bhattarai (2016); Pradhan and Bhattarai (2016); Maharjan (2017); and Acharya (2019). But, in the particular area of insurance companies have very few studies. So that the present study will fulfil the gap of the insurance industry. The objectives of the study has examine the effects of capital structure on financial performance of insurance companies in Nepal. The studies has focuses on 14 sample insurance companies and 126 observations. The samples were taken from randomly sampling technique. The tested independent variables were taken from the different literature review of nationally and internationally based. These independent variables were total debt ratio, equity to total assets, leverage, firm size, liquidity ratio and assets tangibility which were tested on return on assets. The study found that equity to total assets, leverage, and assets tangibility have effects the financial performance in Nepalese insurance companies' cases.

The further study has organized as follows. Section two has explain literature review. Section three has describes about research methodology. Section four has analysis results and discussion. The final section has taken summary and conclusion with reference of the study.

## **2. Literature Review**

The major literature review related to the study nationally and internationally are summarized as follows. The leverage has positive and significant relationship with financial performance (Baral, 1996). The leverage has negative and relationship found by the studied of Ghimire (1999). Similarly the study of Saeedi and Mahmoodi (2011) have examined the relationship between capital structure and firm performance of Tehran Stock Exchange listed firm and used sample of 320 from 2002 to 2009. The study was tested by three dimensions of leverage such as short term, long term and total debt as independent variables. The dependent variables firm financial performance have major by return on assets return on equity, earning per share and Tobin's Q. The mixed results have found among four dependent variable. The positive and statistically significant result found between earnings per share and Tobin's Q likewise negative result explicit between capital structure and return on assets and no relation with return on equity.

Salim and Yadav (2012) have found that company financial performance ROA, ROE and EPS, adversely influence on long term debt ratio (LTD), short term debt ratio (STD) and total debt ratio (TD), while growth positively effects on financial performance for all the sectors in Malaysia. In addition, Tobin's Q has a positive and significant impact on short term debt (STD)

and long term debt (LTD).

Almajali *et al.* (2012) have examined the financial performance of insurance companies in Jordan based on secondary data of 25 insurance companies from 2002 to 2007. The results showed that the leverage, liquidity, size, management competence index have a positive statistically significant effect on the financial performance.

However, the study of Dogan (2013) has found that financial leverage ratio negatively effects on return on assets. Moreover, firm size has a positive while firm's age has a negative and statistically significant effect on performance of insurance companies listed in Borsa Istanbul.

Bhattarai (2016) has analyzed the effect of capital structure on firm performance of by controlling the effect of firm size, tangibility and growth rate of manufacturing firms listed in the Nepal Stock Exchange using a sample of 8 companies during the period 2004 to 2014. The results showed that the firm performance was negatively associated to the leverage and tangibility. The firm performance was positively associated to the firm size. The study concluded that capital structure significantly negatively affects the firm performance. The capital structure, firm size and tangibility were major determinants of firm performance of Nepalese manufacturing companies.

Pradhan and Bhattarai (2016) have examined the impact and importance of financial leverage on firm performance of 16 commercial banks by using secondary data. The return on assets, return on equity and net interest margin were selected as firm's performance whereas debt to equity ratio, debt to total assets ratio and long term debt to total debt of the firms are selected as financial leverage variables. The result showed that there was negative impact of financial leverage on firm performance.

Almajali and Shamsuddin (2019) have examined the relationship between capital structures on the profitability of the Jordanian insurance firms. The sample was selected 19 insurance companies for a period of 10 years from 2008 to 2017. The dependent variables return on equity (ROE) and Tobin's Q, and independent variables capital structure measured by short term debt, long term debt and equity financing has been used. The control variable were inflation rate and sales growth. The results revealed that short term and long term debt were positively with the (ROE) however negatively with Tobin's Q. The result also showed that financial leverage was positively significant with profitability.

