AGENCY COSTS AND FINANCIAL PERFORMANCE OF LICENSED INSURERS IN KENYA

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ABSTRACT

Even though the insurance industry is a key contributor to the provision of financial protection to households and businesses, it is experiencing financial shocks arising from incessant underwriting losses and rising cases of fraud among insurance employees that are costing policyholders billions of monies threatening their financial stability. The specific aims of this study were to assess the influence of monitoring costs, and bonding costs on financial performance of insurance companies in Kenya. The study adopted an explanatory study design, and its target population consisted of 56 finance managers from all licensed insurance companies. It used census sampling method to sample all the 56 insurance companies. The study relied mostly on secondary data collected using a secondary data collection instrument. Moreover, the data was analyzed using Stata statistical application version 17. The data was analyzed using mean, standard deviation and presented on tables and charts. The findings obtained showed that monitoring costs had a positively significant influence on financial performance estimated by both ROE and ROA. The results indicated that bonding costs had a negative and significant influence on financial performance measured by ROE. Moreover, the findings indicated that bonding costs had a negative and significant influence on financial performance as estimated using ROA. The study recommended the introduction of a management incentives and welfare schemes that will provide both financial and non-financial incentives to management in an effort to motivate them to act at the best interest of the shareholders; a situation likely to reduce agency costs and optimize financial performance and shareholders value.

Keywords: Monitoring Costs, Bonding Costs, Financial Performance.

INTRODUCTION

The insurance industry contributes significantly to a nation's economy, as it provides ideal risk mitigation mechanisms that cushions individuals and businesses from various uncertainties that can potentially expose them to financial difficulties. According to OECD (2022) the insurance sector offers financial protection to both individuals and businesses and lowers the financial uncertainties that they are likely to encounter in their day-to-day activity. The insurance sector always provides financial compensation to those entities that have suffered financial losses arising from various insured risks and taking them back to their initial financial position they were in before the risk occurred, enhancing their future stability.

The importance of insurance sector to the economy have been highlighted in a number of studies like that of Tackie et al. (2022) that noted that insurance sector essentially contributes to economic growth mostly through alleviation of financial losses, and promotion of commerce and trade, which in turn leads to sustainable economic growth (KPMG, 2022). According to Swiss Re Institute (2022) the total insurance premium is about 7.5% of global domestic product accentuating the important role insurance play in the global economy.

Whereas the insurance sector has sizeable impact on the economy, it is being faced by a myriad of problems likely to influence its financial performance as accentuated in many studies such as that of IAS (2020) that substantively noted that most insurance companies are constantly under threat of governance and agency problems with potential to influence the future stability of these insurance companies.

Similarly, a report by Swiss Re (2021) pointed out that the insurance sector is experiencing challenges arising from economic stability, cutthroat competition, mismanagement and agency problems. According to this study agency problem arise due to the changing business and regulatory environment, which make management to be indifferent on the kind of the action they take. McKinsey (2022) study also noted that though the insurance companies are crucial to any nation's economic development, they are becoming more and more susceptible to agency issues that put their financial stability on a knife edge. The financial exposure of insurance firms was evident in 2007/2008 financial crisis where the regulatory and management ecosystem did not help in preventing the crisis, which pushed most of them into a financial meltdown.

The moral hazard arising from the principal agent relationship according to Ain et al. (2021) can make an agent to engage in risky underwriting and management behaviors to the detriment of the principal (policyholders or shareholders) who bear economic and financial consequences of their behavior. The moral hazard can significantly result to heightened agency costs that can subsequently impact on the general operation of the insurance business. This study therefore investigated whether these agency costs have a relationship with financial performance of insurance firms (Einav & Finkelstein, 2018).

Globally, there are increasing debates on financial performance of companies in the insurance sector owing to their essential contribution in risk mitigation and financial protection. According to Swiss Re Institute (2022), the world is going through paradigm shifts that are likely to influence long-term insurance policy implications. This is due to economic slowdown due to a confluence of factors such as COVID-19 pandemic, disruption of global supply chains, ever rising energy and commodity prices prompted by the Ukraine-Russian war. All these economic pressures are likely to weigh on insurance markets through reduced insurance intake, rising number of claims, decline in premiums, and reduced return in capital markets. A situation likely to trigger agency problems as the management interests and priorities may tend to conflict with that of insurance stakeholders (OECD, 2022).

