Risk Management for Kenya's SMEs

Demand Side Constraints to the Uptake of Insurance by Small and Medium Sized Enterprises (SMEs) In Kenya

Final Report

Robert Gibbons

Simon Karunditu

Andre Swanepoel

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List of Abbreviations

AKI	Association of Kenya Insurers
ATI	African Trade Insurance Agency
FSD Kenya	Financial Sector Deepening Trust Kenya
GDP	Gross Domestic Product
IMIDS	Integrated Motor Insurance Data System
IRA	Insurance Regulatory Authority
SMEs	Small and Medium Sized Enterprises

Executive Summary

People buy insurance for protection against the risk of accidental losses, but less so in Kenya than in much of the world. To find out why, the Financial Sector Deepening Trust Kenya (FSD) studied the risk management practices of Kenya's small and medium enterprises (SMEs).

Ideally risk management is a structured decision process with a sequence of steps: identifying exposures to accidental loss, evaluating alternative techniques for treating each loss exposure, choosing the best alternative, implementing it, and monitoring the results to refine or improve the program. The alternatives for managing risks include both risk control and risk financing techniques. While there are typically many feasible techniques for controlling risks, including avoidance, financing risks requires either buying insurance or paying the costs of losses when they occur.

Insurance is an important risk management tool because it can be readily adapted to the size and risks of an enterprise. Thus the size and breadth of a country's insurance market provides a rough measure of the economy's resilience to risk. Economies that are better able to manage risk, those with more robust insurance markets, have better records of economic growth.

This study enlisted a research firm to survey a carefully constructed sample of SME decision makers about their insurance and risk management practices. The results showed Kenya's SMEs to be well aware of risk. They practice risk management intuitively, but with major disadvantages. They lack sufficient information to make good estimates of the relevant probabilities of loss. They also lack a full range of risk management tools because they cannot always rely on insurance for risk financing. Thus they avoid many potentially profitable ventures because they cannot finance the risk efficiently.

Kenya's insurance market exhibits major shortcomings. SMEs have little confidence in insurance because they perceive insurers as untrustworthy, and they cannot distinguish the best from the worst. Information problems plague the insurers as well as the SMEs attempting to manage their risks. For the most part, insurers follow a well-worn traditional path rather than seeking competitive advantages through product innovation or more sophisticated pricing.

Building an inclusive market lies in a working and supportive relationship between all the different stakeholders in this section of the industry—namely the IRA, insurers, consumers, intermediaries, media, and other third parties.

The conclusion is that the insurance industry's untrustworthy image is the major impediment to insurance demand among Kenya's SMEs. The recommendations, therefore, focus on improving this image through enhanced supervision, combating fraud, addressing consumer complaints, greater transparency, industry self-regulation, standards of claims practices and market conduct, regulation of intermediaries, better training, and public outreach, as well as disseminating risk management expertise more widely.

Chapter 1: Risk Management

In this uncertain world risk management has become a key ingredient for survival, stability, and success. The global financial crisis has highlighted the significance of risk management for financial institutions. The lessons of that crisis apply as much to governments, individuals, and private enterprise. Risk is inherent in all human activity and should be incorporated into all decision making.

Among the lessons of the global financial crisis is the centrality of risk in all economic activity. As the International Actuarial Association observed,

> The terms "risk" and "risk management" are commonly viewed through a lens of avoiding "bad" things happening and limiting the downside. Whilst understandable, the more enlightened view emerging is one of connecting risk to value maintenance and creation. This includes, for example, the empowerment of people to exploit opportunities. Indeed, the ability to anticipate and react to an opportunity can be as important as readiness for a potentially significant disruptive event.[1]

How well a society manages its risks goes a long way toward explaining how productive it is.[2]

In most economies small and medium-sized enterprises provide a major share of employment opportunities. Thus their success contributes significantly to raising incomes and reducing poverty. But SMEs are especially vulnerable to accidental losses, and that vulnerability threatens their viability. An unexpected mishap may force them to suspend operations or cause the loss of their assets, and they might never recover. Many SMEs come and go with the vicissitudes of time, when with better risk management more of them could survive and grow.

Risk Management in Business Enterprises

Business ventures do not always go as expected. When entrepreneurs make plans, their decisions incorporate assessments of risks that may produce unexpected outcomes. Thus in a sense all enterprises practice risk management, although some do it more systematically than others.

Systematic risk management is a structured process of rational decision making through a sequence of steps: identifying exposures to accidental loss, evaluating alternative techniques for treating each loss exposure, choosing the best alternative, implementing it, and monitoring the results to refine or improve the program. In much of the world it is standard procedure for most businesses. The risk management process helps them weigh the costs and benefits of various techniques for dealing with exposures to loss and choose the most effective combination.

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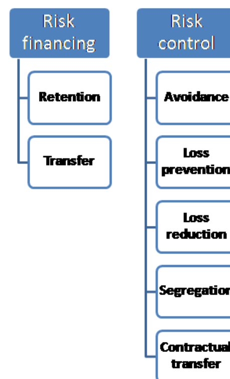
[1] International Actuarial Association, *Dealing with Predictable Irrationality*, February 2009, 7.

[2] For a thorough analysis of these interrelationships in the case of the United States, see David Moss, *When All Else Fails: Government as Ultimate Risk Manager* (Cambridge,MA: Harvard University Press, 2001.)

Figure 1 shows a risk management conceptual framework that facilitates systematic analysis.[3] The analysis weighs the alternative techniques for dealing with the risk of loss. Some techniques involve financing exposures to loss; others involve controlling loss exposures.

Figure 1: Risk Management Techniques



Risk Financing. Financing losses means one of only two possibilities: retention or transfer. *Retention* of a loss exposure implies paying for resulting damages after a loss occurs, which can be a substantial, sometimes even fatal, shock to the enterprise. *Transfer* enlists another party to pay for a loss, such as an insurer who receives periodic premium payments in return for the promise to pay for the loss when it occurs.

Risk Control. In addition to deciding how to finance losses, entrepreneurs usually have many options for controlling losses. Risk control techniques can be categorized as exposure avoidance, loss prevention, loss reduction, segregation of loss exposures, and contractual transfers.

Exposure avoidance eliminates entirely any possibility of loss by abandoning or never undertaking an activity or an asset that presents a risk.

