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GOVERNMENT REGULATION AND SUSTAINABILITY OF KENYA'S INSURANCE COMPANIES

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Abstract

Purpose: The study investigated government regulation and sustainability of Kenya's insurance companies.

Methodology: The study adopted the positivist research philosophy and employed a descriptive research design. The target population of the study was the 51 insurance companies registered by the Insurance Regulatory Authority (IRA) of Kenya as at 31st December 2016. The study took a proportionate sample of 30 companies from 10 life, 15 general and 5 composite companies. The primary data collection was through a structured questionnaire with closed questions. A pilot study was carried out before questionnaire distribution, which ensured the research instrument validity and reliability, before distribution through both hand delivery and email, followed by a telephone call to the respondents and a research assistant later visiting the respondents to collect the filled questionnaires. The raw data was cleaned, edited, coded and analyzed to generate descriptive statistics of ANOVA and T-test and inferential statistics of mean, standard deviation and frequencies, while secondary data was collected using data collection sheets.

Study Findings: The findings showed that there is a moderating effect of government regulation on drivers of sustainability of insurance companies in Kenya. While there was positive and significant effect of government regulation on capital adequacy, management capability and sensitivity to risk, government regulation had no moderation on asset quality as management of other variables of management quality, capital adequacy and risk sensitivity would address the quality of capital.

Unique Contribution: The study recommends that IRA opens up the RBC measurement tool to bring in sustainability and management indices. Further, IRA should review regulation to support the insurance companies to enhance innovation and customer service delivery, which are key for growth, and sustainability of the various insurance companies in the country.

Key Words: *Government regulation, performance sustainability, insurance companies.*

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1.0 INTRODUCTION

1.1 Background of the Study

The enactment of the insurance Act of 1987 of the laws of Kenya (CAP.487) established a framework for regulation of the insurance sector in the country. A division of insurance, under the Ministry of Finance headed by the Commissioner of Insurance was set up to deal with the nature and extent of the operations of insurance business. The Act set out registration requirements for insurance companies and other stakeholders as well as spelling out the rights and privileges of insurers and the insuring public. The Act defined the role of the Commissioner of Insurance, to be that of the authorization of applications for conduct of insurance business in the country in addition to ensuring the solvency (admitted assets divided admitted liabilities) margin is not below certain prescribed levels. The other roles of the Commissioner of Insurance are monitoring various players in the industry to ensure compliance to minimum set standards of operation and taking appropriate intervening measures when insurance companies face difficulties to protect the insuring public's interests. The commissioner also monitors the day-to-day conduct of business such as advertising, treating the customer fairly, misleading statements, connected intermediaries and oversees winding up of failed insurance businesses.

The UN General Assembly agreed on the Sustainable Development Goals (SDG's) in 2015. The SDG's encompass environmental, social and economic targets that each country has to strive to meet towards a more sustainable future of their population. A more sustainable future is the ability of current businesses to address sustainability in a way that meets the needs of their customers, employees, communities and the environment. Sustainability entails addressing issues that concern the people, the planet and the prosperity of the firm. Climate change, energy, water, stewardship, marine conservation, biodiversity, poverty, food security, sustainable production and consumption, gender equality and economic growth are issues addressed under SDG (Jones *et* al., 2017).

Achieving sustainable development in Kenya is part of Vision 2030. The Kenyan Vision 2030 has Financial Services sector as a key strategy to create a vibrant and competitive global financial services sector in Kenya, which will create jobs and enhance the much-needed savings to finance the country's economic development. The vision proposes financial reforms to increase savings from 17% to 40% of GDP, introduce credit reference bureaus to enhance customer background checks and therefore reduce risk and cost of borrowing. Pension sector reforms will affect the insurance companies, as they are partners in savings accumulations through the various products offered to the insured clients. The expansion of the bond equity markets and creation of a regional financial center will further deepen the insurance companies operating scope. The vision 2030 further aims at creating a nation that has a clean, secure and sustainable environment by 2030 through increased forest cover from 2% to 4%, conservation of forest cover, solid waste management and water catchment areas management and thereby reducing the effects of climate change to the country and therefore enhancing the vision of sustainable development.