The insurance trends in Africa have been different from those in most developed countries due to macroeconomic instabilities and social aspects. Despite being a home to about 16.7% of the world population, the insurance penetration rate is relatively low at 2.7% compared to the world average of 7% (IAIS, 2022). The financial stability of the few insurance companies operating in Africa is also not promising as there have been increased incidences of fraud and insolvency that have seen a number of insurances placed under receivership, largely due to agency problems culminated by economic and regulatory pressures (Asnongu & Odhiambo, 2020).

In Kenya, insurance penetration rate according to IRA (2022) is low at 2.2% relative to global average of 7%. The general insurance business has the highest market share at 55% of total insurance premiums collected in 2021. In the same period though the Return on Equity and Return on Assets was still low at 5.1% and 1.6% respectively there was a slight growth as the economy adjusted from negative effects of coronavirus pandemic. Just like with other African countries, Kenyan insurance sector according to Shurie and Cheluget, (2022) has its own fair of challenges emanating from macroeconomic and pandemic pressures, which have mounted pressure on the kind and quality of strategies to be employed by the management.

In the past the insurance sector in Kenya has seen about eight insurance company being put under receivership due to failure to meet with minimum insurance regulatory requirements, such as capital, and solvency requirements all tied to the quality of governance being administered.

Statement of Problem

The insurance industry has been experiencing financial shocks arising from incessant underwriting losses in the non-life insurance business. For instance, in 2021 the underwriting loss stood at Kshs. 4.99 billion, which was a 105% increase from Kshs. 2.33 billion in 2020. A trend that has aroused heated debates among underwriters and other stakeholders in the insurance industry on insurance companies' performance (IRA, 2022; AKI, 2020; AKI, 2021).

The incessant annual underwriting losses are a point of concern to underwriters and other stakeholders in insurance sector, as they are largely caused by agency problems. This is despite the fact that the insurance companies have been incurring high agency costs as depicted through proper remuneration, awarding of bonuses to employees and periodic investigation and auditing costs. The deterioration of combined underwriting loss from one year to another is a global concern, as it can potentially expose the insurance sector into a financial meltdown causing irreparable economic damage (Adams, Upreti & Chen, 2019).

Most insurance companies in the world are increasingly being negatively affected by agency problems, a phenomenon that has evoked numerous debates on ways to alleviate it. In almost all insurance companies in developing countries have in the recent past experienced agency problems manifested through cases of frauds, unsettled claims, boardroom wrangles and declining public confidence (Bhuyan et al., 2022). These plights according to Upreti, Adams and Jia (2022) have forced most insurance companies to incur various agency costs in an attempt to alleviate the ever-rising cases of agency problem.

According to IRA (2021) statistical report 26 insurance companies under general and long-term assurance reported losses after tax for the full year 2021, also there are a total of 8 insurance companies that are currently under receivership due to sloppy underwriting practices stemming from conflict of interest between management and policyholders. The general consensus drawn from a number of studies like Zhang, Liang and Jin (2020) is that the two biggest causes of insolvency are persistent underwriting losses, and declining reserves. The risk exposure that individual enterprises incur is a major determinant of other insolvency-related concerns. Other factors cited as contributing to the demise of these insurance companies include a lackluster regulatory environment for the sector, bad financial management, financial indiscipline, and a complete disdain for ethical business practices. In recent years, agency costs have been on rise threatening the financial stability of most insurance companies (Deloitte, 2020). Other studies like that of Schauble (2019) point out that the impact of agency costs on financial performance may vary from one sector to another, and the question that still lingers is whether agency costs incurred by the insurance companies influence their performance.

It is on this basis that this study investigated the influence of agency costs on financial performance of insurance companies in Kenya.