Loss prevention reduces the frequency of a particular type of loss, perhaps through additional safeguards or through improved maintenance or training.

Loss reduction aims to lower the severity of a loss, possibly by placing limits on the amount at risk or by actions to contain damages.

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[3] This conceptual framework, now standard, first appeared in George L. Head and Stephen Horn II, *Essentials of Risk Management* (Malvern, PA: Insurance Institute of America, 1984, 1991, 1997).

Segregation of loss exposures arranges the enterprise's activities and resources so that no single event can cause simultaneous losses to all of them. It can mean separating assets or locations so that a loss of one is not a loss of all; it can also mean duplicating critical parts, records, or facilities so that operations can continue despite a loss.

Contractual transfer shifts legal and financial responsibility for a loss to other parties under terms of a lease or other contract.

Specific techniques are as varied as the range of businesses ventures. The foregoing conceptual categories help to brainstorm all the possibilities, but individual enterprises are most likely to know what techniques might be feasible for them. Experience or common sense might lead entrepreneurs to employ some of these techniques anyway, but a systematic risk management process improves the quality of their decisions. It enables them to find the most cost-effective combination.

All too often small and medium enterprises (SMEs) control risk by avoiding new ventures when other techniques could mitigate the risk without also eliminating the opportunity. Also too often SMEs finance risk by retention; that is, not having made other arrangements in advance, they end up paying the full costs of losses themselves. Retention becomes the operative risk management technique by default rather than by choice, and it may mean failure of the enterprise.

Although avoidance or retention might be the best technique for managing some risks, a whole range of options in between can support promising ventures while minimizing risks. The essential policy question is whether the theoretical alternatives outlined above actually exist in practice and can be effectively implemented by SMEs. For example, sprinkler systems can be an effective way to limit the damage from fires, but they depend upon a reliable water supply. Infrastructure development has enormous impact on the risk control alternatives available to SMEs.

Similarly, financial development has great impact on the risk financing alternatives available to SMEs. If they cannot obtain reliable insurance at a reasonable price for their specific exposures, they must depend solely on means to control losses or resort to retention.

On the other hand, when SMEs can choose from among a broad range of risk management alternatives, they can employ the combination of techniques that provides the greatest mitigation of risk at the lowest cost. More risk management tools mean more possibilities for improving the risk management program. It is better still when sufficient options are available to allow an enterprise to coordinate its chosen risk control and risk financing techniques. For example, a shop will normally obtain burglary insurance on better terms if it has also upgraded its alarm system. The more effectively SMEs can manage their risks, the more productive they become.

Insurance as a Risk Management Tool

Among alternative risk management techniques, insurance stands out for special attention. As suggested above, there are as many ways to control losses as there are ways to organize an enterprise. The possibilities for financing losses, however, are limited to retention or transfer, and transfer is almost always insurance.

Insurance is a particularly useful risk management tool because it is readily scaleable to the size of the enterprise, and its logistics are not complicated. The availability of good insurance adds significantly to the risk management alternatives from which SMEs can choose the most effective risk management program.

In reasonably competitive economic conditions, the decision to purchase insurance is a "make or buy" question, analogous to outsourcing. If entrepreneurs can buy the needed input for less than the cost of producing it internally, they will obtain it externally. It is comparative advantage at work. Firms specialize according to their competitive strengths. Most SMEs are not good at identifying and pricing specific types of risk, but insurers are. The comparative advantage of insurers arises from the law of large numbers. The more homogeneous risks accepted by insurers, the more closely their actual losses approach the expected losses, enabling them to price risk more precisely. Because insurers specialize in risk transfer, they can accept and manage specified risks, add a reasonable margin to the price they charge for this service, and still offer insurance at a price that can be attractive to risk-averse SMEs.

The motivation of risk aversion makes the demand for insurance as a risk management tool extremely price sensitive. As soon as the cost of transferring risks to insurers exceeds the cost of other risk management techniques, rational entrepreneurs will switch to the alternatives. Naturally insurers incur administrative costs. Other costs can arise because of adverse selection and moral hazard problems, such as the potential for fraudulent claims. Any or all of these costs can make insurance a less attractive option for risk management.

Just as insurers benefit from large numbers, size also matters to buyers. The larger the enterprise, the more opportunities it has to diversify its loss exposures internally. This theoretical proposition has an important policy implication: **a strong and efficient insurance market matters most of all to SMEs.** Large corporations can retain loss exposures more readily and to some extent dispense with insurance.[4] Although vulnerable, micro enterprises have few loss exposures to insure. For SMEs, however, insurance is a vital risk management tool.

Insurance demand may be less sensitive to price when other motivations enter the calculation. For example, when the law requires owners of motor vehicles to carry third party liability insurance, their only choices are to buy insurance, to dispose of the vehicle,

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[4] David Mayers and Clifford W. Smith, "On the Corporate Demand for Insurance," *Journal of Business*, 55 (1982), 281-96. Richard MacMinn, "Insurance and Corporate Risk Management," *Journal of Risk and Insurance,* 54 (1987), 658-77.

or to violate the law. Given those choices, most people will buy insurance even though they think the price is too high. Thus the presence of non-economic decision factors can mask the economic performance of the insurance market.

Risk Management in Economic Development

Better risk management not only makes individual enterprises more productive, but also helps the economy to grow. Access to financial services, including insurance mechanisms, is an essential environmental condition for people to be productive. It is a basic need, analogous to electricity, clean water, and sanitation. The world increasingly recognizes the responsibility of governments to provide stable and secure financial markets for their citizens.[5] Greater variety and availability of financial services and instruments encourages economic growth by providing economic agents more opportunities to save, invest, and borrow.[6]

By giving people and businesses more opportunities to transfer risks, countries with robust insurance markets enjoy higher rates of economic growth. Among the reasons are the following.

Asset protection. Enterprises acquire assets in order to generate income. If the assets are lost, so is the earnings potential. When the assets are insured, funds become available for their immediate replacement and the enterprise can stay in business.

Reduced income volatility. An extreme event can present a greater shock than an enterprise can withstand. A disaster can wipe out years of slow upward progress. Many SMEs come and go with the vicissitudes of time, but with better risk management more of them survive and grow. By transferring risk through insurance, they gain a safety net that helps to stabilize incomes in a risky world.

