

CHALLENGES FACED IN PSV INSURANCE SECTOR IN KENYA:

HOW ADEQUATE IS THE LEGAL AND THE ENFORCEMENT

MECHANISM?

MASTERS OF LAWS PROJECT

FRIDAH LOTUIYA

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DECLARATION

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Signature

.....

Date

This Thesis has been submitted for Examination with my Approval as a University Supervisor.

.....

Signature

.....

Date

Dr. Winnie Kamau Senior Lecturer, School of Law.

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DEDICATION

This Thesis is dedicated to my loving parents, Daniel Lotuiya Kaplich, and Pauline Kaplich, for their love, care and constant support throughout my education. Thank you for sacrificing the little you had to buy me a solid foundation in education. This has indeed made a difference in my life. How I only wish you had the literacy to read my work!

ABBREVIATIONS AND ACRONYMS

AKI- Association of Kenya Insurers

AKIB-Association of Kenya Insurance Brokers

GAAP- Generally Accepted Accounting Principles

IRA- Insurance regulatory Authority

Kenya Re- Kenya reinsurance Corporation Limited

MOA- Matatu Owners Association

OSFI- Office of the Superintendent of Financial Institutions

OB- Occurrence Book

PSV- Public Service Vehicles

PTICL- Public Transport Investment Company Limited

UNCTD-United Nations Conference for Trade and Development

TLB- Transport Licencing Board

List of Statutes

1. *Civil Procedure Act Cap 21 of the Laws of Kenya*
2. *Government Proceedings Act, Cap 40 of the Laws of Kenya*
3. *Fatal Accidents Act, Cap 32 of the Laws of Kenya*
4. *Insurance Act, Cap 487 of the Laws of Kenya*
5. *Insurance (Policyholders' Compensation Fund) Regulations, 2010*
6. *Insurance (Motor Vehicles Third Party Risks) Act Cap 405 of the Laws of Kenya*
7. *Kenya Police Service Act, Act No. 11A of 2011*
8. *Limitations of Actions Act, Cap 22 of the Laws of Kenya*
9. *Law Reform Act, Cap 26 of the Laws of Kenya*
10. *Traffic Act, Cap 403 of the Laws of Kenya*

Table of Cases

1. *Brownlie v Campbell* (1880) 5 App Cas 925
2. *Credit Kenya Limited v Gateway Assurance Kenya Limited* Civil case 1549 of 1994
3. *Derry v Peek* (1889) 5 T.L.R. 625
4. *In the Matter of Invesco Assurance Limited* HCCC No. 318 of 2008
5. *Kensilver Express Limited & 3 others .v. Commissioner of Insurance & 4 others* [2007] eKLR
6. *Peek v Gunney* (1873) LR 6 HL 377 at 403
7. *Reddaway v Banham* 1896 AC 199 at 221
8. *Salomon v A Salomon & Co Ltd* [1897] AC 22
9. *Sanghera v. Thind*(1996) O.R. (3d) 479, 132 (Ont. Crt. Gen. Div.).

ABSTRACT

The PSV insurance sector in Kenya is facing challenges with many of its players having been placed in statutory management over the last decade. In this project, we analyze the causes of the challenges which are faced, and make an inquiry on the adequacy of the applicable law.

It is found that the problems leading to the challenges are within the industry itself in the form of fraudulent claims and collusions, arbitrary awards on insurance claims, and poor distribution of risks. The law as it is, is inadequate to address these challenges.

The major recommendations are that the Insurance Act be amended to give the IRA a statutory mandate to regulate financial services fraud in the insurance sector. Coordination among the various stakeholders in the insurance sector will also go a long way in eliminating fraudulent activities in the sector. Finally, the Insurance (Motor Vehicle Third Party Risks) Amendment Bill, 2013 should be passed to eliminate the problem of arbitrary awards on insurance claims.

DEFINITIONS

In this study, unless the context so otherwise explains, the following words have been used with the following meanings.

Collapse - the term collapse is used to denote a situation of extreme liquidity challenges by an insurance company. The challenge can manifest itself through issuance of moratoriums, statutory protection, being placed under statutory management, and eventual winding up of an insurance company.

PSV- The word PSV has been used to denote public service vehicles which have been licenced by the Transport Licencing Board (TLB) to undertake transportation of passengers.

PSV insurance companies- these are the insurance companies which undertake PSV underwriting as a major component of their underwriting business.

PSV insurance cover- this is used to refer to the third party motor insurance cover and any other cover which a public service vehicle is required by law to undertake.

PSV insurance sector- this is used to mean a collection of the insurance companies which offer PSV insurance covers as a major component of their underwriting business.

Solvency Challenges- These are challenges which affect an insurance company because of incidences such as fraud, poor corporate governance and excessive risks.

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CHAPTER ONE

1.1 Background to the Study

The history of the Public Service Vehicle (PSV) insurance in Kenya is best looked at from the point of view of the history of the insurance industry as a whole. This history is closely tied to colonialism when individual property rights within the protectorate were taking root. During colonization, whites from all over the world where Britain had ties came and settled in the country to take up large scale farming and other economic activities so as to promote the economy of the newly developed protectorate¹.

As there was no established insurance business within the territory at that time, the British insurance companies opened up agency offices in Kenya which enabled them to underwrite the settler's wealth. Records show that as early as 1901, Smith & Mackenzie & Company agents were located in Pemba and Zanzibar, and they conducted insurance services on passenger vehicles. They were acting for British India Steam Navigators Company Limited. It covered risks on the steamers which were vying between United Kingdom and East Africa. Another notable colonial agent, whose work can be traced to the modern day insurance business in Kenya, is Sydney Fichat, an agent who acted for Norwich Union Fire Assurance society since 1905². Norwich Union Fire Assurance Society later merged with Legal and General Assurance society to form the Heritage Insurance. Heritage Insurance merged with African International Insurance Company to form the present day Heritage A.I.I. Insurance Company³.

¹ Before colonization in Kenya, there was in place the concept of collective property ownership. Any loss was distributed among the owners and therefore there was no need of insurance. The concept of insurance was purely foreign.

² Insurance Institute. 2000. *A guide to insurance Industry in Kenya*. Nairobi: Insurance Institute of Kenya. P. 26

³ This can be accessed at www.heritageinsurance.co.ke

As the economy grew, most of the companies which were represented in Kenya by agents sought to open branches in Kenya to reinforce the work of the Insurance agents. Royal Exchange assurance of London opened a fully fledged branch in 1922. In 1930, National Employers Mutual General Insurance Association also opened a fully fledged branch in Kenya. Notable here, is the fact that these branches still maintained a lot of contact with their parent companies abroad, and most of the authority came from abroad⁴.

By the time Kenya got independence⁵, most of these agency firms had established themselves into independent insurance companies⁶. The journey to fully fledged insurance companies incorporated in Kenya started in 1930, with the incorporation of Pioneer Assurance Society Limited. Jubilee Insurance Company followed suit in 1933, and it provided both life and general insurance. Pan Africa Insurance Company was incorporated in 1946, while Provincial Insurance was incorporated in 1949⁷. In 1976, thirteen years after colonization, Kenya had about 47 insurance companies, of which only seven were domestic⁸. This meant that the profit which was made by the remaining 40 insurance companies would be channeled to their head offices abroad.