Kerim, Alaji, and Innocent (2019) have examined the effect of capital structure on profitability of listed insurance firms in Nigeria for the period 2013-2017 from secondary data of the 15 listed insurance companies with 75 observations. The results showed that short-term debt has a negative and significant and long-term debt has a positive and significant effect on profitability. Similarly, the premium growth has positively significant effect on profitability. The above discussion shows that the studies dealing capital structure management and the impact on bank performance and insurance companies are of greater significance. Though there are these findings in the context of different countries, no such findings using more recent data exist in the context of Nepal. Hence, this study focuses on the capital structure and financial performance of Nepalese insurance companies.

### 3. Research Methodology

In order to examine the impact of capital structure on financial performance of Nepalese insurance companies, this study contains a sample of 14 insurance companies of Nepal whose respective secondary data are collected from the time period of 2007/08 to 2015/16 from the annual report, leading to a total of 126 observations. The selected insurance companies are: Surya Life Insurance Company limited (SLICL), Nepal Life Insurance Company Limited (NLIC), National Life Insurance Company Limited (NALIC), Himalayan General Insurance Company Limited (HGI), Asian Life Insurance Company Limited (ALICL), Shikhar Insurance Company Limited (SHICL), Gurans Life Insurance Company Limited (GICL), United Insurance Company (Nepal) Limited (UIC), Premier Insurance Company (Nepal) Limited (PRIC), Sagarmatha Insurance Company Limited (SGIC), Life Insurance Corporation Limited (LIC), Prime Insurance Company (Nepal) Limited (PMICL), Prudential Insurance Company Limited (PUICL), Prabhu Insurance Limited (PICL). The study assumes that the selected insurance companies as samples fairly represent of the population. The data are collected time series and cross-sectional data i.e. panel data.

### 4. The Model

In this study three panel models such as pooled OLS model, fixed effect model and random effect model have been employed for data analysis. The data have been analysis through the Gretl software 1.9 version. In the model, the dependent variable is return on assets (ROA) indicated by percentage of net income to total assets. Total debt ratio, equity to total assets, leverage, firm size, liquidity ratio and assets tangibility are independent variables which are tested on return on assets is tested. The model is presented as follows:

$$ROA_{it} = \beta_0 + \beta_1 TDR_{it} + \beta_2 ETA_{it} + \beta_3 LEV_{it} + \beta_4 SIZE_{it} + \beta_5 LIQ_{it} + \beta_6 TANG_{it} + e_{it}$$

Where,

$\beta_0$  = Constant Term

$\beta_1$  to  $\beta_6$  = Coefficient of Variable

ROA= Return on assets of insurance  $i^{th}$  in year t

TDR=Total debt ratio of insurance  $i^{th}$  in year t

ETA= Equity to total assets of insurance  $i^{th}$  in year t

LEV=Leverage of insurance  $i^{th}$  in year t

SIZE= Firm size of insurance  $i^{th}$  in year t

LIQ=Liquidity of insurance  $i^{th}$  in year t

TANG=Assets tangibility of insurance  $i^{th}$  in year t

$e_{it}$  = error term

## 5. Variables Measurement and Expected Results

The description of dependent and independent variables used in the study and their measurement and expected sign are shown in Table 1.

Table 1. Variables measurement and expected sign

Variables	Scales	Notion	Measurement	Expt. Sign	Major Findings
<b>Dependent Variables</b>					
Return on assets	%	ROA	Net income / total assets	N/A	
<b>Independent Variables</b>					
Total debt ratio	%	TDR	Total debt / total assets	-	Mramor and Crnigoj (2009), Friend and Lang (1988)
Equity to total assets	%	ETA	Equity/ total debt	+	Oladele <i>et.al.</i> (2012), Ponce (2013)
Leverage		LEV	Debt /equity	+	Modigliani and Miller (1963), Adams and Buckle (2000), Fosu (2013)
Firm size (in millions of rupees)	M.Rs	SIZE	Natural logarithm of Total assets of firms in millions	+	Oser <i>et al.</i> (2000) Kipesha (2013)
Liquidity ratio	%	LQ	Current assets/ current liabilities	+	Bourke (1989)
Assets tangibility	%	TANG	Total fixed assets /total assets	+	Himmelberg <i>et al.</i> (1999), Wabita (2013), Rusibana (2016)

Source: Field Survey (2020)

## 6. Results and Analysis

### 6.1 Descriptive Statistics

The Table 2 revealed that the descriptive statistics of the study variables. The average ROA is 0.20 percent whereas minimum and maximum ROA are less than 0.10 to 6.09 percent respectively. The standard deviation of ROA is less than 1, It shows that the goodness of data from Standard point of view.