The Kenyan insurance industry has faced increased regulatory framework, and therefore insurance companies might find it difficult to comply with risk based capital regime. The risk based capital regime defines available capital as the initial capital contributed to start the insurance business plus retained earnings which is the accumulation of annual earnings after tax and any debt the firm might have brought into the firm to support both operating and investment needs. The annual performance of an insurance firm influence available capital in terms of retained earnings. The insurance industry has faced a very difficult operating environment in the last 15 years reporting underwriting losses during most of the period. The revision of the old Insurance Act of 1987 (CAP 487 of the laws of Kenya) is addressing some of these challenges.

This study will be of help to several individuals and organizations. Individual investors invest their funds in insurance companies expecting safety of their funds and returns when due and therefore the findings will avail a pool of information of the companies that are adopting sustainability strategies and therefore help the investor to make the right investment choices. This will aid in raising funds required in achieving some of the Kenya Governments Big Four agenda items like affordable housing and infrastructure development.

1.2 Problem Statement

The Kenyan insurance companies have persistently faced poor investment practices and non-compliance to cash and carry law. These have led to poor premiums collection, low levels of innovation and adoption to new technology; significant shortage of skilled staff, capital inadequacy, mis-selling by insurance intermediaries and severe price undercutting among the many competitors. The poor business practices have led to collapse of 7 companies, representing 16% of the companies in operation during the period under study. The collapse of the insurance companies resulted into loss of employment, reduction in taxes paid to the government and loss of shareholder capital. The collapse of the insurance companies meant inability to pay claims in full, and on time resulting into ultimate collapse of social and economic pillars of insurance sustainability and stability. The collapse of insurance companies coupled with asset and liability mismatch, fraud and mismanagement necessitated the investigation into the drivers of an insurance company's sustainability in Kenya. Therefore, for an insurance company to be sustainable, it has to ensure that the claims costs, management expenses and acquisition costs are contained at a level that is lower than the net earned premiums. There are several studies done in Kenya in the past on the insurance sector performance, however, no study explores the drivers of performance of insurance companies and sustainability in Kenya. It is against this backdrop that the investigation on the effect of government regulation on the drivers of sustainability of insurance companies in Kenya was envisioned.

2.0 LITERATURE REVIEW

2.1 Theoretical Review

The Agency and the stakeholder theories that consider the relationship between the various stakeholders in the insurance industry were considered for the study. The focus of the agency theory is on the relationship between business owners as the principals and the managers as the agents who perform tasks on behalf of the principals. Whereas managers feel that debt may place their jobs at risk, they may fail to use debt to the detriment of the principals mainly due to agency-principal conflict. On the other hand, shareholders, who can diversify away any company specific risks, prefer riskier projects and therefore management might pass up positive net present value projects whose benefits accrue primarily to debtholders and not directly to themselves. Asset substitution and claim dilution are the other agency conflicts found between debtholders and shareholders (Smith & Warner, 2009).

Manager are likely to run a firm inefficiently or contrary to shareholder interests if they own only a small portion of a company's stock or when they own no stock at all (Berle & Means, 1932). In such a case, adverse selection arise because the principal cannot ascertain whether the agent performs his job with all his ability and therefore cannot justify the pay for the job. A moral hazard arise in that he cannot be sure whether the agent exerts all his effort, in doing the job that he has been engaged to do.

The agency cost arises due to the differing interest of owners and managers or owners and debt holders resulting into conflict (Jensen & Meckling, 1976). Different costs arise when companies use equity capital, including agency cost of capital, which arises in the firm due to the conflict of interests between shareholders and managers associated with the firm's decision-making process (Jensen, 1986). When there is a disagreement between the shareholders and debt holders in the firm, the agency cost of debt would arise. Thus, when the management inappropriately uses debt or equity in the formation of debt equity mix, it would be risky for the survival of the firm. To mitigate the problem Jensen (1986) suggests debt holders use their credit as a means of controlling managers in terms of the imposed restrictive covenants.