There was however a desire by the Kenyan government that the insurance industry be localized and it is in light of the above that the then Minister of Finance, Hon. Mwai Kibaki did in 1978 direct in his budget speech that the said insurance branches be incorporated in Kenya. In the same year, there was a ministerial directive to the effect that import licenses for imported goods

⁴ *Ibid* P. 29

⁵ Kenya got independence in 1963

⁶ Macharia, Rose Wachuka, The Motor Insurance Industry in Kenya: Adopting the No-Fault Insurance System (November 17, 2009). Available at SSRN: <http://ssrn.com/abstract=1507642>.

⁷ *Ibid* note 2 P. 30

⁸ *Ibid* note 2 P. 31

be approved only if the goods were insured with a locally incorporated insurance company⁹. This can be said to be the beginning of growth in the insurance business in Kenya.

The PSV insurance covers can be said to have began in Kenya around 1950s with the inception of commercial vehicles on Kenyan roads. The same were covered by insurance companies for general risks, but this occasioned great losses to the insurance companies underwriting them. The loss was as a result of car losses and the situation of the vehicles which were plying the roads at the moment¹⁰. This led to high premiums for the commercial vehicles, and some could not get cover at all. The government then directed that owners of Omnibuses, tankers, *matatus*, and commercial vehicles form a pool whereby all third party risks would be catered for. The pool became operational in 1975, January 1. The same conducted business for almost 8 years when it was disbanded in 1984, because of the withdrawal Kenya National Assurance, two years earlier. The insurance of the commercial motor vehicles was faced with huge third party claims and awards. This led the government to direct the owners of commercial vehicles into forming another motor pool in July 1985, but this time with Kenya National Assurance, Kenya Reinsurance Corporation and a representative from the Ministry of Finance as permanent members. In the next 12 months, the pool has sustained over 40 billion losses and the same was disbanded in 1987¹¹.

The motor vehicle insurance industry has been facing a lot of problems over the years. In 1986, a presidential enquiry was formed to investigate the nature of the general insurance business in Kenya and to determine the adequacy or otherwise of the premiums paid. This was the Hancox

⁹ *Ibid* note 2 P. 35

¹⁰ Timbwa A. O. The Kenya Motor Insurance Pool. *The Kenya Underwriter* Vol. 10-December, 1985

¹¹ *Ibid*

Commission which was established through Kenya Gazette number 4272 of 1986. The commission was headed by a one judge, Allan Robin Winston Hancox, and he was assisted by Mary Angawa. However, the findings of the inquiry have never been made public¹².

The insurance industry was at the time also governed by the companies Act¹³ a legislation which was borrowed from the UK. The companies Act provided for the general regulation of company activities, such as keeping proper records and annual reporting. There was, therefore, a need to ensure that the insurance sector received an industry specific regulation. In the early 1980s, the ministry of finance in collaboration with United Nations Conference for Trade and Development (UNCTD) worked on a suitable legislation (the Insurance Act CAP 487), which was passed into law in 1986. Under the 1986 Act, the Insurance industry was to be regulated by the Commissioner of Insurance which was under the Ministry of Finance. However the Insurance (Amendment Act, number 11 of 2006) created the Insurance Regulatory Authority¹⁴ which replaced the Commissioner of Insurance. This move was meant to install autonomy in the Insurance sector. The Insurance regulatory authority is charged with the mandate of supervising, regulating and developing the Kenya Insurance sector. The difference of the functions of Insurance regulatory Authority with the Commissioner of Insurance is that the Commissioner of Insurance was not independent from the government, and it was a channel of implementing the governmental policies with regards to insurance with the insurance sector. It was desirable to have an autonomous body to regulate insurance. The commissioner of Insurance was not abolished, but his mandate has been greatly reduced.

¹² Njenga, G. 2012. *Thriving on Borrowed Time: Reviving Invesco Assurance: Case for Reforming the Insurance Industry*. Nairobi: Hope centre International

¹³ Cap 486 of the laws of Kenya.

¹⁴ Section 3 of the Insurance Act

There are also other bodies which have been formed in the insurance sector, and which are worth noting. The first is the Policyholders Compensation Fund which was formed in 2004, through legal notice number 105 of 2004 by the Minister of Finance. The purpose of the fund is to partially compensate policyholders in cases where insurance companies are faced with collapse. The other purpose of the fund is to instill confidence in the public. However, the efficacy of the fund has not been tested, noting that the maximum compensation which one can get is Ksh. 100,000. This is inadequate, because some insured events run up to millions of shillings.

The association of Kenya Insurers is a body which was formed in 1987 by insurers in Kenya. Its main objective is to promote common objectives and interests in the insurance sector. They also offer advisory services to the public and the government regarding insurance matters.

Almost fifty years since independence, Kenya's insurance industry has flourished, and now has about 46 registered insurers¹⁵, transacting general insurance business including life insurance, or acting as composite insurers, i.e – transacting in both life and general insurance businesses. However, a few of the insurance companies have entered into the PSV sector, and most of those who engage in 3rd party PSV insurance, only undertake minimal policies. Kenya's insurance industry leads within the East Africa Community, and is a key player in the COMESA region¹⁶.

A number of insurance companies do offer motor vehicle third party insurance cover (hereinafter referred to as PSV insurance cover). The companies have, however, in the recent past, faced a lot of challenges with eight of them being declared insolvent¹⁷. Given that PSV operators do business in all parts of the country and are high risk clients and yet they lack proper sectoral

¹⁵ Association of Kenya Insurers (AKI), Annual Report , 2011

¹⁶ AKI Annual Report, 2005

¹⁷ *ibid* note 12

regulatory mechanisms. Currently, motor vehicle insurance is governed by the Motor Vehicle (Third Party Risk) Act¹⁸ which provides for compulsory insurance and prescribes a penalty for a motor vehicle owner who fails to take up such insurance cover¹⁹.

Kenya lacks proper public transportation facilities. What this means is that the government does not have mechanisms put in place which offer transportation to the public. The Kenya railways corporation has very few trains which operate in a few parts of the country. These trains are usually overloaded and are in poor conditions. There are no governmental matatu operators. Therefore, road users have been forced to use the available means of road transport vehicles which belong to private individuals. The traffic law in Kenya is clear and no vehicle is allowed on the road without an insurance cover²⁰. The purpose of this is to protect the third parties and other users who may be injured in the course of transit. There is, therefore, the need to protect our PSV insurance companies from collapse or extinction. This is because without insurance, there might not be transportation. The study hereof is crucial for it seeks solutions to some of the above mentioned concerns.

The research will discuss the underlying issues behind the collapse of the PSV insurance companies in Kenya over the recent past. Such discussion shall also cover insurance models which have been adopted by other countries. PSV insurance covers only public transport vehicles in Kenya which provide the major forms of transportation in the country. The public transport is thus vital given that Kenya is a third world country where the proportion of people with personal vehicles is far much less compared to those who do not and hence have to rely on public

¹⁸ Enacted in 1946

¹⁹ Section 4 of the Act.

²⁰ Section 4 of Motor vehicle (Third Party Risk Act)

transportation. The collapse of the PSV insurance companies therefore means that the people who travel in vehicles covered with those companies are at risk as they remain exposed to the possibility of missing out on essential policy cover while the vehicle owners seek alternative covers. It is also problematic when an insurance company collapses while having pending claims. Given that such claims could relate to the repair of motor vehicles, subrogation or personal injury claims. When an insurance company collapses, all pending claims are stopped pending investigations and revival of the company. If it is not possible to be revived, then it will be liquidated and the claimants will get a very small proportion of their claims if any.