Credit enhancement. Businesses need credit to grow, and SMEs in particular depend on external financing to expand. When their growth is constrained by the shortage of credit, they cannot hire more workers. Newly available data from the World Bank Enterprise Surveys across 98 countries shows access to finance to be the most binding constraint on employment growth, especially for small firms and especially in Africa.[7] Insurance is integral to finance. Lenders expect satisfactory collateral so that they will not lose if the borrower cannot repay the loan. When the collateral is insured, the lender

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[5] United Nations, *Building Inclusive Financial Sectors for Development* (New York, 2006).

[6] Beck, Thorsten, Ross Levine, and Norman Loayza, "Finance and the Sources of Growth," *Journal of Financial Economics*, 58, 261-300

[7] Hinh T. Dinh, Dimitri A. Mavridis, and Hoa B. Nguyen, "The Binding Constraint on Firms' Growth in Developing Countries," *Policy Research Working Paper 5485,* The World Bank (November 2010).

is more likely to find it satisfactory. Thus once infeasible activities become feasible because insurance opens the door to credit.[8]

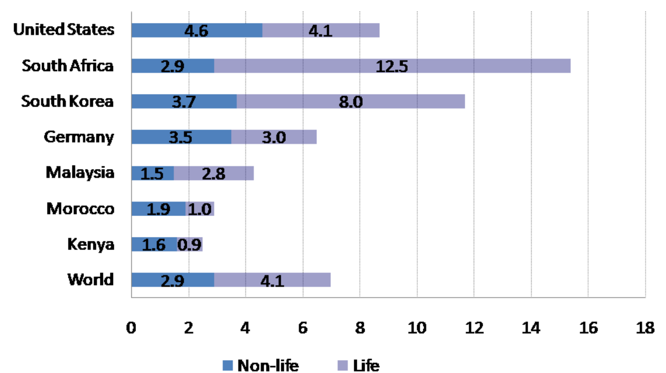
Price signals to allocate risks. Insurance markets also contribute to more efficient allocation of resources because they generate price signals for various kinds of risk. Even when an insurance transaction does not take place, an economic benefit accrues from a decision maker's avoidance of a certain activity because the cost of insuring it is unacceptably high. A vibrant insurance market provides information regarding costs and benefits that helps entrepreneurs calculate which loss prevention techniques are worthwhile. In the absence of such price signals from the insurance market, they resist making investments for the sake of unknown benefits. The resulting loss is unseen.

Incentives for loss mitigation. Insurers have incentives to identify and mitigate risks, which is to everyone's benefit, especially as the benefits of loss prevention compound over time. Insurers can monitor and communicate safety standards, influencing both public policy and private behavior. By analyzing information from a large number of similar exposures, insurers can more readily identify specific loss factors and structure their products accordingly. When policyholders receive a discount for employing a particular safety device, more of them will adopt it, leading to fewer losses for the society as a whole.

Mobilization of capital and financial sector development. Insurers receive the premiums paid by many policyholders and invest them in productive ways. Those investments fund infrastructure development as well as new business ventures. Insurers can be significant players in the capital markets. Financial sector development encompasses banking, insurance, and capital markets, and each of these three reinforces the other two. A growing body of research confirms the correlation between economic growth and each of these aspects of financial sector development separately; the correlation is even stronger when they are combined.[9] Moreover, this research suggests that insurance market development is a supply-leading phenomenon. That is, insurance is an agent of growth, not just a by-product.[10]

Thus the size of a country's insurance market is more than just an indication of one economic sector's

Figure 2: Insurance as % of GDP



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[8] Lael Brainard, *What is the role of insurance in e* 2007).

[9] Ian P. Webb, Martin F. Grace, and Harold D. Sk Growth of Capital and Output," *Working Paper 0* 2002). Marco Arena, "Does Insurance Market Ac *Insurance,* 75 (December 2008), 921-46. Liyan H "Insurance Development and Economic Growth,"

[10] USAID, Assessment on How Strengthening the to Economic Growth, *Final Report* (February 200

level of development; it is a proxy measure of the country's ability to manage its risks. Economies with more insurance are more resilient to shocks, they allocate resources more efficiently, and they are safer and more productive. Figure 2 shows annual insurance premiums as a percentage of GDP for selected countries.

Chapter 2: Current Risk Management Practices of Kenya's SMEs

To assess the current risk management practices of Kenya's SMEs, the Financial Sector Deepening Trust Kenya (FSD) undertook a study in conjunction with the International Insurance Foundation, a non-profit research center with experience investigating risk management and insurance in many parts of the world. The objective of the study was to make recommendations for possible interventions that will promote the development and use of insurance by SMEs.

Survey methodology.

The study enlisted the research firm Synovate to survey 150 SME decision makers drawn from a carefully constructed sample. A questionnaire specifically addressing the risk management practices and insurance perceptions of SMEs was prepared, then revised in accordance with feedback from the Synovate field team and project manager. These revisions facilitated correct interpretation of the questions according to local language and context. Further such revisions resulted from a pilot test of the questionnaire. Once finalized, the questionnaire was formicalized by the field team in preparation for fieldwork.

A general training session again briefed all the interviewers and their supervisors on the purpose of this project and on the concept of risk management. This training ensured that all questions were understood and administered correctly from the onset to the end.

The field work collected the project data on a face-to face basis. It commenced on the 11th of January and ended on the 28th January 2010.

The field work targeted interviews with decision makers on financial services, who were mostly the financial managers, general manager, or owner of the enterprise. Sample quotas were established by location, by size of enterprise, and by economic sector. Since SMEs are concentrated around Nairobi, 70 percent of the sampled SMEs came from Nairobi, 20 percent from Mombasa, and 10 percent from Kisumu. Table 1 shows the sample composition by size and

Table 1: Survey respondents by size

Less than 10 employees	50
10-50 permanent employees	50
51-100 permanent employees	33
More than 100 permanent employees	17
Total	150

Table 2 by economic sector.

Table 2: Survey respondents by economic sector

Financial Sector, including banks, insurance, etc.	9
Wholesale and Retail Trade	50
Agriculture or Forestry or Fishing or Resources	19
Manufacturing	13
Building and Construction	10
Hotels and Tourism	16
Technology and Communication	33
Total	150

SMEs from the telephone sample list in Nairobi were contacted via telephone to schedule interviews. In Mombasa and Kisumu, walk in interviews were conducted for randomly chosen SMEs in the urban centres. From over 300 SMEs contacted, about 200 interviews were scheduled. Some cancelled their appointments or were unable to complete the interview at the scheduled time, but 150 were completed successfully.