Table 2. Descriptive statistics

Variable	Minimum	Maximum	Mean	Std. Dev.	Skewness	Ex. Kurtosis
<b>ROA</b>	-0.0100	6.0900	0.2021	0.6928	6.6404	47.1769
<b>TDR</b>	0.0000	263.6100	24.8837	31.1888	4.6764	29.6704
<b>ETA</b>	0.0300	17.2200	2.2375	3.5386	2.7383	7.0528
<b>LEV</b>	0.0000	156.0800	33.7567	35.3457	1.1552	0.7072
<b>SIZE</b>	15.5700	9514.0200	1379.9200	1697.5200	2.7160	8.4850
<b>LQ</b>	0.1600	212.0900	12.3600	23.5695	5.6627	40.9744
<b>TANG</b>	0.0300	70.0500	12.8771	14.4848	1.9562	3.5977

Source: Annual Report of Sample Insurance Companies and Results are Draw from Gretl 1.9.6 Software.

The average total debt ratio is 24.88 percent. The minimum and maximum total debt to total assets ratio 0.03 percent to 17.22 percent whereas average is 2.24 percent. Similarly, firm size varies from a minimum of Rs.15.57 million to a maximum of Rs.9514.02 million leading to an average of Rs. 1379.92 million. Liquidity ratio varies from a minimum of 0.16 percent to a maximum of 212.09 percent leading to an average of 12.36 percent. Assets tangibility varies from a minimum of 0.03 percent to a maximum 70.05 percent leading to an average of 12.87 percent.

### 6.2 Correlation Analysis

Table 3 reveals that Person's correlation between dependent variable (ROA) and independent variables (TDR, ETA, LEV, SIZE, LIQ and TANG). ROA is positive with TDR, ETA, and LEV.

Table 3. Pearson's correlation coefficient matrix of study variables

ROA	TDR	ETA	LEV	SIZE	LIQ	TANG	Variables
1.0000	0.3695	0.3287	0.3210	-0.1098	-0.1012	0.1084	<b>ROA</b>
	1.0000	0.3116	0.3726	-0.2798	-0.2964	0.4390	<b>TDR</b>
		1.0000	-0.2787	-0.0506	-0.1234	0.3118	<b>ETA</b>
			1.0000	-0.3651	-0.2487	0.1395	<b>LEV</b>
				1.0000	0.2851	-0.2486	<b>SIZE</b>
					1.0000	-0.2888	<b>LQ</b>
						1.0000	<b>TANG</b>

It indicates that when TDR, ETA and LEV increases ROA also increased. Moreover they are moving on same direction. However, the results show that there is negative relationship between firm size and ROA. This means that larger the firm size, lower would be the return on assets. Similarly, liquidity ratio has a negative relationship with return on assets. This means that higher the liquidity ratio, lower would be the ROA. Although, the result shows that assets tangibility is positive relationship with ROA. It indicates that higher the assets tangibility higher would be the ROA. The correlation matrix reveals that all the correlation coefficients among the independent variables are less than 0.40, implies the absence of multicollinearity.

### 6.3 Regression Analysis

Table 4 shows that regression result of three different model likewise Pooled OLS Model, Fixed Effect Model and Random Effect Model respectively.