The collapse of PSV insurance companies also has an effect on the existing insurance companies. This is because the entire financial sector is generally prone to panic attacks and runs. The hardships of one company may, therefore, be spilled over to other healthy companies thereby causing rampant collapse within the whole market. There is always cause for alarm of impending problems if the collapse of the PSV insurance companies is not adequately addressed. According to experts in the industry²¹, the insurance sector works best by way of the insured putting money into the insurance companies as premiums. The premiums are then invested by the insurance companies and it is from these investments that the insureds will be paid the money after the occurrence of the insured event. It therefore becomes problematic when the insurance company cannot pay the money when it is expected to pay.

1.2 Statement of the problem

Inadequate or poorly enforced insurance legal framework leading to solvency challenges in the PSV insurance sector.

²¹ Hansmann, H., 1981. "The Organization of Insurance Companies: Mutual Versus Stock" *Journal of Law, Economics and Organization* pp. 128.

1.3 General Objectives of the Study

The intended goal and objective of this research was to investigate the adequacy of the law in promoting solvency and liquidity of PSV insurance companies in Kenya and to suggest recommendations as to how to forestall any further collapse of the companies.

The study more specifically sought to:

1. To critique the role of various stakeholders in the insurance sector, and their contribution to the overall success of the industry.
2. To find out the underlying problems leading to the solvency challenges.
3. To find out the sufficiency of the legal and institutional framework promoting the solvency and liquidity of the PSV insurance companies.
4. To undertake a comparative analysis of insurance models in other jurisdiction.
5. To come up with recommendations on way forward to curtail further challenges in the insurance sector.

1.4 Research Questions

The following question were answered in the course of the research

1. Who are the major players in the PSV insurance sector?
2. What are the underlying problems leading to solvency challenges?
3. How effective is the insurance legal and institutional regulatory framework to address the question of solvency?

1.5 Justification of the study

This is a sector which has received little literature, and therefore, there is need for further research and investigation in order to make it clearer. The insurance Act does not point out to specific measures to follow in order to salvage the falling insurance companies. Reports of the investigation of the collapsed insurance companies have not been publicly published, reducing further the available information for the sector.

It is also hoped that the various recommendations which will be put forth by the author can be useful to the government when setting policies regarding insurance in Kenya.

1.6 Hypothesis

Given the trends of the collapse of PSV insurance companies, the author hypothesis as follows:

1. Kenya lacks proper legal and institutional framework to sustain a healthy PSV insurance sector. Lack of proper legal framework has caused fraudulent activities to thrive in the PSV insurance sector in Kenya.

1.7 Theoretical framework

An insurance arrangement is a contractual arrangement which confers rights and obligations to either of the parties to an insurance contract. The consumer of services (Policyholder) is obligated to pay premium and make a full disclosure of material facts to enable the insurance company make a correct judgment on the amount of premium to levy. In return, the policyholder expects to be indemnified in case of the occurrence of the insured event. The kind of indemnity expected from the insurance company depends on the nature and the terms of the policy. Third party insurance will protect the insured from claims arising from third parties. However, when the insurance company is facing solvency and liquidity problems, it

may not be able to perform its part of the bargain and the policyholder may lack indemnity and be liable to third parties in case of third party motor vehicle insurance.

In a well functioning market, the market forces of supply and demand are responsible for bringing equilibrium into the market. Therefore, there is no need of regulation in this kind of market. However, in a typical financial market, the market is not well functioning due to information asymmetries and externalities in the sector. Therefore, it necessitates the concept of regulation in an otherwise private market.

*In Thomas Muoka Muthoka & another v Insurance Company of East Africa limited*²², Justice Onyancha clearly pointed out that the reason in which the Insurance (Motor Vehicle Third Party Insurance) Act was passed was to enable third parties who were injured in an accident to be compensated even when the driver and the owner of the motor vehicle causing the accident were poor. This statement by Justice Onyancha can be applied to the motor insurance system as a whole that the reason why insurance is undertaken is to provide a cushion for unforeseeable losses. However, when insurance companies face liquidity challenges and are unable to honor their claim obligations, it's the claimants who go without recourse. This goes against the very aim why an insurance policy is undertaken.

In order to achieve the above consumer protection goal of insurance, regulation has to be undertaken²³. Regulation for consumer protection is best looked at from the nature of the market which the financial service sector is based. Adequate regulation for the protection of

²² *Thomas Muoka Muthoka & another v Insurance Company of East Africa limited*. [2008] eKLR

²³ Bird J, 2010. *Modern Insurance Law*. London: Sweet & Maxwell

the policyholder is achieved through two systems of regulation of insurance market²⁴. These are;

1. Prudential regulation
2. Market conduct regulation

The **prudential regulation** is responsible for the safety and soundness of the financial institutions which are being regulated. This is with regards to issues such as the solvency and the financial capital which the financial institutions have, and whether the same comply with the applicable legal requirements²⁵.

The **market conduct regulation** will regulate the day to day conduct of the financial institutions. This is aimed at protecting the consumers in the market. This will also bring in the required confidence in the financial sector, and the consumers will propel the financial institutions to success²⁶.

It is on the basis of the above regulatory theory that this paper is written. The regulatory framework which has been put in place by the government and the institutional arrangements should cover both the prudential and market conduct of the insurance companies in Kenya. This could be inadequate and the same should be modified so that it can be effective in ensuring solvency of the PSV insurance sector as well as consumer protection and

²⁴ Financial Regulation Reform Steering Committee, 2013. *Implementing a twin peak model of financial regulation in South Africa*. A task force constituted to look into the possibility of implementing a twin peak regulatory system in South Africa.

²⁵ Allen F. and Gale D. 2004, "Competition and Financial Stability", *Journal of Money, Credit and B Banking*, 36 (3), Part 2, pp. 453-480.

²⁶ Anderson, G. 2009. *Market Conduct Regulation: World Bank Brazilian Study Tour*. [Online]. Available at http://cenfri.org/documents/microinsurance/2009/SA%20MI%20study%20tour_FSB%20Market%20conduct%20regulation_March%202009.pdf. (Accessed October 31, 2013)

confidence. However, the prudential regulation and the market conduct regulation should not be made too independently of each other. The same should complement each other.

1.8 Methodology

In collecting data for use in this study, the author used various books and articles which were be obtained from the library. The researcher used the various university of Nairobi libraries, as well as the library of the college of Insurance, Kenya. The research materials were composed of various primary sources such as statutes, cases and legal opinions. Another primary source which was utilized was interviews. Secondary information from books and articles were also be used.

The interviews were conducted on three major institutions. The first was the college of insurance whereby the author wanted to find out whether students are well equipped with knowledge to manage PSV insurance companies. The second institution was the Insurance Regulatory authority and finally, on Invesco. Some interviews were also carried out on persons on their personal capacity. These were the interviews conducted on the police commandant, the chairman of Matatu Owners Association and on a prominent Advocate who deals majorly with PSV insurance matters. The data collected was deemed reliable and relevant if more than 50% of the respondents had a similar opinion. Only relevant and reliable data is referred to in this report.

