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The Influence of Financial Ratio on Financial Distress of General Insurance Companies in Indonesia

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Abstract

This study aims to analyze the effect of financial ratios on financial distress of general insurance companies in Indonesia from 2017 to 2021. The research method used is a quantitative approach with testing using logistic regression analysis on the STATA program. Data sources come from annual reports that have been audited and submitted to the Financial Services Authority. The type of data used is secondary data based on the financial statements of general insurance companies. The results show that Early Warning System indicators including equity, risk-based capital, and investment adequacy ratio have a significant negative effect on financial distress. Furthermore, other financial ratios, namely the operating result ratio, liquidity ratio have a significant negative effect on financial distress, while the loss ratio has a positive effect on financial distress. This study suggests that the authorities continue to use EWS in their supervisory activities and can add other ratios as part of the supervisory tools.

1. Introduction

Disclosure of financial difficulties is an important discussion in economic and accounting literature because it affects several stakeholders (Bredart, 2014). When a company faces financial difficulties, many parties will be affected, namely investors, debtors, creditors, employees, government/authorities, auditors, consumers and the general public. During the economic crisis of 2007, when many businesses faced financial difficulties and filed for bankruptcy, detection of financial difficulties became a significant problem (Li and Zhong, 2013).

The condition that most often occurs during financial difficulties is the company's inability to pay off its obligations, either partially or completely. The failure of an entity to fulfill its commitments,

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especially temporary obligations, is caused by several factors. Firstly, it could be because the running business is not producing any results at all. Furthermore, it is possible that the organization has reserves, but in its development the organization does not have adequate assets in the form of real money (Kasmir, 2012: 121).

Inadequacy in handling financial difficulties will result in the need for additional capital from shareholders or, worst of all, closing the company. In the last four decades, the development of prediction models for the possibility of bankruptcy or financial distress has become the main focus of various parties in the finance sector. The development of the characteristics of companies that face financial difficulties and bankruptcy periodically becomes a significant aspect for practitioners, academics, as well as the government or related authorities. This requires continuous monitoring, testing and improvement of the performance of existing prediction models. Accuracy in monitoring the financial condition of a financial services institution is important for regulators. Likewise, determining the feasibility of a business for auditors as valid information for potential investors, including measuring portfolio risk, setting credit derivative prices and taking into account other fixed income effects is part of the expansion of the prediction model. Analyzing a company's financial reports can provide insight into the condition or evolution of the company and the performance it has achieved from the previous period to the present. The financial distress faced by a company can be determined by analyzing financial ratios (Widhiari and Merkusiwati, 2015). As is the case with knowing a company's performance by using financial ratios as indicators for a period presented in the company's financial reports (Jiming and Weiwei, 2011). Kasmir (2012:216) revealed that liquidity, leverage and profitability ratios can be useful indicators for predicting the possibility of financial bankruptcy. The capability to fulfill a company's direct financial responsibilities is measured byliquidity ratio. Liquidity measures used in research include:*Current Ratio*And*Working Capital to Total Assets*(WCTA).The entity's ability to fulfill its short-term commitments using current assets is called the Current Ratio, while the comparison between working capital (current assets - current liabilities) and total assets is called WTCA. The WTCA ratio is a metric that assesses the liquidity of a company's assets compared to its total capital (Kasmir, 2013). Furthermore, assessing a company's ability to generate profits is known as profitability (Kasmir, 2013). Various studies generally use the rate of return on equity, better known as ROE, and the profitability of assets ratio, also known as ROA. Both are performance indicators, where ROE is a ratio that shows the efficiency of using its own capital, while ROA is a ratio that reflects the rate of return on a number of assets that the entity has for use. The profitability measure shows that conditions are getting better if the two ratios in question are higher (Kasmir, 2012).

The financial services sector, which is the driving force of the economy in a country, including Indonesia, continues to grow. The intermediation capabilities carried out by various financial institutions in their development to date have provided a great commitment in the availability of a number of funds to finance national development in the economic sector, especially the circulation of money in society.

The insurance industry, which is a sector in financial services after banking, also has a significant role in supporting national development. This happens through collecting public funds through insurance premium payments which are then invested. These funds can provide financial assistance for expansion in both the short and long term. Insurance is a financial service institution that provides a sense of security to individuals by covering the risk of events that result in losses, such as accidents, loss, damage and other risks specified in the insurance policy.