The various financing and corporate strategy choices can offer motivational incentives to the different stakeholders that limit value-reducing behavior thereby diminishing the relevant agency costs. Specifically, the choice of management ownership structures, use of debt and profits as dividends can moderate agency costs emerging from the companies financing contracts (Crutchley & Hansen, 2009). Jensen and Meckling (2006) proposed that management expand its share of ownership in a firm and move towards aligning their interests with those of the shareholders and therefore ensuring there is interests convergence.

The second theory under consideration was the stakeholder theory. The stakeholder theory as postulated by Freeman (1984) sees management as having a fiduciary responsibility to the many stakeholders who are the groups that have a residual claim on the firm. The stakeholders who have residual claim include; suppliers, customers, employees, stockholders and the general communities in which the companies do business with. The stakeholder theory though quite applicable in the Kenyan insurance sector, does not consider all the players in the industry. Some of players that Edward Freeman might not have envisaged in the early stages of the stakeholder theory as the local industry is highly regulated. The government through the IRA is a key stakeholder together with the insurance firm's policyholders.

The stakeholder theory postulates that all stakeholders have similar rights and that managers through the board of directors should ensure they build consensus, avoid conflicts and harmonize each employee's goals to achieve organizational objectives (Donaldson & Preston, 1995). Berlet and Means (1932) points the stakeholder theory to be a fiction as managers have more powers than anyone else in managing the companies. Goodpaster (1991) argued that managers have both fiduciary and non-fiduciary duties to various stakeholders and fiduciary duty is only to shareholders while managers have different duties to the rest of the stakeholders.

2.2 Empirical Review

According to Sean (2015) while investigating the ways in which government regulation influence the insurance sector, government control is unpredictable among all types of insurance companies. He notes that the sanctions imposed on AIG for offering guarantees on credit insurance in the financial markets varied significantly from those applied on health insurance providers. Therefore, government regulations increases the cost doing insurance business by restricting underwriting practices in terms of products and services offered to policyholders.

Cheng and Wang (2012) investigated the relationship among government controls, strategy preference and performance in the manufacturing industry. The investigation built a hypothetical framework on the relationship among government controls, manufacturing techniques and performance. In their paper, they analyzed the relationship among government directives, strategy and performance using structural equation model and a sample of 135 Small and Medium Enterprises of Jiangsu Province. The results of the investigation demonstrated that administration controls have a critical beneficial outcome on cost, quality and development. The findings of the study shows government regulations have a significant positive effect on cost, quality and innovation. They further found out that cost, quality and innovation, had significant positive influence on financial performance while quality and innovation had a significant positive effect on non - financial performance while cost had no influence at all.

Li (2014) examined governance and regulation, and their effect on performance of non-listed small corporations in Australia. The researcher employed structured online questionnaires to collect data from 387 respondents. He investigated the constructs of governance, regulation, financial performance, social performance and sustainable performance. The study findings showed that governance had negative impact on both financial performance and corporate social responsibility while regulation had positive impact on financial performance and corporate social responsibility.

Sean (2015) focused on ways in which government regulation influence the insurance sector. The study focused on how government regulation influences the insurance sector but failed to look at sustainability of the insurance sector. This represented a conceptual gap. Li (2014) examined governance and regulation, and their effect on performance of non-listed small corporations in Australia. The study was conducted in Australia thus presenting a contextual gap. The current study will be conducted in Kenya.

3.0 RESEARCH METHODOLOGY

The study adopted the positivist research philosophy and employed a descriptive research design. The target population of the study was the 51 insurance companies as registered by the Insurance