Objectives of the Study

i. To assess the influence of monitoring costs on financial performance of licensed Insurers in Kenya.
ii. To examine the influence of bonding costs on financial performance of licensed Insurers in Kenya.

Theoretical Framework

Jensen and Meckling Theory of Agency Costs

Jensen and Mecking are the known proponents of the agency theory in 1976; they observed that a major weakness with majority of public companies lies in the inactivity of the shareholders in running of the company, which give leeway to management to abandon the interests of shareholders for their own selfish interest, giving rise to agency problems (Vitolla, Raimo, & Rubino, 2020; Marashdeh et al., 2021). According to this theory the managers are the agents and shareholders are principal. Both the agent and principal are utility maximizer, implying that as much as the managers are supposed to act at the best interest of the shareholders at times, they may choose to advance their selfish interests. The core aim of the shareholders is to maximize the net present value of the company while the main interest of the managers is to maximize utility, this results into a conflict of interest (Naz et al., 2022).

This theory argues that for shareholders to compel the management to act in their best interests they come up with various incentives that could be in the form of monitoring, bonding costs, to monitor the activities of the managers. These give rise to the agency costs incurred on monitoring, and bonding expenditures, as well as the residual losses. This theory often tries to describe and resolve the agency problems that tend to occur in most companies. This is because the shareholders often rely on managers to manage the affairs of the company. As such the management and directors of the companies are under a duty of care to make optimal decisions that are geared towards shareholders' value creation. The primary foundation of agency theory is that managers are constantly seeking ways to act in their own best interest even if it disadvantages the shareholders. This often happen due to information asymmetry arising from the fact that managers have superior information with regard to the day-to-day activities of the companies (Tijjani & Bello, 2020).

This theory is of importance to this study as it expounds on the factors influencing the relationship between the agents and shareholders, which in this case are managers and shareholders. This theory explains how the misalignment of corporate interests between the managers and shareholders can be addressed to maximize the value of a company. Also, it provides an understanding on the key indicators of agency costs that are central to this study (Laher & Proffitt, 2020).

Conceptual Framework

The illustrative interconnection of independent variables and dependent variables is illustrated in figure 1.

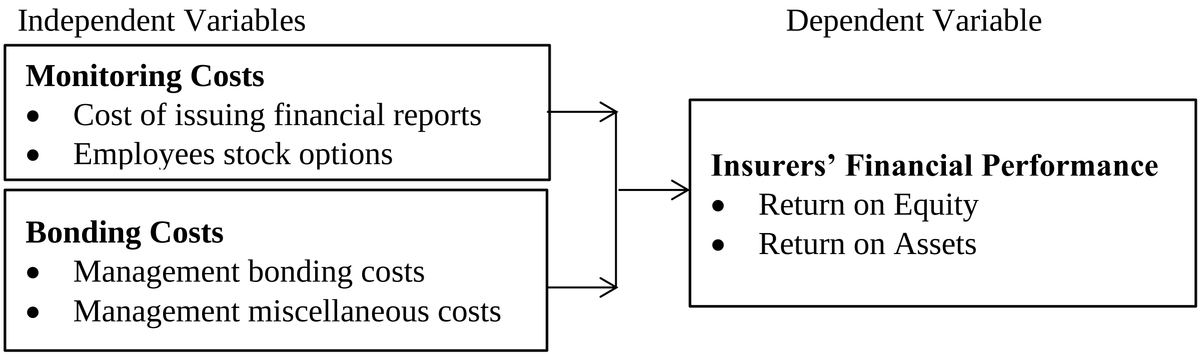

Figure 1: Conceptual Framework

Empirical Review

The study on the influence of agency costs on financial performance is increasingly attracting considerable interest among scholars, with the most conspicuous one being that of Ain et al. (2021) on female directors and agency costs in listed firms in China Securities Exchange. The study found out that agency costs strongly influenced the performance of most state-owned corporations with gender-diverse boards. The study establishes the agency costs were more severe in those state-owned corporations highly characterized with agency problems. It also noted that those boards with more female directors had reduced agency costs as compared to those with most men.