The development of the national insurance industry continues to show signs of strong growth, as reflected in the increasing public interest in insurance products. This can be observed from the latest trends in market conditions which show increased public awareness and participation in purchasing and understanding insurance protection. As of December 31 2021, data from the Financial Services Authority shows that there are 149 insurance companies in Indonesia that have obtained

business permits. There are 77 general insurances, 60 life insurances, 7 reinsurances, 3 mandatory insurances, and 2 social insurances. Trends in the quantity of insurance business from 2017 to 2021 are presented in 1.

Table 1. Composition of the Number of Insurance Companies

Business fields	2017	2018	2019	2020	2021
General insurance	79	79	79	77	77
Life insurance	61	60	60	59	60
Reinsurance	7	7	7	7	7
Mandatory Insurance	3	3	3	3	3
Social Insurance	2	2	2	2	2
Total	**152**	**151**	**151**	**148**	**149**

Source: Primary Data 2021

In 2021, the insurance market recorded gross premiums of IDR 530.9 trillion based on figures from the Financial Services Authority. Density is a measure that shows how much the average person in a population spends on insurance premiums. In the context of Indonesia, where the population is estimated to reach 272.2 million people in 2021, the average density of insurance premiums can be calculated at IDR 1,950,756 per individual. Density means that each Indonesian resident in 2021 will on average spend IDR 1,950,756 to pay insurance premiums. On the other hand, the insurance sector penetration rate or the percentage of gross premiums to Gross Domestic Product (GDP) is expected to fall in 2021. This figure fell by 0.13%, reaching 3.13% compared to a level of 3.26% in the previous year. indicates that the contribution of the insurance sector to the national economy has decreased during this period. Meanwhile, there was an increase of 5.8% in the number of gross claims for the insurance industry in 2021 compared to 2020, where in 2021 gross claims were recorded at IDR 377.07 trillion, an increase from 2020 of IDR 356.53 trillion.

The development of the insurance industry is not yet fully in line with the level of public trust in insurance. Cases of insurance company failure to pay in recent years have become an obstacle to the development of this industry, because this often makes people hesitate to buy insurance products. At the beginning of February 2023, 11 insurance companies were recorded as under OJK special supervision status after 13 insurance companies in the previous year and improvements had been made to 2 companies so that they could return to normal supervision, 1 company had to have its business license revoked and there was an additional 1 company which was included in the special supervision category (Kompas, 2023). Determination of supervisory status is part of the risk-based supervision implemented by OJK in order to increase supervisory measures for non-bank financial services institutions as regulated in Financial Services Authority Regulation Number 9/POJK.05/2021 concerning Determination of Status and Follow-up Supervision of Non-Bank Financial Services Institutions.

On the other hand, the level of public understanding of insurance has improved with an increase in the literacy index from 19.4% in 2019 to 31.72% in 2022 but this is not accompanied by an increase in inclusion which only increased from 13.2% in 2019 to 16 .6% in 2022.

Regulations related to the financial health of insurance companies and reinsurance companies have been issued by the Financial Services Authority through Financial Services Authority Regulation number 71/POJK.05/2016 concerning the Financial Health of Insurance Companies and Reinsurance Companies (POJK 71/2016). This regulation provides guidelines and provisions that require

compliance with the company's financial health level at all times. Setting the level of a company's financial health includes several aspects, namely the level of solvency, formation of technical reserves, adequate investment, own capital, adequacy of guarantee funds and several other provisions related to the company's financial stability. An assessment of each existing element is an important basis for understanding the company's health condition in determining the steps needed to maintain its financial health. In accordance with Financial Services Authority Regulation number 71/2016, the minimum solvency level required is 100% or the equivalent of minimum risk-based capital (MMBR). The minimum internal solvency level must be 1.2 times the MMBR, taking into account the company's risk profile and the results of simulations of various scenarios (stress tests). It is important to maintain a company's internal solvency above a minimum threshold, taking into account risks and capacity to handle changing conditions in the future.