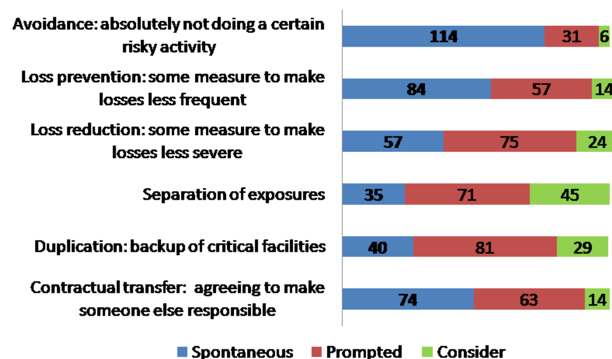
All interviewers were required to attach the business cards of the interviewees to the completed questionnaires. The completed questionnaires were returned to the head office and reviewed by the field supervisors and managers for any errors or inconsistencies. Once all the questionnaires were collected, field managers conducted back checks of the completed questionnaires to ensure accuracy of the results.

Survey findings.

This research showed that Kenya's SMEs are exceptionally conscious of the risks they face. At the time of the survey, memories of Kenya's post-election violence of December 2007 and January 2008 were still fresh. The interviewers noted that many respondents participated in this particular survey more eagerly because they recognized the importance of preparing for unforeseen events. When asked to identify specific risks they face, they were able to enumerate them spontaneously.

The survey also found that Kenya's SMEs engage in extensive, but largely unsystematic, risk management activities. A relatively high percentage of respondents spontaneously volunteered examples of risk control techniques they employed. Many others responded affirmatively when specifically asked whether they employed each type of risk control technique. In virtually all of the remaining cases, they indicated

Figure 3: Risk control measures

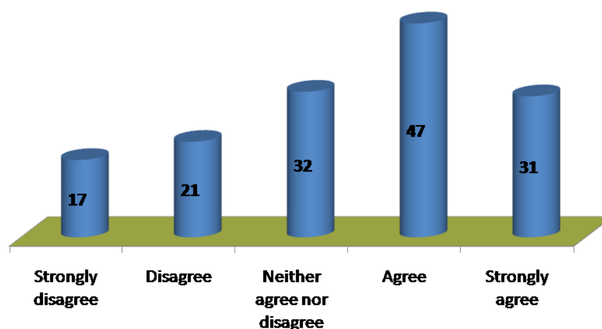


willingness to consider techniques they were not already using. Figure 3 shows these results in detail, with the numbers inside the bars showing the number of respondents for each.

Another question in the survey asked SME decision makers to estimate the annual costs of unforeseen losses. A noteworthy answer was: “I never thought of it that way, but probably I should.” Such responses show that Kenya’s SMEs are ready and willing to improve their risk management.

They are handicapped in this effort, however, by a paucity of relevant and reliable information. To evaluate the costs and benefits of any risk control measure, they need to estimate the frequency and severity of the associated losses before and after taking that measure. When the survey asked SME decision makers to estimate the likelihood of the losses they feared most, 28% had no idea. The remaining responses revealed such logical inconsistencies, such as expecting a loss more likely in the next five years than in the next ten years, that they could only be characterized as wild guesses.

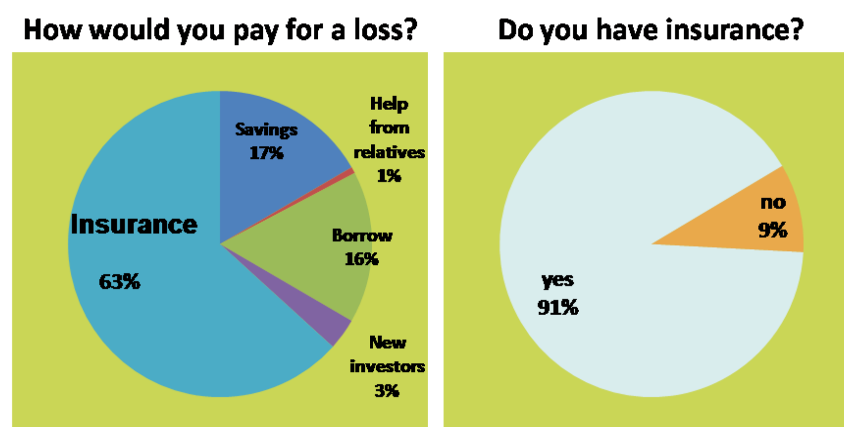
Figure 4: “I only buy the minimum amount of insurance that is required.”



Kenya’s SMEs also face difficulties in calculating the effectiveness of risk financing. Although 41 insurance companies operate in Kenya, they generate surprisingly small volume. The evidence strongly suggests that these insurers do not serve the needs of SMEs effectively. While 91 percent of Kenya’s SMEs carry some form of insurance, 53 percent (78 of 148) agree with the statement “I only buy the minimum insurance required.”

Most SMEs surveyed are willing to put money aside to pay for future losses. Most also have insurance, but as Figure 5 shows they do not necessarily expect it to provide protection against their most significant loss exposures. When asked how they would finance future losses, only 63 percent indicated insurance. In some cases the SME has only some type of insurance that does not address the most significant exposures, such as an enterprise that carries motor liability insurance but its gravest risk is a fire on the premises. Most of this gap, however, can only be explained by limited confidence in the reliability of their insurance.

Figure 5: Risk Financing Expectations



In other words, when evaluating the costs and benefits of their risk management alternatives, **Kenya's SMEs significantly discount the potential benefit of insurance.** As a consequence, they **under-utilize insurance** compared to the experience of other countries. The corollary is that they over-utilize other risk management alternatives, which would be fine except that their preferred alternative is **avoidance**. Clearly many potentially rewarding ventures are not pursued because Kenya's SMEs are unwilling to retain the risks and are unable to obtain satisfactory insurance for them.