Bitti et al. (2019) work on agency costs and scarce resources in Brazil, after evaluating a panel data of 270 franchised companies for the duration 2011-2016; recognized that agency costs of monitoring influence the scarcity of resources available in a given company. This study however did not dig dipper into the link that exist between agency costs and company's performance, it only assessed the impact of agency costs on scarcity of resources available in a given company. The study also relies on outdated panel data of 2011-2016, as opposed to the present study that aimed in probing the association that exist between agency costs and financial performance of insurance companies, as well as evaluating latest data.

In Rizwan and Akhtar (2022), research on exploring effect of agency costs on competitive advantage of Banks and Small and Medium Enterprises in Pakistan, which used dyadic questionnaires issued to branch managers, found out that proof exist on the link that exist between agency monitoring costs and the competitive advantage. It noted that for banks to achieve competitive advantage there must be a decline in the level of agency costs. Despite this, the research does not comprehensively quantify the size of the relationship that exist. The present research studies the various agency costs and how they influence company's performance in Kenya, as there are limited research done, to bring on board new perspectives on the interaction that exists.

A review of most recent literature such as that of Sapuan et al. (2021) has shown that the burden of agency problems has resulted to remarkable agency monitoring costs. The study which focused on impacts of agency costs on financial performance of 350 listed firms in Malaysia for the duration 2005 - 2016 observed that that monitoring agency costs negatively influenced the return on asset of a company. However, the limitation of this study is that it placed much emphasis on free cash flow instead of agency costs as it is the case in the present research that studies it thoroughly using current data in different country to see whether the results obtained align with those of the appraised study.

There is a growing body of literature that acknowledges the influence of bonding costs on financial performance, specifically that of Abdulrahman (2014), that while evaluating the link between agency costs and financial performance of listed firms in Nairobi Securities Exchange for the duration 2008-2012 and using multiple regression found out that bonding expenditures incurred by a company have a mild influence on the financial performance. However, in contrast with the present research, it evaluated only listed firms and relied on data from 2008 to 2012. The present research expanded the scope of the research to non-listed insurance companies and rely on current data providing mew perspectives.

The other prominent study is that of Baykara and Baykara (2021) who while researching on the impact of agency costs on financial performance in 38 firms listed in Istanbul Stock Exchange, and using regression found out that there is a negative influence of bonding agency costs on performance was insignificant in listed small and medium enterprises. The study used data from 2017 to 20220 and only focused on small and medium enterprise firms it did not evaluate listed and non-listed big companies making it difficult to recast its findings within a wider context.

RESEARCH METHODOLOGY

The study used explanatory study design that is appropriate when probing for cause-effect relationship where the study variables are not adequately studied by previous research. The study targeted all the 56 insurers in Kenya offering both life assurance and general insurance that are licensed by Insurance Regulatory Authority of Kenya. The researcher used census technique to sample all the 56 insurers offering general insurance and life assurance. In an effort to collect the data this study relied on secondary data obtained from insurers' financial reports, Association of Kenya Insurer's reports and Insurance Regulatory Authority's statistical reports. The study relied on secondary data on monitoring costs, bonding costs and residual losses and financial performance for the period ranging from 2018 to 2022.

The assembled information from the field was checked for accuracy, completeness, coded and analysed using Stata statistical application version 17; which is suitable when handling panel data. The assembled data was presented on charts and tables, the information deduced there interpreted and discussed as per the variables under study. A multiple regression was utilized to assess the nature of the influence of each type of agency cost on financial performance.

FINDINGS AND DISCUSSION

Descriptive Analysis of Research Variables

The descriptive statistics used in this research include maximum, minimum, mean, and standard deviation. The results yielded from the descriptive analysis of monitoring costs, bonding costs, Return on Equity (ROE) and Return on Assets (ROA) are depicted in the following table.