Risk-based supervision has been implemented by the Financial Services Authority to supervise the insurance industry. Supervisory operations for insurance businesses within a risk-based supervision framework vary in focus and intensity depending on the company's risk level. The success of risk-based supervision is highly dependent on the analytical techniques used to assess a company's risks.

The risk analysis process in the context of the insurance business involves the stages of detection, measurement and comprehensive analysis of a number of risks that may arise in the company's operations. These risks include aspects such as insurance risk, operational risk, liquidity risk, market and investment risk, and capital-related risks. The use of analytical methods that are able to detail the company's risk profile is the main thing for insurance sector supervisors to be able to properly understand the characteristics of the risks faced by the company, so that relevant and timely supervisory actions can be formulated. A careful and structured risk analysis process is the key to providing the information needed for effective supervisory decision making.

Insuranc companies can proactively find, assess and evaluate risks using Early Warning System (EWS) techniques. EWS is a set of indicators and ratios designed to evaluate the financial performance and resilience of insurance companies, identifying areas that require closer monitoring and rapid response. EWS can be used to carry out a comprehensive examination of an insurance company's risk profile. The results of the EWS analysis provide a comprehensive picture of the financial condition and risks that the company may face. This information becomes a tool for the supervisory authority to carry out its duties more effectively, and makes it possible to take appropriate preventive or corrective action according to the circumstances identified through the EWS.

OJK, which has the authority to regulate and supervise the financial services sector, one of which is insurance, has equipped its supervisory apparatus with the tools or instruments needed to carry out EWS measurements for the insurance industry. In 2019, the EWS guidelines were implemented by the Financial Services Authority, using three key financial ratios, namely 1) Solvency Achievement Ratio (RBC), 2) Total Own Capital, and 3) Investment Adequacy Ratio (RKI). Each result of these ratios is then classified into three main criteria, namely normal, alert and alert. This approach provides a structured framework for the Financial Services Authority to monitor and assess the level of financial health of insurance companies.

In accordance with Article 2 POJK Number 71 of 2016, insurance and reinsurance business actors must consistently comply with the specified financial stability criteria. Assessing a company's financial well-being involves evaluating key factors such as solvency, technical reserves, investment adequacy, equity, guarantee funds, and other considerations important for financial stability. Furthermore, article 19 of POJK 71/2016 regulates liabilities which include: 1) All company liabilities, including technical reserves which must be included in calculating the solvency level. 2) formation of technical reserves adjusted to the type of product. 3) Actuaries are responsible for the process of establishing technical reserves

Article 25 of the Financial Services Authority Regulation 71/206 mandates the investment adequacy requirements that insurance and reinsurance companies must comply with as follows: 1) Obligation to have reasonable assets (AYD) in the form of investments and non-investments in the form of cash and banks. These two amounts must be equal to the sum of own retention technical reserves, own retention claim liabilities, and other liabilities. 2) Liability for payment of retention claims is the company's obligation to pay claims that have been approved but are still outstanding. This liability is then reduced by claims expenses which are part of reinsurance.

The specific regulation of equity is contained in article 33 POJK number 71 of 2016. The provisions in question stipulate that each insurance company has a minimum equity of one hundred billion rupiah. Through this regulation, the OJK provides a clear and firm legal basis in order to guarantee that insurance companies have sufficient capital to support operational activities and provide adequate financial protection for policy holders and other stakeholders.

Research on 64 companies listed on the Nairobi Securities Exchange for a period of one decade was conducted by Ogachi (2020). This research uses logistic regression to build a predictive model to identify financial difficulties in companies. Research findings show that the variables asset turnover, total assets, and working capital ratio have positive coefficients in predicting bankruptcy. On the other hand, the variables inventory turnover, debt to equity ratio, debtor turnover, debt ratio and current ratio have negative coefficients. Research shows that inventory turnover, asset turnover, debt to equity ratio, debtor turnover, total assets, debt ratio, current ratio, and working capital ratio are key indicators in estimating company bankruptcy.

Curry, K., and Banjarnahor (2018) examined the determinants of financial difficulties in public property businesses in Indonesia. Liquidity, profitability, and financial leverage have a negative correlation with the likelihood of a financial crisis, as this research shows. Earnings per share (EPS) has a positive impact on the possibility of financial distress. Sales growth does not have a major impact on financial distress among public property companies in Indonesia.