Chapter 3: Kenya's Insurance Market

Although on the surface Kenya's insurance market resembles typical insurance markets around the world, further examination reveals some significant shortcomings in its ability to serve the risk financing needs of SMEs efficiently. Unlike much of the general population, SMEs do seem familiar with the concept of insurance.[11]

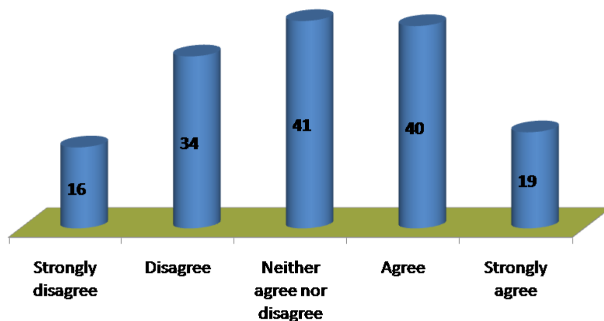
Confidence.

Responses to the survey clearly show that SMEs lack confidence in the ultimate performance of insurance contracts. Since insurance transactions occur over time—policyholders pay premiums now in the expectations that insurers will pay valid claims later—there is a possibility that the insurance company will go out of business in the

[11] The 2009 FinAccess Survey showed that 93.2% of rural households and 83.3% of urban households have never had an insurance product. FSD Kenya, *FinAccess National Survey 2009*, 18.

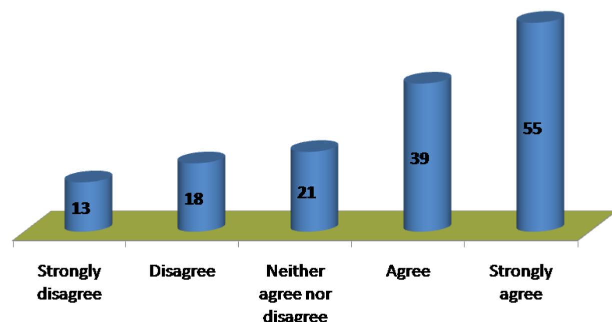
meantime. Kenya has in fact witnessed seven insurance company failures in the last decade.[12]

Figure 6: "Insurance is OK in theory, but how do I know the insurance company will pay my claim?"



SMEs also entertain reasonable doubts about ultimate performance because they suspect insurers might resort to differing interpretations of the contract to reject their claims. Figure 6 reveals this high degree of skepticism regarding insurance contracts, with 39 percent (59 of 150) of the survey respondents doubting that claims would be paid. As Figure 7 shows, an overwhelming number of respondents, 94 of 146 (64 percent), agreed with the statement: "I would be more likely to buy insurance if I knew that an independent body would help to resolve claims disputes," while only 21 percent disagreed. The Insurance Regulatory Authority does address claims disputes, but no one in the survey knew that. In fact 46 percent agreed and only 27 disagreed with the statement: "No one looks out for consumers to be sure they are treated fairly."

Figure 7: "I would be more likely to buy insurance if I knew that an independent body would help to resolve claims disputes."



Information.

Beyond this issue of trust, there are also serious information problems hindering the operation of an efficient market. Kenya has 41 insurers, but SMEs have little basis for discriminating among them. The survey explored their perceptions of insurers, asking them to name the insurer that is the most financially secure, is the most reliable, offers the best products, offers the lowest price, offers the best service, and generates the fewest complaints. Relatively few respondents could even address these questions. Those that did, not surprisingly, cited their own insurer most often. However, less than 17 percent had an opinion any of these questions except which

[12] Stallion, United, Lakestar, Liberty, Access, Standard Assurance (under statutory management), and Invesco (now restructured).

insurer generates the fewest complaints, answered by barely half of the respondents. Regarding which insurer is the most financially secure, arguably the most important question of all, only 7 percent had any opinion. Market competition drives prices down and quality up, but only when buyers have enough information to make distinctions.

By global standards, Kenya's insurers are small and thinly capitalized. With more intense competition, some of them probably would not survive. The perpetuation of small, inefficient insurers hinders the market's responsiveness. Their small size limits the ability of Kenya's insurers to innovate in product design, to invest in training, to promote loss control measures, to investigate suspected fraud, to fund consumer education, or to conduct research.

With more information and actuarial analysis Kenya's insurers could adopt pricing systems that better reflect actual exposures. The current unsophisticated pricing structure obscures many inefficiencies and cross-subsidies. The variation in reported industry-wide loss ratios suggests that most types of insurance could be much less expensive if motor insurance losses were better contained.[13] Insurers keep prices high on all insurance products to be sure they do not lose money, but in doing so they forgo additional business which could be written profitably. The Association of Kenya Insurers annual report shows premiums and underwriting profits for each company, but not a separate breakdown of losses and expenses, which would reveal how efficiently the insurers operate. High insurer expense ratios could be one reason that SMEs seldom choose to finance their risks with insurance.

Reliable loss data is crucial for risk management. Kenya's insurers are attempting to establish an Integrated Motor Insurance Data System (IMIDS). They have correctly articulated the potential benefits of this system, including:

- Detection and reduction of fraudulent claims
- Increased transparency in the motor vehicle claims and underwriting practices
- improved underwriting through physical verification of motor vehicle details and condition, up to date and relevant information, records of declined risks or cancelled policies, standard templates, and claims status reports
- uniform privacy protection
- a statistical resource for the industry regarding stolen motor vehicle data, salvage data, written-off motor vehicle data, uninsured motor vehicles, accidental claims, and underwriting data.
- a link to other motor stakeholders such as the Kenya Revenue Authority, Ministry of Transport, and the Police

[13] In 2008 loss ratios ranged from 31.2% for miscellaneous accident insurance to 83.5% for private motor insurance. Association of Kenya Insurers, *Insurance Industry Annual Report for the Year 2008*, 22.

- Improved perception of the insurance industry resulting from faster claims processing[14]

The Minister for Finance has exempted the expenses of the system from income tax during the current year. At this time, however, the system is still an idea rather than a reality. Kenya's insurance market will be more efficient when the IMIDS is operational, and more efficient yet when it is extended to other types of insurance. With relevant statistical information at hand, insurers will be better able to price their products according to the risk and thus better serve the risk financing needs of Kenya's SMEs.

In March 2010 FSD Kenya hosted a workshop to discuss the survey results with Kenya's insurance market leaders. They confirmed that a greater awareness and understanding of insurance needs of SMEs is required. Because the corporate market is saturated, many insurers are considering expanding into micro insurance, possibly bypassing a missing middle of potential SME insurance clients.