1.9 Literature Review

Few scholars have written about the insurance and especially issues pertaining to regulation and insolvency. There is very little literature with respect to Kenyan situation as most of the

available literature is foreign. In the literature review, the author will try to apply the foreign situations to the Kenyan context.

According to Dennis Kelsner²⁷, Regulation is an important tool which the government uses to protect the insured's. According to Dennis, it is imperative that the government regulates and ensures fair enforcement of the insurance contract as well as supervise the entity during collapse in order to ensure a fair settlement with the insured's. The author also appreciates the fact that every unique crisis requires unique responses and therefore the governmental control will not be uniform for everybody²⁸. This journal article is therefore very informative in respect of the duty of the government to protect the insured, especially during insolvency. However, it still leaves a gap as to what actually causes this insolvency and what the government should do in order to prevent firms from collapsing. The author does not also address the Kenyan story of the collapse of PSV insurance companies. The purpose of this thesis is to critique the adequacy of the legal framework which has been put in place by the government to regulate the insurance sector.

According to Kwon,²⁹ financial institutions collapse due to overregulation by the governments and also due to market externalities. According to her, the forces of supply and demand should be allowed to direct the performance of financial institutions and government intervention should be minimal. The governmental regulation should only be sufficient enough to ensure that there is a level ground in the market. She also advocates for the need of equal access to information. This will reduce instances of insider trading and unfair

²⁷ Kelsner, D., 'The future of Insurance regulation and Supervision'- A Look at a global perspective Insurance regulation for post war crisis, Geneva Journal. PP 33-41

²⁸ Ibid pp. 34

²⁹ Kwon, J. 'Economic Rationale for Insurance regulation' Insurance regulation for post war crisis, Geneva Journal. PP 7-21

advantages by some stakeholders to the detriment of others. This journal article is very informative on the need of insurance regulation and the effects of overregulation. However, it does not directly address the issue of PSV insurance and in particular in Kenya. It only gives general information on the regulatory framework. The journal is also based on a perfect market economy. As explained in the theoretical framework above, the reason why regulation is necessary in the PSV insurance sector is because of information asymmetries and externalities, which makes a perfect market economy impossible.

According to Macharia³⁰, the collapse of the PSV insurance industry in Kenya is due to the fault system which has been adopted by the industry. The no fault system entitles the insured to be indemnified by the insurance company in case of a loss or damage regardless of whether the insured was at fault or not. It presumes a no fault status on the part of the insured and obligates the insurance to indemnify him. This system is helpful because it has reduced the number of litigations tremendously and thereby enabling a fast conclusion of claims. However, it is prejudicial to the insurance companies because it does not consider issues like negligence and recklessness. This article is therefore very useful as far as the adoption or otherwise of the no fault system in the enforcement of the insurance laws in Kenya. However, the article does not look at other possible causes of collapse of insurance companies in Kenya. This paper will discuss a case for the introduction of no fault insurance model in Kenya. A comparative analysis with jurisdictions which undertake no fault insurance models will also be considered.

³⁰ Macharia, R. W. 2009. *The Motor Insurance Industry in Kenya: Adopting the No-Fault Insurance System*. [Online] Available at SSRN: <http://ssrn.com/abstract=1507642>. (Accessed November 17, 2012)

Gakeri³¹, argues that the financial service sector regulation in East Africa, as well as in other developing countries in Africa are not deeply affected by the global financial crisis. He opines that the challenges which are faced by the financial services sectors are majorly regulatory challenges whereby the same are either over regulated or under regulated. In his article, he argues a case for an integrated regulatory system in Kenya, and he concludes that Kenya is not ready for such a system yet. He opines that the fragmented regulatory system is adequate at the moment, although certain reforms should be effected. I agree with Gakeri on his assertion that Kenya is not yet ready for an integrated financial system, and that certain reforms should be factored in to make it more effective.

Young³² stresses on the objective of regulation. He asserts that regulation is an important tool which helps the policyholder and other third parties entitled in an insurance contract. Therefore, due to information asymmetry and low bargaining power, the government compels the insurer through legal mechanisms to perform his part of the obligation. However, it may seem that the reason why insurance companies fail is due to poor legal enforcement mechanisms. This paper analyses the available legal mechanisms in the PSV insurance sector, and critiques the adequacy of the legal mechanisms and the enforcement thereof.

According to Keeton³³, regulatory mechanisms in the insurance sector should fulfill one of three categories of regulatory outcomes listed. The regulatory mechanisms should ensure

³¹ Gakeri, J. K. 2011. Financial Services Regulatory Modernization in East Africa: The Search for a new paradigm for Kenya. *International Journal of Humanities and Social Science* Vol. 1 No. 16; 161- 172

³² F Young, 'Is Insurance a Niche Business? Reflections on Information as an Insurance Product' (1995) 1:1, Connecticut Law Journal, 5.

³³ Keeton, R. E. 1963. Basic Insurance Law. *The Journal of Insurance* Vol. 30, No. 1 pp. 133

than the insurers keep within their scope, remain solvent at all times, and finally ensure fair charging of premium. This paper interrogates the ability of the legal mechanisms in Kenya to ensure the solvency of the PSV insurance sector in Kenya.

1.10 Chapter Breakdown

This thesis is composed of five chapters.

1.10.1 CHAPTER ONE- INTRODUCTION

Chapter one is an overview of the research, and provides the rationale for undertaking it. It enables the users of this work to understand what the researcher was researching on, and also gives an overview of what is expected from the study. It is composed of the background to the research, justification of the study, the statement of the problem, objectives of the study, hypothesis, theoretical framework, methodology to be used and the literature review.

1.10.2 CHAPTER TWO- OVERVIEW OF THE PSV INSURANCE INDUSTRY

This chapter gives an overview of the working of the PSV insurance sector. The chapter introduces the various actors in the PSV insurance sector, and how these actors contribute to the working of the sector. At the end of this chapter the reader will be able to understand that the PSV insurance industry has many actors who influence the workings of the sector without being privy to the contract of insurance. The second part of the chapter enumerates the various causes leading to the solvency challenges of insurance companies.

1.11.3. CHAPTER THREE- ADEQUACY OF THE LAW IN PSV INSURANCE SECTOR IN KENYA

This chapter gives an in-depth analysis of the legal and regulatory framework of the PSV insurance sector. There are many legal enactments which contribute to the workings of the PSV insurance sector. The second part of the chapter considers the adequacy of the applicable law and institutional framework to promote the solvency and liquidity of insurance companies. The major areas which are considered are reinsurance provisions, solvency provisions and corporate management provisions in the Insurance Act. Finally, the chapter considers consumer protections mechanisms which are in force and whether they are adequate in shielding the claimants against losses in case of solvency and liquidity challenges on an insurance company.

1.11.4. CHAPTER FOUR- THIRD PARTY MOTOR INSURANCE MODELS IN OTHER JURISDICTIONS

This chapter is comparative in nature, and considers motor insurance models undertaken in other jurisdictions. The areas considered are the no-fault model of insurance as experienced in Canada and Michigan, and the declined pool insurance system which is undertaken in India. The aim of the chapter is to give options which the insurance industry in Kenya can borrow from.