Table 4. Regression results

<b>Pooled OLS Model</b>					
Variables	Coefficient	Std. Error	t-ratio	p-value	VIF
Constant	-0.360436	0.129004	-2.7940	0.00607 (***)	
TDR	0.00340078	0.00215175	1.5805	0.11665	1.651
ETA	0.0895313	0.0178814	5.0070	<0.00001 (***)	1.467
LEV	0.00881169	0.00188856	4.6658	<0.00001 (***)	1.633
SIZE	2.95524e-05	3.44706e-05	0.8573	0.39299	1.255
LQ	0.00159084	0.00243042	0.6546	0.51402	1.203
TANG	-0.00623973	0.00420158	-1.4851	0.14016	1.357
R-squared: 0.323607, Adjusted R-squared: 0.289503, F: 9.488883, P-value (F): 1.65e-08 or 0.0000000165, DW: 1.806751					
<b>Fixed Effect Model</b>					
Variables	Coefficient	Std. Error	t-ratio	p-value	
Constant	-0.358101	0.165841	-2.1593	0.03308(**)	
TDR	0.00415009	0.00244036	1.7006	0.09195(*)	
ETA	0.0990707	0.0199931	4.9552	<0.00001 (***)	
LEV	0.00994041	0.00303644	3.2737	0.00143 (***)	
SIZE	3.27799e-05	4.41307e-05	0.7428	0.45925	
LQ	0.0010336	0.00257816	0.4009	0.68930	
TANG	-0.0122965	0.00505426	-2.4329	0.01665(**)	
R-squared: 0.421781, Adjusted R-squared: 0.318137, F: 4.069548, P-value (F): 1.58e-06 or 0.00000158, DW: 2.142448					
<b>Random Effects Model</b>					
Variables	Coefficient	Std. Error	t-ratio	p-value	
Constant	-0.360436	0.129004	-2.7940	0.00607 (***)	
TDR	0.00340078	0.00215175	1.5805	0.11665	
ETA	0.0895313	0.0178814	5.0070	<0.00001 (***)	
LEV	0.00881169	0.00188856	4.6658	<0.00001 (***)	
SIZE	2.95524e-05	3.44706e-05	0.8573	0.39299	
LQ	0.00159084	0.00243042	0.6546	0.51402	
TANG	-0.00623973	0.00420158	-1.4851	0.14016	
S.E. of Regression: 0.581557, Breusch-Pagan Test: Chi-square (1) = 0.215203, P-value = 0.642719, Hausman Test: Chi-square(6) = 12.5032, P-value = 0.0516399					

Note: \*\*\* Significant at the 0.01 level (2-tailed), \*\* Significant at the 0.05 level (2-tailed), \* Significant at the 0.10 level (2-tailed)



In this study, the data analysis technique employed are panel data regression models. The variance inflation factors (VIF) have been tested for collinearity. The Pooled OLS Model VIF less than 2.0 which implies that there is absence of multicollinearity problem.

According to Gujrati (2004) the VIF less than 10 acceptable at the point of view of collinearity. The three models revealed that there is positive and significant result found among ETA and ROA. It implies that the result is priori expectation which is consistent with the study Oladele *et.al.* (2012) and Ponce (2013). The result shows that profitable insurance companies have increase their debt i.e. Insurance policy. Likewise, the leverage is found positive and significant with profitability (ROA) in all three models.

The result indicated that if the insurance companies increases the leverage they will have got more profit and vice-versa. The results is found similar with the study of Modigliani and Miller (1963); Adams and Buckle (2000), Fosu (2013) and Bhattarai (2016). In the Fixed Effect Model, the assets tangibility is found significant but negative with profitability. The findings consistent with study of Getahun (2016) and Bhattarai (2016). It is significant effect to the profitability but opposite direction.

## 7. Summary and Conclusion

The study has examined the effects of capital structure on profitability of insurance companies in Nepal. Data were collected from the annual report of the respective insurance companies' web site. The panel data of 14 Nepalese insurance companies from 2007/08 to 2015/16, leading to a total of 126 observations. The data were analyzed using pooled OLS model, random effect model and fixed effect model. The study has been return on assets as dependent variable whereas total debt ratio, equity to total assets, leverage, firm size, liquidity ratio and assets tangibility are independent variables. The result concluded that equity to total assets, leverage, and assets tangibility effects the profitability in Nepalese insurance companies' cases.

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