Such an outcome is possible because it would be the easiest path. Although there are signs of improvement, Kenya's lethargic insurance market clings to familiar habits.

Chapter 4: Building an Inclusive Insurance Market

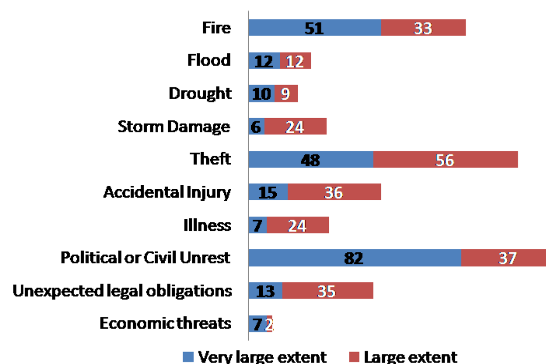
The support it provides for business enterprise (as well as social protection) makes the breadth and efficiency of the insurance market a national concern. Insurance markets should work for everyone, not just the traditional participants. The size of the banking, securities, and insurance sectors matters for economic growth. But the breadth as well as the level of these sectors is important. For this reason the G-20 has pledged to improve access to finance by promoting successful regulatory, supervisory, and policy approaches and elaborating standards on financial access.

Meeting Customer Needs

Access criteria include whether products are appropriate for consumer needs, whether their cost is affordable for most people, and whether they are readily accessible in terms of purchase, payment, and claims settlement.

Products. Most insurance is still written on forms resembling ones used in Britain decades ago. Thus the insurance products offered are not necessarily the insurance products needed.

Figure 8: Serious threats to business



[14] Association of Kenya Insurers, http://www.akinsure.or.ke/Projects/Integrated-Motor-Insurance-Data-System--IMIDS.

Two examples, political risk and business income, illustrate the difficulties in matching Kenya's supply and demand for insurance. As Figure 8 shows, more SMEs in the survey found political unrest a serious threat to their business than any other loss exposure. Standard fire policies, however, typically exclude coverage for losses resulting from "riot or civil commotion," forcing insureds to seek additional specific coverage, which most of Kenya's insurers do not offer because reinsurance for it is not widely available. The fact that it is a distinct additional coverage accentuates the adverse selection problem—only those who expect to have losses buy the coverage. This factor drives the price to unaffordable levels, especially at times when political tensions are on the increase. With reinsurance support from the African Trade Insurance Agency (ATI), three of Kenya's insurers are now experimenting with a basic property form that includes modest political risk cover, but the need is much greater.

People commonly picture insurance as a way to replace a destroyed building or other property. They are less likely to imagine insurance as a way to replace lost income, but for Kenya's SMEs lost income is the greater exposure. SMEs typically generate ongoing income with relatively few assets. Business interruption insurance addresses this exposure, but it is underutilized in Kenya. One possible reason is unfamiliarity on the part of the marketing force, for whom a burning building makes a more dramatic sales pitch than red ink in the ledgers. Even more importantly, business interruption insurance requires the insured to maintain accurate accounts in order to prove the amount of the loss. Both the decrease in turnover for the comparable period and the increase in expenses must be documented. The accounting expertise required to market business interruption insurance effectively, to utilize it in an SME risk management program, and to adjust losses properly stretched the realistic bounds of feasibility for Kenya's SMEs. The limitations of the past, however, might be overcome with some creative product design keyed to the growing application of Electronic Tax Registers.

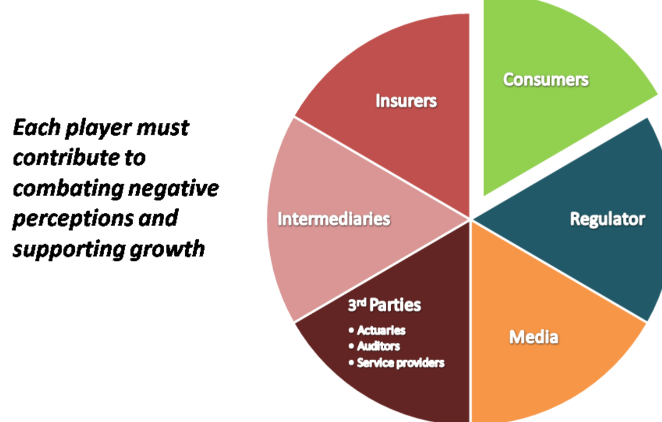
These two examples show how insurance may be possible in theory, but difficult to apply for Kenya's SMEs. Insurance companies should try harder to research and develop products specifically tailored to the needs of SMEs. Insurance executives agree that insurers should employ more analytical methods themselves to understand risks being insured better. They also need a better understanding of the SME market to design the right products. More can be done with life products, such as key man insurance, especially since many SMEs are sole proprietors. Although ATI now offers credit insurance, its potential is much greater, and many more examples can be found.

Payments. Even when they want the specific insurance offered, buyers in Kenya face obstacles. For example, the recently implemented "cash and carry" rule, intended to reduce the dangerous level of premium receivables on the books of insurers, precludes some buyers from obtaining insurance because they cannot pay the full annual premium due at inception of the policy. Either more flexible payment terms (such as monthly premium payments) or wider use of insurance premium financing are needed to make insurance more accessible.

Stakeholders in Augmented Insurance Demand

Building insurance demand does not depend on a single entity. All the stakeholders must make a concerted collaborative effort to change the perceptions of Kenya's SMEs. As Figure 9 suggests, each has a role to play in building demand for insurance.

Figure 9: Role players in building the insurance market



Insurance Regulatory Authority. For the sake of consumer confidence, smoothly functioning insurance markets require credible, effective supervision to monitor the solvency of insurers and safeguard the integrity of the market. The regulatory authority must be politically independent, set and enforce prudent capital requirements for insurers, require a "fit and proper" culture with regard to directors and senior management, enforce good corporate governance in financial institutions, expect the implementation of efficient risk management processes within these institutions and set standards for the licensing and conduct of financial intermediaries. The regulatory authority must also ensure that a cost efficient complaints process exists for consumers and simultaneously promote consumer education. All these factors enhance the insurance industry's reputation, respect, and trust, which are essential to support the demand for insurance products.

Kenya's supervisory framework is still in its infancy. The Insurance Regulatory Authority (IRA) became an independent body in 2007. Its functions have now been expanded, enabling it to issue supervisory guidelines, establish prudential standards, and share information with the other regulatory authorities. Through the International Association of Insurance Supervisors the IRA is working to implement global standards of insurance supervision in Kenya.