Table 1 Summary of the Descriptive Analysis

Variable/Statistics	Obs	Mean	SD	Maximum	Minimum
Monitoring Costs	280	0.512	0.24	0.81	0.01
Bonding Costs	280	0.48	0.34	2.37	0.01
ROE	280	0.47	0.21	0.71	0.12
ROA	280	2.21	0.85	4.8	0.89

Key: Obs: observations; Sample Size; SD = Standard deviation; ROE = return on equity; ROA = return on assets

The results from the descriptive analysis show that monitoring costs had a mean of 0.512 and standard deviation of 0.24 with the highest and lowest value being 0.81 and 0.01 respectively. This is suggestive that most insurers bear high monitoring costs in an effort to deter undesirable management behavior. The constant monitoring of management activities compels them to stay in line or face consequences from their erratic management behaviors.

The results further depict that bonding costs had a mean of 0.48 and a standard deviation of 0.34 with the highest and lowest value being 2.37 and 0.01. Overall, it can be deduced that there exists a relationship between bonding costs and financial performance of licensed insurers in Kenya. The findings were in partly in agreement with Abdulrahman (2017) study that established that bonding expenditures incurred by a company influenced its financial performance. Nonetheless, they were in disagreement with Baykara and Baykara (2021) study that found that bonding agency costs negatively influenced performance of listed small and medium enterprises in Istanbul Stock Exchange.

On the other hand, the mean and standard deviation of financial performance measured by return on equity is 0.47 and 0.21 with a high and low of 0.71 and 0.12 respectively. Moreover, the mean and standard deviation of financial performance expressed as return on assets is 2.21 and 0.85 respectively; its highest value was 4.8 with the lowest value of 0.89. The descriptive analysis shows that financial performance measured by ROA and monitoring costs had the highest mean while return on equity and monitoring costs had the least standard deviation, which meant that dispersion from the mean was relatively lower compared to other items. These findings are in agreement with Tripathi (2019) that had found that monitoring costs had a high influence on the profitability and financial performance of an entity.

Correlation Analysis

Correlation between Monitoring Costs and Financial Performance

The results from the correlation of monitoring costs and financial performance measured by Return on Equity and Return on Assets are summarized in the following table.

Table 2: Correlation between Monitoring Costs and Financial Performance

	Monitoring Costs	ROE	ROA
Monitoring Costs	1.000	0.323	0.112
ROE	0.323	1.000	0.745
ROA	0.105	0.814	1.000

The results show that there exists a positive relationship between monitoring costs and financial performance as estimated by both measures (ROE and ROA). More precisely, the relationship between monitoring costs and ROE was found to be positive with a correlation coefficient of 0.323. On the other hand, the relationship between monitoring costs and ROA was found to be positive with a correlation coefficient of 0.105. This means that as monitoring costs increase so does return on assets.

Correlation between Bonding Costs and Financial Performance

Table 3: Correlation between Bonding Costs and Financial Performance

	Bonding Costs	ROE	ROA
Bonding Costs	1.000	-0.15	-0.12
ROE	-0.157	1.000	0.812
ROA	-0.108	0.842	1.000

The table shows that bonding costs negatively influence financial performance of licensed insurers in Kenya. It was observed that bonding costs negatively influenced ROE and ROA with correlation coefficient of -0.157 and -0.108 respectively.

Regression Analysis

Influence of Monitoring Costs and Financial Performance

The results from the regression analysis of monitoring costs and financial performance measured through ROE and ROA is summarized in the following two tables.

Table 4: Influence of Monitoring Costs on ROE

Variable	Beta Coefficient	Std Error	t-Statistic	Probability
Constant	0.455	0.023	19.78	0.000
Monitoring Costs	0.131	0.002	65.50	0.032
Root MSE	0.198			
R-Squared = 0.71.8				
Adjusted R^2 = 0.71.6				

The result from the regression analysis indicate that monitoring costs has a positive and significant relationship on financial performance as estimated using ROE (β =0.131, P = 0.032); implying that for every unit rise in monitoring costs results to a 13.1 unit increase in return on equity.