Fadrul and Maria (2019) conducted research examining how Early Warning System (EWS) variables

Including Claim Expense Ratio, Asset Liquidity Ratio, Own Retention Ratio, and Risk Based Capital (RBC) influence the financial performance of general insurance businesses. This research uses multiple linear regression analysis to estimate the correlation between these variables and Return on Assets (ROA), which functions as a proxy for a company's financial performance. The research results show that Early Warning System (EWS) components such as Claim Expense Ratio, Asset Liquidity Ratio, and Own Retention Ratio have a significant effect on the financial performance of general insurance companies. Risk Based Capital (RBC) does not have a significant effect on financial performance. These findings provide a deeper understanding of how certain indicators in the EWS can influence the financial performance of general insurance companies.

Mutia (2019) examined the impact of ratios in the financial early warning system on the share prices of insurance companies listed on the Indonesia Stock Exchange. This research uses multiple linear regression analysis to evaluate the relationship between these ratios and insurance company stock prices. The study determined that the ratio of early warning systems has an important impact on the stock value of insurance businesses. It is understood that the claims expense ratio, liquidity ratio, and premium growth ratio have an important impact on stock value. However, the partial fund adequacy ratio does not have a big influence on share prices.

Previous research provides inconsistent results regarding the impact of several financial ratio variables on Early Warning System (EWS) forecasts. This ratio is complicated due to its tiered assessment criteria, which vary based on certain factors. Financial ratios are generally studied as a method for predicting financial stress in insurance companies.

The use of EWS variables to assess insurance company performance has also been widely used. Research on the EWS ratio for early prediction of financial difficulties in general insurance businesses

has never been conducted. This research will use a sample of general insurance business actors registered with the Financial Services Authority as research objects. The research was conducted for a period of 5 years, namely from 2017 to 2021. Based on this, the author formulated the research title "The Influence of Financial Ratios on Financial Distress of General Insurance Companies in Indonesia".

2. Materials and Methods

This research uses annual financial report data from general insurance companies in Indonesia from 2017 to 2021 sourced from the Financial Services Authority (OJK). This research uses population data from general insurance companies in Indonesia. Namely general insurance companies registered with the Financial Services Authority in the period 2017 until 2021 and general insurance companies in Indonesia that report audited financial reports from 2017 to 2021. Thus, the population data obtained is panel data with general insurance companies as cross sections and data years 2017 to 2021 as time series.

This research uses secondary data taken from OJK data in the form of annual financial reports of General Insurance Companies in Indonesia from 2017 to 2021. The data collection technique was carried out by observing the financial reports of general insurance companies in Indonesia which had been audited and submitted to the OJK. The research instrument is a logistic regression model along with estimators and tatistical tests to estimate the influence of the independent variable on the dependent variable. The estimator used is Maximum Likelihood Estimation (MLE) and the statistical tests used are the multicollinearity test and the Goodness of Fit (GOF) statistical test.

3. Results and Discussion

Results

The data used in this research is secondary data in the form of annual financial reports of General Insurance companies in Indonesia from 2017 to 2021. The data source comes from the Financial Services Authority (OJK), which is in the form of financial reports published and registered with the Financial Services Authority (OJK).

This population is all General Insurance companies registered with the Financial Services Authority (OJK) from 2017-2021.

Hypothesis testing

1. *Hypothesis Testing* H1 : Total Equity (EQU) has a negative influence on the potential for Financial Distress.

   The EQU variable has negative significance because the EQU coefficient value is negative and the absolute value of the t-statistic for the four models is; so H0 is rejected at α=0.01. Thus, Total Equity (EQU) has a negative influence on the potential for Financial Distress. $|t_{stat}| > 2.55$
2. *Hypothesis Testing* H2 : Risk Based Capital(RBC) has a negative influence on the potential for Financial Distress. $|t_{stat}| > 2.55$

   The RBC variable has negative significance because the RBC coefficient value is negative and the absolute value of the t-statistic for the four models is; so H0 is rejected at α=0.01. Thus, Risk Based Capital (RBC) has a negative influence on the potential for Financial Distress. $|t_{stat}| > 2.55$.
3. *Hypothesis Testing* H3 : The Investment Adequacy Ratio (RKI) has a negative influence on the potential for Financial Distress.