1.11.5 CONCLUSIONS AND RECOMMENDATIONS

This chapter is divided into two parts. Part one concludes on the findings of the research project, on the adequacy of the law to promote solvency and liquidity of the PSV insurance companies. Part two provides the various recommendations which have been suggested and which are thought to remedy the insurance industry from the noted solvency and liquidity challenges.

CHAPTER TWO

OVERVIEW OF THE PSV INSURANCE SECTOR: ACTORS AND CHALLENGES

2.0 Introduction

This chapter is divided into two parts. The first part lays down the various actors in the PSV insurance sector. These players are instrumental to the success or otherwise of an insurance process. The second part of this chapter gives an analysis of the issues and challenges which have arisen in the companies which offer third party motor insurance to PSV in Kenya. The aim of this chapter is to identify the actors in the PSV insurance industry and highlight the salient problems which lead to solvency and liquidity challenges in the PSV insurance sector. This will lay a foundation for the next chapter which deals with the adequacy or otherwise of the law to address the causes of solvency and liquidity challenges in the PSV insurance sector.

2.1 Players in the general insurance sector

An insurance business has been defined by the Insurance Act as the business of undertaking liability by way of insurance in respect of any loss of life and personal injury and any loss or damage, including liability to pay damage or compensation, contingent upon the happening of a specified event³⁴. This section of the paper deals with the various actors in the PSV insurance sector. These actors are instrumental to the success of an insurance contract, and their actions impact the insurance business in one way or another. Some of the actors are in the ambit of insurance law regulation. However some like the police and the courts are regulated by different regulatory bodies and the insurance regulator may not be able to control their actions with

³⁴ Section 2 of the Insurance Act, Cap 487 of the Laws of Kenya

regards to the PSV insurance sector. The provisions of the insurance law with regards to some of these players are administrative in nature, and do not impact on the way in which the players interact with the policyholders.

2.1.1 Insurance Intermediaries (Brokers and Agents)

The insurance Act defines a broker as an intermediary whose work is to place the insurance and reinsurance companies in contractual positions with third parties. This means that a broker is actually an agent of the insurance company³⁵. A broker is paid on brokerage commission, depending on the amount of insurance businesses which he underwrites.

An agent, on the other hand, is defined as a person who procures or solicits the insurance business for an insurance company or a broker. As a broker, an agent is also paid on commission. However, it would seem from the definition that an insurance agent is more junior as compared to a broker, because he also works for a broker³⁶.

The insurance Act provides for the qualifications and regulation of the way in which brokers conduct their business. However, the same is silent on the qualifications of agents. A broker is required to be a body corporate, with a paid up capital of one million shillings³⁷. The broker should also have a satisfactory professional indemnity cover. The share capital of the brokerage firm should be held by Kenyans to the tune of 60%. A broker is also required to submit statements showing the amounts of premium underwritten twice every year, in June 31st and

³⁵ Section 2 of the insurance Act

³⁶ Section 2 of the insurance Act

³⁷ Section 153(2) of the Insurance Act

December 31st each year³⁸. This is a move which is geared towards the audit and investigation of the activities of the broker by the Commissioner of Insurance.

From the above definition, it is clear that an insurance broker is not the same as an insurance agent, but they have a number of activities in common. Both solicit for insurance business for another party. They are not the ones offering insurance per se. From an economical point of view, insurance agents and brokers have been applauded for reducing transaction costs for insurance companies, and also minimizing information asymmetries³⁹. This is done through the dissemination of advice and information to prospective clients at cost effective rates. It is noteworthy that the intention of the agent and the broker is to increase their commission and brokerage fees, and they would devise many ways of wooing the clients to their side. This leads to a greater information, and therefore, business to the insurance company with minimal accompanying costs.

The German Code of Commerce differentiates insurance agents from brokers in the way in which they handle their operations. The Code⁴⁰ provides that insurance brokers act independently and at times liable for the loss which is occasioned to clients because of incorrect advice. Insurance brokers are distinct legal entities from the insurance or reinsurance bodies which they work for. They also work for various insurance companies. An agent, on the other hand, is defined by the same code to mean that they are semi-independent from the insurance companies

³⁸ Section 153 of the Insurance Act

³⁹ Eckardt, M. 2002. Agent and Broker Intermediaries in Insurance Markets- An Empirical Analysis of Market Outcomes. Paper presented at the 6th Annual meeting for the International Society for New Institutional Economics, Cambridge/Mass. Retrieved September 2, 2013 from http://www.wirtschaftssprachen.univie.ac.at/fileadmin/user_upload/wirtschaftssprachen/Englisch/Fitzsimons/Text6.pdf

⁴⁰ Article 87pp

or the brokers they work for. At times they are retained by the insurance company or brokers to work exclusively for them. They have a lesser liability as compared to the brokers.

Agency and brokerage relationships as defined by the insurance Act are similar to the typical legal agents which are created by law. Therefore, for the purpose of this chapter they will be considered collectively as agents of the insurance companies. Agent-principal relationships are contractual relationships of utmost good faith. However, because agents are compensated through commissions for work done, problems can arise with regards to conflicts of interests⁴¹. The conflict of interests can arise because the insurance company's aim is to underwrite risks in the right procedure with due consideration to valuation and other antecedent procedures before a policy is granted. However, to some agents this procedure may take time and lead to fewer policies, and hence lesser compensation on their side.

Agents are usually licensed to carry out insurance business, and one insurance agent can represent several insurance companies. The agents are paid in terms of commission, and therefore, the higher the number of motor vehicles they underwrite, the more profit for them. The insurance agents are only registered by the IRA after they have satisfied the requirements which are specified in the Insurance Act⁴². The brokers are professional insurers, and therefore, they can be held liable for their acts or omissions which occasion injury to the policy holders. However, because they are agents, their work is to connect the principal with a third party, and thus their liability is limited to misrepresentations, and to cases where they act on individual capacity. Therefore, a loophole is established whereby an agent can award insurance to a PSV

⁴¹ Padilla, A. (n.d). *Property economics of Agency Problems*. Retrieved July 25, 2013 from <http://mises.org/journals/scholar/padilla3.pdf>

⁴² Section 150(2) of the insurance Act

motor vehicle owner without due regard to the valuation and other antecedent procedures which follow the award of a policy. The PSV insurance company will then award cover to such motor vehicle, and ratifying the acts of the agent which did not follow the right procedure. The work of agents is to give professional advice on insurance matters, advising on the insurer who is best suited to undertake the cover, checking on appropriate covers, advising on risk management initiatives, claim management initiatives, and keeping insurance records for the principal.

The Insurance Act also expressly provides that any failure of the agent to comply with the provisions of the insurance Act shall not invalidate the insurance policy so granted⁴³. What this means is that even when the agents have acted negligently and offered insurance irregularly, the policy will still be valid and it will bind the insurer and the insured.

2.1.2 Valuers

Valuers are licensed by the Insurance Regulatory Authority⁴⁴. They are the ones who are referred to by the PSV insurance companies to value PSV motor vehicles before the policy is confirmed. The valuation by the valuer is final with regards to policy confirmation, and no other confirmation of value from the insurance company is undertaken. There are many motor vehicle valuers in the Kenyan market, who have been retained by various PSV insurance companies to value their vehicles before the same are covered⁴⁵. However, it would seem that the integrity and qualifications of the same is only based on the brand image they have been able to build over time. This is because there are no provisions in the Insurance Act, or any other law for that matter, on the qualification of valuers.