Slightly more than half the survey respondents agreed with the statement: "Only reputable companies can sell insurance in Kenya because they must be authorized by government regulators," but the opinion on that score should be unanimous. The IRA is

not well enough known. A communication strategy for informing the public of the IRA's role and its enforcement actions would help to build trust in the insurance market.

Insurance companies. Insurance companies should also be more aggressive in parading their virtues. To have a good story to tell, they should structure more innovative and applicable products; capitalise themselves properly to shed the image of being risky underwriters, educate and train intermediaries to understand the market and its customers, pay claims in a timely manner, and treat customers fairly. The insurance association should increase its efforts on regular communication with the public and consumer education exercises.

Intermediaries. Intermediaries should be embraced as major participants and engaged in creating a better value proposition for the end customer, including understanding and communication of risk and pricing. Insurance intermediaries could improve the level of service and guidance they offer customers in sorting out the sometimes confusing provisions of insurance contracts. In the survey, 46 percent agreed while only 16 percent disagreed with the statement: "Insurance agents push their products without understanding my needs." Some observers suggest that agents should be more honest with consumers. There is also a problem with rogue agents and brokers, who do not appear to be effectively controlled by the industry. Inept marketing adds to distribution costs as well as to the further erosion of consumer confidence.

Third parties. Third parties—auditors, actuaries, research and development specialists, and others—also play an important role.[15] As consultants to the industry, their expertise helps to create the best products and to systematize the risk management function. The watchdog role of actuaries and auditors should be encouraged as well. They are the on site 'eyes and ears' of the supervisor because their professional responsibilities give them a "whistle blowing" role.

Media. The media—radio, television, business and popular press—are important allies in the quest for better consumer awareness and education. They can expose bad services in claims payment, unacceptable contractual specifications, and deceptive marketing, while highlighting good market conduct, prompt claims handling, and effective loss control measures. A healthy and vibrant market conduct environment in general bodes well for the financial strength of the insurance institutions. Another important player to create demand side awareness is the media.

Consumers. The distrust and poor value proposition of consumers should be countered by proper analyses of SME risks, a proper disclosure regime when selling policies, and an effective, affordable, and trustworthy complaints process. Consumer organizations and NGOs can help to shape appropriate expectations and to establish

[15] A number of insurance executives attending the workshop argued that these are such important skills that they should exist in-house as well. They also pointed to the availability of support software, such as actuarial software to assess risk and facilitate pricing.

benchmarks for insurer performance. They can also play an important role in educating SMEs about risk management.

Each of these stakeholders has an important and essential role to play. It rests mainly on the shoulders of the government and the supervisor to steer these activities firmly in the right direction.

Chapter 5: Conclusions and Recommendations

Of the three possible explanations for the limited demand for insurance from Kenya's SMEs, this study found the perceived doubtful value of insurance to be the major factor. Marketplace frictions also exist and to some extent impede effective utilization of insurance. The universal tendency to underestimate actual risks plays less of a role, especially since recent events in Kenya accentuated risk awareness. **The SMEs surveyed appear ready to buy insurance if convinced that it offers good value.**

At this point, therefore, efforts should focus on improving the image of insurance in Kenya. The negative perceptions apparent in the survey must be addressed, even if they are unwarranted.

Building trust is crucial. Insurance transactions occur over time: policyholders pay premiums at the beginning and receive claims payments later, if stipulated events occur. People cannot be expected to pay premiums willingly unless they have confidence that the contract will be honored. Both insurers and supervisory authorities have a large task before them to gain the trust of consumers. Market participants must be able to conclude desired transactions in confidence.

The following recommendations identify specific steps toward an insurance market that engenders trust. While some require action by the IRA, some by the industry, and some by others parties, all stakeholders should support and reinforce these efforts to improve the breadth and efficiency of Kenya's insurance market.

Enhanced supervision. To enhance the uptake of insurance products in the market, an essential precondition is an insurance regulator committed to achieving international supervisory standards and enforcing clear, unbiased legislation, and striving to promote economic development. The IRA should continue to upgrade its staff so that it can perform more rigorous financial analysis and on-site inspection of Kenya's insurers. It should also move toward risk sensitive solvency measures and higher capital requirements. The transition to improved capitalization, however, will itself generate instability in the market, necessitating even greater scrutiny from the IRA and timely interventions.

Fraud prevention. Increasing levels of insurance fraud threaten the integrity of the market. False claims inflate the cost of insurance and make it harder for SMEs, or anyone else, to manage risks economically. Insurers have urged the Insurance Regulatory Authority to create an anti-fraud unit, similar to the one at the Central Bank which also includes members of the criminal investigation unit of the police, to deal with fraud. A

collaborative response to the problem is essential, since unilateral efforts to combat fraud reinforce consumer perceptions of an industry that does not want to pay claims.

Consumer complaints. The IRA has dedicated staff to receiving and investigating consumer complaints, but few people know about it. The IRA could easily disseminate in a simple format information regarding the comparative claims performance of all of the companies in the market. Consumer complaints provide useful insights into the health of the insurance market, and such information should be captured systematically for statistical analysis. Public disclosure of complaint ratios would encourage improved market conduct.

Transparency and disclosure. The survey revealed that SMEs have little basis for choosing one insurer over another, particularly regarding financial strength. Since more information will give them more confidence in an insurer's financial strength, it makes sense to publicize more widely the financial information already contained in the IRA Annual Report.

Perhaps an even greater boost to consumer confidence might come from more detailed analysis of claims. SMEs could make better risk management decisions if they had available average loss ratios for comparable situations. Conversely, insurers could make better underwriting decisions if they had more detailed loss data. In the absence of good information, buyers tend to underestimate the actual cost of risk while sellers tend to overestimate it. With better information, they would be more likely to agree on appropriate terms to transfer risks.

Finally, better information would help to focus public attention real problems, such as the overall social cost of insurance fraud.

Industry self-regulation. Kenya's insurers have much to gain from cooperative efforts to improve the performance of the market. Voluntary standards will promote the image of the industry, which can be reinforced through consumer education. More frequent communication about insurance issues will facilitate the needed changes. With a proper forum the IRA can build a rapport with the industry whereby industry participants realize that their interests and that of the supervisor coincide rather than conflict. It will be important for industry participants to see the IRA's role as supporting industry development through its commitment to creating an enabling environment that encourages genuine innovation but prohibits undesirable practices.