The RKI variable has negative significance because the RKI coefficient value is negative and the absolute value of the t-statistic for the four models is; so that H0 is rejected at α=0.05. Thus, the Investment Adequacy Ratio (RKI) has a negative influence on the potential for Financial Distress.1.96. $|t_{stat}| > 2.55$

4. *Hypothesis Testing* H4 : The Insurance Business Results Ratio (RHU) has a negative influence on the potential for financial distress.

   The RHU variable has negative significance because the RHU coefficient value is negative and the absolute value of the t-statistic for the four models is; so that H0 is rejected at α=0.05. Thus, the Insurance Business Results Ratio (RHU) has a negative influence on the potential for financial distress. $1.96 < |t_{stat}| \leq 2.55$

5. *Hypothesis Testing* H5 : The Liquidity Ratio (LIQ) has a negative influence on the potential for Financial Distress.

   The LIQ variable has negative significance because the LIQ coefficient value is negative and the absolute value of the t-statistic for the four models is; so H0 is rejected at α=0.01. Thus, the Liquidity Ratio (LIQ) has a negative influence on the potential for Financial Distress. $|t_{stat}| > 2.55$

6. *Hypothesis Testing* H6 : *Loss ratio* (LOSS) has a positive influence on the potential for Financial Distress.

   The LOSS variable has positive significance because the LOSS coefficient value is positive and the absolute value of the t-statistic for model 2 is$|t_{stat}| > 2.55$and for model $41.96 < |t_{stat}| \leq 2.55$; so that H0 is rejected at α=0.01 for model 2 and at α=0.05 for model 4. Thus, the Loss ratio (LOSS) has a positive influence on the potential for Financial Distress.

The results of hypothesis testing and their coefficients can be seen in the table below:

Table 2. Hypothesis Results

Hypothesis	Model 1 Test Results	Model 2 Test Results	Model 3 Test Results	Model 4 Test Results
H1: Total Equity (EQU) has a negative influence on the potential for Financial Distress	H1 is accepted (coef. -1.332)	H1 is accepted (coef. -1.345)	H1 is accepted (coef. -1.408)	H1 is accepted (coef. -1.371)
H2: Risk Based Capital (RBC) has a negative influence on the potential for Financial Distress	--	--	H2 is accepted (coef. -0.0108)	H2 is accepted (coef. -0.0109)
H3: The Investment Adequacy Ratio (RKI) has a negative	H3 is accepted (coef. -0.0113)	H3 is accepted (coef. -0.0106)	--	--

influence on the potential for Financial Distress				
H4: The Insurance Business Results Ratio (RHU) has a negative influence on the potential for financial distress	H4 is accepted (coef. -0.0135)	--	H4 is accepted (coef. -0.0113)	--
H5: Liquidity Ratio (LIQ) has a negative influence on the potential for Financial Distress	H5 accepted (coef. -0.0329)	H5 accepted (coef. -0.035)	--	--
H6: Loss ratio (LOSS) has a positive influence on the potential for Financial Distress	--	H6 accepted (coef. 0.0213)	--	H6 accepted (coef. 0.0125)

Source: Primary Data 2021

Discussion

Based on the results of research using the logistic regression method, the independent variables used are equity (EQU), Risk Based Capital (RBC), Investment Adequacy Ratio (RKI), Insurance Business Results Ratio (RHU), Liquidity Ratio (LIQ), and Loss Ratio (LOSS), allsignificantly influenceFinancial Distress(FD) general insurance company in Indonesia.

Under normal conditions, where there are no capital deposits or operational losses, the equity value (EQU) of general insurance companies will tend to increase along with the growth of the company's operating profit. Furthermore, (Archanskaia et al., 2023; Iftinan & Trisnawati, 2023; Pietrzak, 2022; Septarini, 2022) states that increasing the amount of equity will reduce the opportunity forFinancial Distress(FD). Company equity is the main component that can encourage business activities which ultimately provide revenue. Therefore, the results of this research, namely that equity (EQU) has a significant effect on reducing the chance of Financial Distress (FD) is in accordance with the initial hypothesis and can be used as the main predictor variable for the Early Warning System (EWS).