⁴³ Section 77 of the Insurance Act.

⁴⁴ Sec 3A of the Insurance Act

⁴⁵ Each year, the IRA will publish a list of persons who have been licenced to undertake insurance business in Kenya. This years list can be accessed through www.ira.go.ke/index.php?option=com_docman&task=doc...

When undertaking valuation, the valuers look at the vehicle parts which are in the vehicle at the time of valuation. Some of the parts of the vehicle are not marked with the identity of the vehicle. This means that in case of an accident, the owner of a PSV motor vehicle can easily swap the undamaged parts with other damaged parts so as to claim a higher value.

2.1.3 Insurance investigators and motor vehicle assessors

Insurance assessors are licensed bodies whose work is to evaluate and quantify the damage which has been occasioned to the insured vehicle. They assess the vehicles based on the amount of damage which is occasioned, and this is determined as a comparison between the initial state of the vehicle and the after accident state of the vehicle.

The investigators on the other hand, are not licenced bodies, and their work is to investigate the circumstances of the accident, and produce a report on the liability or otherwise of the insured. The investigation report is also useful as it informs the insurance company if the third party was insured, and the probability of success if the insurance company goes after the same on the doctrine of subrogation. The investigation report is a subjective report which is based on secondary information obtained at the scene of the accident. Mostly it is based on hearsay on witnesses of the accident, who may later agree to come and testify to the occurrence of the accident or not. When a PSV motor vehicle is involved in an accident, the passengers will be taken to hospital for treatment depending on the level of their injuries. The investigators will arrive at the scene long after the passengers have left and this is why their report is basically hearsay.

After the insured event has occurred and the insured makes a claim with the insurance company, the insurance company will usually send the motor vehicle to an assessor to assess the amount of

loss which the vehicle has undergone. This will determine whether the insurance company will repair the insured's vehicle, or if the vehicle will be declared a total loss. The valuation which will be done will be compared with the pre-accident valuation report, to determine the amount which is due to the insured. It is noted that the valuer and the assessor not the same. This brings in the question of subjectivity. There is no exact measure of measuring the state of a motor vehicle, and it depends on factors such as the year of manufacturer, experience of the driver, and the physical condition of the vehicle.

The insured events are well laid down in the policy document, and there are some events which are excluded⁴⁶. When a PSV vehicle is taken for assessment, the motor vehicle assessor will usually take an overall look at the state of the PSV vehicle. This means that pre-accident defects can easily be hidden in the accident defects, and the same be subject to compensation from the insurance company. It is noted that many public service vehicle drivers in Kenya are very reckless, and this can be deduced from the state of PSV vehicles plying Kenyan roads⁴⁷. This means that by the time the accident finally occurs, the vehicle had already suffered other defects from other events which are not covered by the policy.

Insurance investigators and motor vehicle assessors are licensed by the IRA⁴⁸ and further regulated by guidelines which are provided by the IRA on a regular basis. The guidelines regulate the conduct of the insurance investigators and assessors and also place them on a relationship of trust with the insurance companies. This means that the relationship is one of utmost good faith and complete disclosure. The IRA also undertakes continuous scrutiny and

⁴⁶ Kogi, M., & Maragio, M., 2001. *Introduction to insurance*. Nairobi: Focus Publishers Limited

⁴⁷ Njenga, G. *Thriving on Borrowed Time: Reviving Invesco Assurance: Case for Reforming the Insurance Industry*. Nairobi: Hope centre International

⁴⁸ Section 3A of the Insurance Act

appraisal of these service providers to ensure that they do not collapse with the policyholder's money. In 2013, the Authority blacklisted twelve insurance Brokers and one Motor Assessor.⁴⁹

2.1.4 Police

Police are given powers to control and regulate traffic on Kenyan roads by the Kenya Police Service Act⁵⁰. This also resonates with the Traffic Act⁵¹. The police are mandated to demand and inspect the driving license of any person driving a motor vehicle at any given time⁵². A police officer above the level of superintendent of police is also empowered to apply to the registrar of licenses for the revocation of driving licenses of any person who in the opinion of the police is suffering from a disease or physical disability likely to be of danger to the public⁵³. All accidents are also supposed to be reported to the police within 24 hours of the occurrence of such accidents⁵⁴.

When one is submitting a claim to the insurance company, the insurance company will require a police abstract which is submitted by the traffic officer who witnessed PSV the accident. The police are given the power to investigate and report on accidents by the Traffic Act. The provisions are not very clear, and there is no outright authority to give a police abstract⁵⁵. The

⁴⁹ Anyanzwa, J. 2013. *Regulator Bans 11 Insurance Agents*. Retrieved July 26, 2013, from http://www.standardmedia.co.ke/m/story.php?articleID=2000083386&story_title=Regulator-bans-11-insurance-agents

⁵⁰ Section 54 of the Kenya Police Service Act, Act No. 11A of 2011, Section 69 of the Traffic Act, Cap 403 of the Laws of Kenya

⁵¹ Cap 403 of the Laws of Kenya

⁵² Section 36 of the Traffic Act Cap 403 of the Laws of Kenya

⁵³ Section 40 of the Traffic Act Cap 403 of the Laws of Kenya

⁵⁴ Section 75 of the Traffic Act Cap 403 of the Laws of Kenya

⁵⁵ There is no definition of what a police abstract is in the Traffic Act, but a copy of a police abstract is attached in schedules

report of the accident to the police should be done within 24 hours of the occurrence of an accident⁵⁶.

This also brings in a number of questions which can be of interest to an insurer. The claimants in PSV insurance companies are mandated to submit police abstracts⁵⁷ and P3 forms to the doctors when they are going to hospital for an examination. Because the same is to be procured within 24 hours of the accident, this means that the police abstract is often procured without any examination of the accident scene. This means that anyone, even those who were not passengers in the accident vehicle can easily get a police abstract, and more so a P3 form as long as they have an injury. Some of the injuries may not be related to the accident complained of.

2.1.5 Courts

The courts adjudicate on PSV insurance matters on two fronts. The first front is when an injured insured person approaches the court to claim for the injuries which were occasioned in the course of the accident. The claim arises out of the third party motor insurance which is compulsory for all PSV vehicles plying Kenyan roads. The insured will be approaching the court on a tortious claim that the driver of the insured vehicle was negligent and caused the accident occasioning his injuries. The injured person will usually present a P3 form duly filed by the police and the medical doctors. The insured will be required to submit evidence that he was indeed in the accident vehicle, and that the injuries were occasioned from the accident. This is usually not simple because Kenyan public service vehicles hardly give receipts, and the judge will use circumstantial evidence to determine the presence of the injured person in the vehicle which was

⁵⁶ *Ibid*

⁵⁷ This is when one is claiming for motor vehicle accident or theft. Most insurance companies have this in their website to inform the policy holders well in advance. An example of such can be accessed through the Pacis Insurance website <http://www.paciskenya.com/customer-service/claim-procedure.html>

involved in an accident. After liability has been proved on a balance of probabilities, the court will use the doctrine of precedent to award damages to the injured person⁵⁸. The same procedure will be followed in case of deceased persons whose personal administrators claim to have died from the accidents occasioned by negligent drivers. The courts do not consider the condition of the injured or the deceased persons prior to the accident. The settlement is very subjective, and at times the public service vehicle would have been overloaded meaning more passengers to claim⁵⁹. However the court can also come to a conclusion that there was contributory negligence from the passenger, like cases when he did not strap a seat belt. In such cases the damages will be proportioned according to the contributed negligence. The courts will also be approached by the insurance companies, when they are claiming against negligent third parties through the doctrine of subrogation. Subrogation is a doctrine which allows an insurer to stand in the shoes of the insured, and claim from the accident which the insurance company has reimbursed the insured of the loss which was occasioned⁶⁰. However, the insured is still required to make the verifying affidavit⁶¹. It is to be noted that at this point, the insurance company has already made good of the insured's loss, and the insured has no more interest in the suit. This poses a lot of challenges because in most circumstances, the insured has no interest at all in instituting a suit. If the insurance company files a suit without a verifying affidavit, the same will be struck out and the insurance company will gain nothing from it⁶².