Table 5: Influence of Monitoring Costs on ROA

Variable	Beta Coefficient	Std Error	t-Statistic	Probability
Constant	2.124	0.098	21.67	0.000
Monitoring Costs	0.384	0.155	2.48	0.010
Root MSE	0.869			
R-Squared = 0.684				
Adjusted R^2 = 0.677				

The results shows that monitoring costs has a positive and significant influence on financial performance estimated through ROA (β =0.384, P = 0.010); this means that in every unit rise in monitoring costs it results to a 38.4 unit rise in ROA (financial performance). This resulted to rejection of the hypothesis that monitoring costs have no significant influence on financial performance of insurance firms licensed Insurers in Kenya. This finding is in line with Tripathi (2019) study that also established that monitoring costs has a significant relationship on not only the firms' value but also on financial performance.

The finding on monitoring costs espoused with Tripathi (2019) study that discovered that monitoring costs had a positive influence on the value of the firm; as monitoring expenditures are necessary to align the interests of the managers with that of the shareholders.

Influence of Bonding Costs on Financial Performance

The regression result assessing the influence of bonding costs on financial performance of insurance firms licensed Insurers in Kenya is highlighted in the following tables.

Table 6: Influence of Bonding Costs on ROE

Variable	Beta Coefficient	Std Error	t-Statistic	Probability
Constant	0.512	0.013	39.38	0.000
Monitoring Costs	-0.128	0.018	-7.11	0.012
Root MSE	0.198			
R-Squared = 0.112				
Adjusted R^2 = 0.204				

The result indicates that bonding costs has a negatively significant influence on financial performance as measured through return on equity (β = -0.128, P = 0.012). This means that a unit rise in bonding costs causes a 12.8-unit decline in financial performance. The influence of bonding costs on the second measure of financial performance is illustrated in the following table.

Table 7: Influence of Bonding Costs on ROA

Variable	Beta Coefficient	Std Error	t-Statistic	Probability
Constant	2.375	0.0711	33.40	0.000
Bonding Costs	-0.134	0.085	-1.58	0.026
Root MSE	0.926			
R-Squared = 0.808				
Adjusted R^2 = 0.802				

The results also indicate that bonding costs has a negative and significant influence on financial performance as estimated by return on asset (β = - 0.134, P = 0.026); this means that a unit rise in bonding costs result to a 13.4 unit decline in financial performance as estimated by ROA. This led to rejection of the hypothesis that bonding costs have no significant influence on financial performance of insurance firms licensed Insurers in Kenya.

The finding on bonding costs was in disagreement with Abdulrahman (2014) study that found out that bonding expenditure had mild positive influence of financial performance of listed firms in Nairobi Securities Exchange.

Conclusions

The result indicated that monitoring costs had a significant positive influence on financial performance measured by both ROE and ROA. This implied that increased monitoring expenses correlate with improved financial performance of licensed insurers in Kenya. Effective oversight seems to bolster not only profitability but also shareholders value; emphasizing the importance of diligent supervision within these insurers.

The result indicates that bonding costs had a negatively significant influence on financial performance as measured by both ROE and ROA. This implies that increased bonding expenses are linked to decreased financial performance. This finding therefore suggests that reducing bonding costs may result to high profitability and shareholders returns.

Recommendation

In order to lower the monitoring costs, the study recommends the introduction of management incentives and welfare schemes that will provide both financial and non-financial incentives to management in an effort to motivate them to act at the best interest of the shareholders. The incentives can be based on various performance indicators like monthly or annual sales and profits targets. Financial incentives pegged on financial performance tend to align the interests of management with those of the shareholders. There should be enhanced oversight mechanisms through regular audits to optimize monitoring efficiency, therefore enhancing financial performance.

In order to lower the bonding costs that have been found to have a negative influence on financial performance, the study recommends the use of stock options and policies on profit sharing that will see management become part of the company and receive a certain percentage of company annual profits; motivating them to maximize shareholder’s value. Also, the management should be provided with a conducive working environment, provided with training opportunities and their effort acknowledged. Though the agency costs rampant in the insurance sector cannot be fully done away with, it can be lowered and therefore bolstering financial performance of insurers.

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