Regulatory Authority of Kenya as at 31st December 2016, of which the researcher proportionately chose 30 from the various insurance companies conducting life, general and composite insurance business. Using probabilistic procedures for data collection and employing stratified random sampling method, the study collected the required data. The primary data collection was through a questionnaire with closed questions. A pilot study done before questionnaire distribution, ensured their validity and reliability before distribution by email, followed by a telephone call to the respondents and a research assistant visiting the respondents to collect them. The period of the study was 2001-2015, a period during which the industry faced turbulence, increased regulation and collapse of several insurance companies. The study collected data by sampling 357 staff from senior, middle and junior cadres of staff of the 30 insurance companies. The raw data was cleaned, edited, coded and analyzed using SPSS tool to generate descriptive and inferential statistics while secondary data was collected using data collection sheets. Data analysis using multiple regression analysis was performed to determine the relationship of each of the independent variables to the dependent variable. The researcher used descriptive statistics such as the mean, standard deviation and frequencies to analyze the data. Before conducting the regression model, diagnostic tests which included normality, multicollinearity and heteroscedasticity were conducted.

4.0 RESULTS AND DISCUSSIONS

The objective of the study was to investigate the moderating effect of government regulation on drivers of sustainability of insurance companies in Kenya. The descriptive statistic for the moderating effect of government regulation variables on sustainability of insurance companies in Kenya revealed that 88.4% of the respondents agreed that risk based capital management law has strengthened the company's sustainability. The results, 57.6% of the respondents, further agreed with the statement that pricing guidelines by IRA enhances company's sustainability while some of the respondents, 70.6% indicated agreement that the prescription of risk departments by regulators enhances the company's sustainability. Further, 57.6% of the respondents suggested that the introduction of Actuarial departments by IRA enhances company sustainability, with 70.3% of them supporting the introduction of risk management departments by the regulator. In addition, 85.9% of the respondents agreed that the vetting and approval of senior management and board of directors by IRA enhances company's sustainability, with 57.6% of the respondents agreeing that the capping of commissions by the regulator has made conduct of business inflexible, inhibiting innovation and hence does not enhance the company's sustainability.

In the results further, 85.5% of the respondents agreed that compulsory local reinsurance cessions enhanced company's sustainability. Finally, the results of the study suggest that 46.6% of the respondents agreed that the NEMA regulation on solid waste management enhances the company's sustainability. The data was analyzed using a five point scale, with the average mean of the responses being 3.79 which meant that majority of the respondents indicated agreement with the statements; however the answers were varied as shown by a standard deviation of 1.19. These results imply an industry which is over regulated and all companies are working towards implementing the regulatory guidelines. Over regulation may be stifling insurance industry innovation in terms of innovative products, seamless service to customers and even ways of doing business increasing business operating costs and therefore the high level of reported underwriting losses.

To ensure the insignificant variables of government regulation are dropped and the significant ones analysed further, the various government regulation measures were analysed using Cronbach Alpha Test of reliability and the factors that scored less than 0.5 were dropped during the regression analysis. The purpose the factor analysis for government regulation variables was to enable pick the significant measures for regression analysis while the insignificant ones were dropped from any further consideration.

4.1 Measures of Sampling Adequacy for Government Regulation

To examine whether the data collected was adequate and appropriate for inferential statistical tests such as the factor analysis, multiple linear regression analysis and other statistical tests, two main tests were performed namely; Kaiser-Meyer-Olkin (KMO) Measure of Sampling Adequacy and Barlett's Test of Sphericity. For a data set to be regarded as adequate and appropriate for statistical analysis, the value of KMO should be greater than 0.5 (Field, 2000). The results of KMO Sampling Adequacy and Bartlett's Sphericity Tests on influence of government regulation on sustainability of insurance companies in Kenya are significant. The findings showed that the KMO statistic was 0.696 which was significantly high; that is greater than the critical level of significance of the test which was set at 0.5 (Field, 2000). In addition to the KMO test, the Bartlett's Test of Sphericity was also highly significant (Chi-square = 1561.694 with 36 degree of freedom, at $p < 0.05$). These results provide an excellent justification to conduct further statistical analysis.