⁵⁸ Precedent is legal doctrine whereby courts of lower jurisdiction are bound to follow the decisions of courts with higher jurisdiction on matters which are related.

⁵⁹ Macharia, R. *The Motor Insurance Industry in Kenya: Adopting the No-Fault Insurance System*. Retrieved July 26, 2013 from <http://ssrn.com/abstract=1507642> .

⁶⁰ Bird J., 2010. *Modern Insurance Law*. London: Sweet & Maxwell

⁶¹ Verifying affidavit is a formal oath affirming that the allegations set out in the plaint are true to the best of the knowledge of the maker.

⁶² Order 4 Rule 1(2) of the Civil Procedure Act Cap 21 of the Laws of Kenya

2. 1. 6 Association of Kenya Insurers (AKI)

AKI is an association which is registered as a society in the Societies Act⁶³. The body was formed in 1987 and it is an association which draws its membership from insurance companies in Kenya. It exercises an oversight role over insurance companies in Kenya by ensuring that they adhere to the provisions of the Insurance Act. AKI is managed by a board which is constituted by members every annual general meeting. The association has both the general insurance council and the life insurance councils. These councils are paramount to giving day to day advisories on the policy decisions to be undertaken. The council responsible for the PSV insurance sector is the General Insurance Council because this council deals with the motor vehicle sector, marine sector and engineering. The main aim of General Insurance Council is to address growth and development issues in the general insurance issues, enhance working standards of members as well as enhancing competition in the sector⁶⁴.

2.1.7. Association of Kenya Insurance Brokers (AKIB)

Association of Kenya Insurance Brokers (AKIB) is a body which has been formed to bring together licensed Insurance Brokers in Kenya. The membership of the association is voluntary but all insurance brokers in Kenya are members. The body is run by subscription which is committed to the society annually by the brokers. Its work is to regulate the conduct of the insurance brokers in Kenya and also ensure compliance with the Insurance Act.

⁶³ Cap 108 of the Laws of Kenya

⁶⁴ Association of Kenya Insurers. n.d. General Insurance Council. [Online]. Available at <<http://www.akinsure.com/general-insurance-council>> (Accessed 9 September 2013)

2.1.8. The Commissioner of Insurance

The Commissioner of Insurance is established in section 3E of the Insurance Act. The Commissioner is to be appointed by the board⁶⁵ in consultation with the minister of Finance. The Commissioner is the Chief Executive Officer of the Insurance Regulatory Authority. The Commissioner is responsible for the day to day running of the affairs of the Authority.

The Commissioner was mandated with the overall supervision and licensing of insurance players in Kenya. However, with the amendment of the insurance Act to create the Insurance Regulatory Authority, the functions of the Commissioner have diminished. The Commissioner is a member on the Board of Trustees which is in charge of the Policy Holders Compensation Fund. The Board is mandated to run the day to day operations of the Compensation Fund as well as to advise the Minister with regards to the functioning or otherwise of the Fund⁶⁶. The Commissioner is also empowered to institute winding up proceedings against insurers who are not conducting their affairs according to the Insurance Act⁶⁷. The Commissioner has been mandated by the Act to prescribe the form in which medical insurance providers are to be licensed, and he is also supposed to consider any application to renew the registration⁶⁸. However the Insurance Act gives the Commissioner power to register brokers, assessors, loss adjustors and other bodies, while the same Act empowers the IRA to do so⁶⁹. This can be termed as a drafting oversight because the commissioner is also the CEO of the IRA, and therefore, there is no need of division of duties.

⁶⁵ This is the Board of Directors of the Insurance Regulatory Authority

⁶⁶ Section 179(2)(aa) of the Insurance Act

⁶⁷ Section 123 of the Insurance Act

⁶⁸ Section 151 of the Insurance Act

⁶⁹ Section 152 of the Insurance Act

2.1.9 Insurance Regulatory Authority (IRA)

This Authority is established under section 3 of the Insurance Act. The Authority is a state corporation with a perpetual succession and a common seal. The purpose of the Authority under the Act is to administer and supervise the insurance industry in Kenya. The authority is also charged with the duty of formulating and enforcing policies and guidelines which guide the players in the market. Further, it is mandated to register and license insurance brokers , agents and other bodies which take part in the insurance business. It also has the mandate of protecting the interests of the policyholders and give advice to the government on all matters regarding insurance. The protection of the policyholders was effected by the establishment of the Policyholders Compensation Fund⁷⁰. The Authority also has power to derigester insurance agents and brokers whose work is not in accordance with the provisions of the insurance Act. In pursuant to this arm, the authority deregistered eleven insurance agents for insurance malpractice⁷¹.

2.2 Solvency and Liquidity Challenges in Kenyan PSV Insurance Sector

The major challenge affecting the PSV insurance sector in Kenya is the solvency and liquidity challenge which has seen eight⁷² of its players having placed under statutory management in the last two decades⁷³. This is the inability of the insurance companies to pay up their claims when

⁷⁰ Established under section 179 of the Insurance Act

⁷¹ Anyanzwa, J. 2013. *Regulator Bans 11 Insurance Agents*. Retrieved July 26, 2013, from http://www.standardmedia.co.ke/m/story.php?articleID=2000083386&story_title=Regulator-bans-11-insurance-agents

⁷² The collapsed insurance companies are United Insurance, Kenya National Assurance, Liberty, Stallion, Standard Assurance, Lakestar, Invesco-which the Matatu Owners Association has managed to revive and the Blue shield Insurance. Directline Assurance had moved to court to seek protection from its creditors and claimants but the stay was lifted on 1st March 2011.

⁷³ Macharia, Rose Wachuka, *The Motor Insurance Industry in Kenya: Adopting the No-Fault Insurance System* (November 17, 2009). Available at SSRN: <http://ssrn.com/abstract=1507642>.

they fall due. The inability to honor its claims as and when they arise in a PSV insurance sector can be caused by various factors in the insurance industry. The factors are:

- a) Poor solvency regulations
- b) Taking excessive risks
- c) Poor managerial practices and lack of proper corporate governance
- d) Fraudulent activities
- e) Arbitrary awards by the courts

2.2.1 Poor solvency regulations

Financial institutions such as banks and insurance companies by their nature try to match their assets to their liabilities. However, the insurance sector is marred with uncertainty as to when the liability to pay out claims will arise. This is more difficult for the general insurance sector as compared to the long term insurance sector because risks are much better predictable in the long term insurance sector⁷⁴. Capital adequacy is instrumental to the successful operation of any financial institution because of the benefits which come with capital adequacy. Capital adequacy provide a cushion for the company to honour its claims when the returns for the particular financial year are not adequate, it also gives the confidence to the insurance company to avoid undesirable levels of risks, and finally enables the regulator to monitor the performance of the

⁷⁴ Severinson, C. & Yermo, J. 2012. *The Effect of Solvency Regulations and Accounting Standards on LongTerm Investing: Implications for Insurers and Pension Funds*. OECD Working Papers on Finance, Insurance and private pensions, No 30, OECD Publishing.

insurance company⁷⁵. The capital requirement to be considered is composed of both the target capital and the minimum capital. The target capital is the amount of capital which the company to strives to have in consideration to the risks which have been undertaken. The minimum capital is the capital which a company requires to comply with the solvency regulatory requirements⁷⁶.