On the other hand, the Risk Based Capital (RBC) variable provides an overview of the company's financial stability. As stated by (Gennaro, 2021; Sadaa et al., 2023; Zhao et al., 2024), that a decrease in this variable will have an impact on increasing the chances of Financial Distress (FD). On the other hand, increasing company stability will certainly reduce the company's chances of experiencing

financial difficulties or Financial Distress (FD). Therefore, the results of this research, namely that Risk Based Capital (RBC) has a significant effect on reducing the chance of Financial Distress (FD) is in accordance with the initial hypothesis and can also be used as the main predictor variable for the Early Warning System (EWS).

The final EWS variable, namely the Investment Adequacy Ratio (RKI), provides an overview of the adequacy of a company's assets in the form of investment and cash which can cover the company's obligations to policyholders. (Andersen & Juelsrud, 2023; Çam & Özer, 2022; Glocker & Url, 2022; Liu et al., 2022) states that increasing this variable will reduce the chance of Financial Distress (FD). Adequacy in fulfilling obligations to policyholders is a signal of the absence of financial difficulties, so the results of this research, namely the Investment Adequacy Ratio (RKI), have a significant effect on reducing the chance of Financial Distress (FD) which is in accordance with the initial hypothesis and can also be used as the main predictor variable for Early Warning. System (EWS).

The first additional variable, namely the Insurance Business Results Ratio (RHU), provides an idea of whether the amount of premium obtained by the company is able to cover the insurance expenses that arise. (Isayas, 2021; Octavia & Aidina, 2020; Restianti & Agustina, 2018; Septyanto et al., 2022) states that a low RHU value indicates that the insurance burden cannot be financed from the premiums obtained so there is a possibility that it will be taken from operational expenses. This can cause losses which ultimately result in Financial Distress (FD). The adequacy of the premium value obtained to cover insurance expenses is a signal of the absence of financial difficulties, so the results of this research, namely the Insurance Business Results Ratio (RHU), have a significant effect on reducing the chance of Financial Distress (FD) which is in accordance with the initial hypothesis and can also be used as an additional variable. for the Early Warning System (EWS).

The second additional variable, namely the Liquidity Ratio (LIQ), provides an illustrationthe company's ability to repay its short-term loans. (Masdupi et al., 2018; Moch et al., 2019; Wisnu & Astuti, 2023) states that a high LIQ value will reduce the potential for Financial Distress (FD). Adequate liquidity value shows that the company has reserves and is better prepared to fulfill its obligations and is a signal of the absence of financial difficulties. The results of this research, namely that the Liquidity Ratio (LIQ) has a significant effect on reducing the chance of Financial Distress (FD) is in accordance with the initial hypothesis and can also be used as an additional variable for the Early Warning System (EWS).

The final additional variable, namely Loss Ratio (LOSS), provides an overview of losses to insurance companies. (Arifiana & Khalifaturofi'ah, 2022; Ritho et al., 2023; Trie Chandra Dewi, 2016) states that this ratio has a strong correlation with Financial Distress (FD). The large value of the claim against the premium value will cause the company to experience losses which, if it occurs continuously, is an indication or signal of increasing Financial Distress (FD). Therefore, the results of this research, namely that the Loss Ratio (LOSS) has a significant effect on increasing the chance of Financial Distress (FD) is in accordance with the initial hypothesis and can also be used as an additional variable for the Early Warning System (EWS).

4. Conclusion

Based on the results of data analysis, the conclusions obtained in this research (three points) are stated as following.

1. The EWS variable has a very important role in relation to Financial Distress in the general insurance industry in Indonesia. The EWS variables in this study include Equity (EQU),*Risk Based Capital*(RBC), and Investment Adequacy Ratio (RKI).
2. The three EWS variables, namely EQU, RBC, and RKI have a significant negative influencepotential for Financial Distress (FD) in the general insurance industry in Indonesia.

3. VariableInsurance Business Results Ratio (RHU), Liquidity Ratio (LIQ), and Loss Ratio (LOSS) also significantly influence the potential for Financial Distress (FD) in the general insurance industry in Indonesia. The RHU and LIQ variables have a significant negative effect on FD, while the LOSS variable has a significant positive effect on FD.

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