4.1.1 Communalities for Government Regulation

For Government Regulation, to determine the extent of how each of the variables of Government Regulation measures accounted for the Government Regulation factors taken together, a communality analysis was performed. According to Kothari and Garg (2014) communalities should be 0.4 or greater for better measurement of factor analysis and therefore a high value of communality means that not much of the variable is left over after whatever factors represented taken into consideration. According to Kaiser (1974), factor-loading values that are greater than 0.4 should be accepted and values below 0.4 should lead to collection of more data to help researcher to determine the values to include. Values between 0.5 and 0.7 are mediocre, values between 0.7 and 0.8 are good, values between 0.8 and 0.9 are great, and values above 0.9 are superb. Factor analysis was conducted on statements regarding government regulation and five statements had a coefficient of less than 0.4 and hence was dropped for correlation and regression.

4.2 Correlation Test

The test of correlation between government regulation and sustainability of insurance companies suggest that Risk Based Capital management law has a positive and significant effect on sustainability of insurance companies ($r=0.526$, $p=0.000$). In addition, the prescription and set up of risk departments by regulators have a positive and significant effect on sustainability of insurance companies (r=0.594, p=0.032). The capping of commissions by the Insurance Regulatory Authority have a positive and insignificant effect on sustainability of insurance companies (r=0.083, p=0.168). Further, compliance to NEMA regulation on solid waste management has a positive and insignificant effect on sustainability of insurance companies (r=0.260, p=0.000).

4.3 Regression Analysis

The study further investigated the combined effect of drivers of sustainability on the insurance companies.

Table 1: Model Fitness Results for Overall Regression Model

Variables	Coefficients
R	0.797
R^2	0.636
Adjusted R^2	0.631
Std. Error of the Estimate	0.361

Exploration of performance was found to be satisfactory in explaining sustainability of insurance companies which is supported by coefficient of determination also known as the R^2 of 63.6% meaning that the model fitness found government regulation to explain 63.6% of the variations in the dependent variable which is sustainability of the insurance companies. The analysis of the variance (ANOVA) results indicated that the model was statistically significant implying that the management capability, capital adequacy, sensitivity to risk and asset quality are good predictors of sustainability of insurance companies.

Table 2: ANOVA Results for Overall Regression Model

Measure	Sum of Squares	Df	Mean Square	F	Sig.
Regression	61.992	4	15.498	118.347	0.000
Residual	35.489	271	0.131		
Total	**97.481**	**275**			

The results are supported by an F-statistic of 118.347 and the reported p-value (0.000) which was less than the conventional probability of 0.05 significance level.

Table 3: Regression Coefficients for Overall Regression Model

Variable	B	Std. Error	T	Sig.
Management Capability	0.083	0.039	2.120	0.035
Capital Adequacy	0.644	0.062	10.441	0.000
Sensitivity to Risk	0.134	0.046	2.896	0.004
Asset Quality	0.233	0.044	5.251	0.000

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The results of revealed that management capability have a positive and significant effect with sustainability of insurance companies ($r = 0.083$, $p=0.035$). Further, capital adequacy has a positive and significant effect on sustainability of insurance companies ($r = 0.644$, $p=0.000$). The sensitivity to risk has a positive and significant effect on sustainability of insurance companies ($r = 0.134$, $p=0.004$). Lastly the results revealed that asset quality have a positive and significant effect on sustainability of insurance companies ($r = 0.233$, $p=0.000$).

Regression model

The final regression results led to the regression model here below.

$Y = 0.473+0.083X_1+0.644X_2+0.134X_3+0.233X_4+ \varepsilon$
where Y = Sustainability, X_4 - Management Capability, X_1 - Capital Adequacy, X_3 - Sensitivity to Risk , X_2 - Asset Quality and ε - Error term

4.4 Post Moderation Regression Model

The objective of the study was to investigate the moderating effect of government regulation on sustainability of insurance companies in Kenya. The regression results of the Model Fitness after moderation of the effect of government regulations on sustainability of insurance companies in Kenya.

Table 4: Model Fitness Results after moderation

Variables	Coefficients
R	0.758
R^2	0.574
Adjusted R^2	0.568
Std. Error of the Estimate	0.391

The R^2 reduced from 63.6% to 57.4% after moderation implying that government regulation has a negative moderation on the sustainability of insurance companies in Kenya. The reduction of Analysis of Variance results after Moderation imply that the overall effect after moderation is significant with an F-statistic declining from 118.347 to 91.271 as in the table here below.