It might seem to go against the grain for insurance companies to increase operational and training expenditures, to advocate stronger regulation, and to publicize their own shortcomings, while seeking ways to lower premium rates. Given the existing mistrust, however, such steps are prerequisites for growing the market. The increased volumes in a responsive and transparent market will soon offset the additional costs, and insurers will be able to capture more economies of scale. With the benefit of appropriate technology (such as document management systems and enterprise resource planning) to improve efficiency, over time insurers can reduce costs and lower premiums while enhancing their

profitability. Insurers should expect to be rewarded because they excel at analyzing and bearing risk, not merely because they exist.

Standards of claims practice. AKI should establish and publish clear standards for handling life and non-life claims. The performance of individual insurers can be periodically assessed according to these standards, and the results announced in the press. Standards of claims handling and an avenue of redress will foster the necessary and much needed consumer confidence in the insurance industry. Insurers should also encourage consumers to take their complaints to the IRA and to compare the tabulated results.

AKI might also develop codes of marketing practices. If needed, FSD might sponsor workshops to illustrate successful industry codes from other countries and to examine international experiences with industry self-regulation.

Supervision of intermediaries. There is a need to create a framework for licensed intermediaries based on international professional standards of conduct, including educational requirements and disciplinary procedures. The IRA should deal with misconduct without hesitation. The issue of payment of premiums within the stipulated period should be strictly enforced.

Training. A responsive insurance industry depends on competent human resources. Companies need properly educated underwriters, claims adjusters, accountants, data managers, and executives. The sales force also must be professionally trained to advise prospective clients on complex products according to their specific risks. Insurers that emphasize the professionalism of their staff should be singled out, and others encouraged to emulate their example.

The insurance training levy is modest by international standards. While some countries have a well educated insurance workforce without imposing a training levy, other countries have a training levy ten times greater than Kenya's. If the government is serious about developing the insurance industry, an increase should be considered. Accountability of the Insurance Training and Education Trust should be improved to match the training curricula to the skills needed by the industry.

Public outreach. The Association of Kenya Insurers awareness campaign includes a booklet aimed at educating consumers on insurance risks and products. In addition AKI is encouraging its members to invest in more public relations and marketing. This is a beginning, but more is needed.

Newspapers and radio reporting on the performance and claims paying statistics of insurers could be very effective; regular articles on the insurance industry and risk identification, assessment and management could make an important contribution. Efforts to support effective and penetrating financial journalism will be rewarded with greater appreciation of the insurance mechanism and more confidence in its reliability.

Risk management workshops. Since SMEs appear receptive to improved risk management, a logical next step is to disseminate risk management expertise more

widely in Kenya. Insurers can be the vanguard, since as risk specialists they stand to gain the most from an increase in knowledge and skills. Not only would they reinforce their own risk assessment capabilities, they could gain the respect and appreciation of potential clients by inviting them to participate. Contributing to the development of essential business skills would also be an important public service.

Joint participation in risk management workshops would also help to shift the focus of insurance marketing toward customer needs. More cooperation and interaction among regulators, insurance companies, intermediaries, third parties, and consumers would promote a holistic view of risk. While SMEs, insurers, and intermediaries each have their own perspectives, their common concern should be to reduce the cost of risk. When that happens, everyone benefits.

Kenya's risk management capacity need not be bound by the past. Until the year 2000 India had a moribund insurance market characterized by a British legacy in contracts and by a rigid tariff pricing structure. The only permitted insurers were public companies, which had become very bureaucratic and unresponsive to customer needs. A major reform opened the market to competition and foreign investment, but with stringent regulation by a highly respected independent authority, high capital requirements, and stipulated targets for underserved markets. Under these conditions India's insurance premium volume has tripled in less than a decade, prices have become more flexible, and measurements of risk more sophisticated.

Kenya, too, can make its future better than its past by instituting reforms to facilitate better risk management. If insurers focus on their customers rather than their products, they will lead the way in the dissemination of risk management expertise. They will perform a public service by augmenting the business skills of SMEs while growing their own market. With better risk management, SMEs are more likely to thrive, producing more goods and services and employing more workers.

Risk management expertise is not a panacea for all of Kenya's problems. Many other improvements in the business environment are also needed to facilitate more efficient risk financing. Stronger regulation, higher professional standards, more consumer protection, and better information can all contribute. These improvements, many of which are already underway, accord perfectly with Kenya's new emphasis on transparency and accountability.

In concert with Kenya's financial development and political evolution, SMEs can enhance their risk management capacity. The ability to allocate their resources to the most efficient ways of mitigating risk will allow them to capture more of their potential. They will be able to expand geographically, venturing into regions they have avoided in the past, and creating employment opportunities outside of the increasingly crowded urban areas. They will be more likely to seize new opportunities offered by the East African Community or by new technology. Better risk management will open many new possibilities, allowing more SMEs to pursue their dreams while helping the economy grow.

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SME Insurance Demand Study Workshop – Thursday 25th March 2010

Attendees:

Kennedy O. Abincha, *African Merchant Assurance Company Limited*

B.N. Akwir, *Association of Kenya Insurers*

Alex Amolllo, *CFC Life*

Anne Chelagat, *Insurance Regulatory Authority*

James Irungu, *British American Insurance Company (Kenya) Ltd*

Julius Karuga, *African Trade Insurance Agency*

Protus N. Kathenya, *Metropol East Africa Ltd*

Saagar Khimasa, *APA Insurance Ltd*

Edna Kihara, *CFC Stanbic Bank*

Nelson Kuria , *CIC Insurance*

Charles Makone, *The Monarch Insurance*

Nicholas M. Malombe, *Old Mutual*

Lawi Mamai, *Pioneer Assurance*

Fridah Mburu, *APA Insurance*

S. Mishra, *Kenindia Assurance Company Ltd*

Frida Mwaura, *Kenya Orient Insurance*

Michael Odour, *Jubilee Insurance Company of Kenya*

Walter Orato, *Chartis Kenya Insurance Co. Ltd*

Stephen Wandera, *British American Insurance Company (Kenya) Ltd*

Linda Were, *Pan Africa Life*

Figure 1: Risk Management Techniques