Table 5: ANOVA Results for Government Regulation

Measure	Sum of Squares	Df	Mean Square	F	Sig.
Regression	55.950	4	13.988	91.271	0.000
Residual	41.531	271	0.153		
Total	97.481	275			

The study tested the null hypothesis that government regulation had no moderating effect on sustainability of insurance companies in Kenya. The null hypothesis was tested by using multiple linear regression. The acceptance/rejection criteria was that, if the p value is greater than 0.05, the H_o5 fails to be accepted but if it's less than 0.05, the Ho5 rejected. The null hypothesis was that there is no moderating effect of government regulation on sustainability of insurance companies in Kenya. The results show that the p-value was 0.000<0.05. The null hypothesis was rejected with the conclusion that there was a moderating effect of government regulation on sustainability of insurance companies in Kenya. The significance of each of the independent variables and their influence on the dependent variable are presented in the table here below.

The study results after moderation revealed that government regulation has a positive and significant moderating effect on management capability, capital adequacy and sensitivity to risk while that of asset quality was found to be insignificant. Therefore, government efforts on improving the quality of investment assets in the insurance industry do not have any impact. This means government regulation should concentrate on the rest of the factors and not asset quality.

Table 6: Regression Coefficients after Moderation

Variables	B	Std. Error	t	Sig.
Constant	4.615	0.520	8.872	0.000
Drivers	-0.522	0.140	-3.736	**0.000**
Government Regulation	-0.788	0.149	-5.279	**0.000**
X.M	0.273	0.035	7.803	**0.000**

The study results after moderation revealed that government regulation has a positive and significant moderating effect on management capability, capital adequacy and sensitivity to risk while that of asset quality was found to be insignificant. Therefore, government efforts on improving the quality of investment assets in the insurance industry do not have any impact.

Regression model

Y = 4.716 – 0.522 X - 0.788 M + 0.271 X.M, Where Y is sustainability, X is the composite of all independent variables and M is the moderator (government regulation)

5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

The insurance companies complied with NEMA regulations on solid waste management, which may be viewed as one sided policy restrictions or penalties on policyholders violating the NEMA rules and regulations should be enforced. The introduction of risk based capital management in insurance companies and setting up of risk management departments have strengthened the risk conscious position of the insurance companies in terms of improved management skills, increased levels of capital adequacy and application of risk management schemes and policies.

The null hypothesis that stated that government regulation has no moderating influence on sustainability of insurance companies in Kenya; was rejected revealing the existence of moderation of government regulation on sustainability of insurance companies in Kenya, and that there is a moderating effect of government regulation on the sustainability of insurance companies in Kenya. The study concluded that there was a moderating effect of government regulation on management capability, capital adequacy and sensitivity to risk.

5.2 Recommendations and Roadmap

The involvement of government in insurance business is well understood, but too much government involvement stifles innovation. The insurance sector has lagged behind in product and service delivery innovations, compared to the banking and telecommunication sectors.This means that there is a need for government to review its approach, to become a facilitative stakeholder rather than being the prescriptive policing authority. The government should also play a more active and facilitative role in the management of insurance companies as they grow through the various stages of development, which will aid in increasing insurance penetration and its contribution to GDP beyond the current 1.6%.

There has been inadequate and poorly trained insurance workforce in the country for a long time and despite the efforts by IRA to offer scholarships to bright actuarial students to study abroad and enhance the industry skills bank, the problem has not been diminished and therefore the need for the industry to adopt a common approach. The IRA and AKI has over time levied charges to insurance companies to support their operations which may not be sufficient in the modern era of digitization, in addition to partnering with the government sponsored College of Insurance to offer insurance courses. Further partnership with the insurance industry stakeholders would speed up the process of increasing the number of insurance professionals in the sector. It is therefore time the country adopted a centralized structured approach to the industry management by defining who an insurance professional ought to be, working with college of insurance to ensure that all insurance professionals have gone through the college and gets certified to work in the sector. Such an approach should apply across all cadres of staff, from junior management all the way to the board of directors.

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