However, the nature of capital which is held by the company also matters. In the case of United Assurance, there are allegations that the insurer held its capital in form of land, which is a very illiquid asset, and which could not be disposed of in time to cover the ensuing claims⁷⁷. Capital adequacy and solvency regulation is the back bone of most prudential guidelines across the world. Canada's federal regulator, Office of the Superintendent of Financial Institutions (OSFI), which is in charge of solvency regimes in the financial sector, uses audited financial statements to calculate the level of solvency to be maintained by the financial institution in the coming financial year. In the United States, the capital requirement is determined based on the risk based model, and the regulator will take control of any insurance company whose capital adequacy falls below a certain recommended level⁷⁸. This shows that capital adequacy is major component which promotes the going concern of any insurance company, failure to which the insurance company will face challenges. This is, therefore, one of the threats to solvency of an insurance company. The PSV insurance sector is very volatile and the solvency regulations are required so as to cushion the companies and the policyholders against any unforeseeable risk which can

⁷⁵ International Actuaries Association. 2004. *A Global Framework for Insurer Solvency Assessment*. A Report by the Insurer Solvency Assessment Working Party of the International Actuarial Association.

⁷⁶ Ibid at page 9

⁷⁷ See the case of *Kensilver Express Limited & 3 others .v. Commissioner of Insurance & 4 others* [2007] eKLR

⁷⁸ Severinson, C. & Yermo, J. 2012. *The Effect of Solvency Regulations and Accounting Standards on LongTerm Investing: Implications for Insurers and Pension Funds*. OECD Working Papers on Finance, Insurance and private pensions, No 30, OECD Publishing

collapse the company. There are a number of risks which are considered in a PSV insurance sector⁷⁹. They include:

(I) Random fluctuations of claims

An insurance company is formed so as to undertake risks for its policyholders. The insurance company gets premiums in exchange of the underwritten policies to the policyholders. The insurance company will also indemnify its policyholders in the case of occurrence of the insured event. The liabilities of an insurance company are uncertain and are subject of complex actuarial calculations. When claims fluctuate, they make the compensation process very uncertain, and that is why there ought to be a margin of safety called the solvency margin. The fluctuation of claims can arise out of a natural reason with no attributing factor.

Fraudulent claims have also been noted as the major cause of fluctuation of claims. These are PSV claims which the insurance companies are called upon when they were not underwritten at the particular time, or when the event claimed never occurred. These claims have been attributed to complex relationships in insurance setting, and their elimination from the insurance sector is very difficult⁸⁰.

(II) Loss of investment

Insurance companies invest the premium they receive to get returns which will be used to pay arising claims. However, at times, the insurance company makes poor investment decisions and end up losing a lot of money which would be used to clear outstanding claims. The United

⁷⁹ Helsinki. n.d. Of Solvency of Insurance Companies. [Online]. Available at <http://www.actuaries.org/LIBRARY/ASTIN/vol4no3/236.pdf>. (Accessed October 1, 2013)

⁸⁰ PWC. 2010. Face to Face Fraudulent Relationships in Insurance. [Online]. Available at http://www.pwc.com/jm/en/research-publications/pdf/F2F_FraudRelationships.pdf. (Accessed October 1, 2013)

Assurance in Kenya, is such a case on point whereby the insurance company was accused of investing in non liquid assets, which could not be disposed off to pay urgent claims⁸¹.

2.2.2 Excessive risks

A contract of insurance has been defined as a contract in which one party (the insurer) assures the risk of occurrence of an uncertain event in the future⁸². The insured will pay a premium as a consideration for the risk which is undertaken by the insurance company. The premium is usually calculated as a percentage of the value of the motor vehicle secured. As a requirement to the validity of the contract, insured event should be uncertain⁸³. This means that the more the vehicles which are insured by an insurance company, the higher the uncertainty undertaken, and the higher the risk the company is undertaking. If the insurance company gets more claims than the amount of returns received from its premium and investment, it may be unable to honour its claims and this may lead to solvency challenges. The collapse of the American giant insurance company American International Group (AIG) has been attributed to high risk activities which were undertaken by the insurance company. At the wake of the financial crisis, the company had underwritten bank guarantees which the banks were resorting to hedge on their liabilities⁸⁴. Therefore, the law should provide a mechanism which allows insurance companies to pass over excess risks.

The Drake insurance, a small auto insurance which separated from the parent company, Sphere Drake, in the early 1990s is an example of an insurance company which collapsed due to

⁸¹ Kimutai, S. Chairman Matatu Owners Association.

⁸² Birds J., 2010. *Modern Insurance Law*. London: Sweet & Maxwell

⁸³ *Prudential Assurance CO. Ltd Vs Inland Revenue Commissioner* [1904]2 KB 658 AT 663

⁸⁴ Acharya, Biggs, Richardson & Ryan. 2009. On the Financial Regulation of Insurance Companies. [Online]. Available at <http://web-docs.stern.nyu.edu/salomon/docs/whitepaper.pdf>. (Accessed October 31, 2013).

excessive risks in the UK. The company was doing quite well and it was decided to cut down on reinsurance premium, probably to save on reinsurance expenses. However, the company was faced with increasing risks and collapsed almost three years later due to underwriting losses.

2.2.3 Poor managerial practices and lack of proper corporate governance

The collapse of PSV insurance Companies in Kenya has been attributed to poor managerial practices⁸⁵. This means that the stakeholder's funds were not directed in the way in which the same should have been directed. The 2008 financial crisis in the US has also been attributed to some extent to poor managerial practices by the financial institutions. It is claimed that the management boards of many companies did not appreciate the objectives and strategies of the companies, so as to work for their realization⁸⁶.

The issue of management is best explained by the theory of the firm. The backbone of the theory of the firm is that firms exist in order to maximize returns and profits. This is to be made through the increase of revenue which the profit making entity is making, or decreasing the costs which the company incurs in the process of making the revenue. However when considering managerial behavior in large organizations, theorists have modified the theory of the firm to include other managerial issues such as corporate social responsibility, corporate governance and issues of management and control. Each of the above factors will contribute to the way the management of any company behaves.

⁸⁵ The collapse of United Insurance, as highlighted in the case of *Kensilver Express Limited & 3 others .v. Commissioner of Insurance & 4 others*, shows that issues of management and corporate governance contributed to a larger extent. The managers of the company were also the major shareholders of the company, who awarded themselves a lot of money in unsecured loans.

⁸⁶ Kirkpatrick, G. 2009. The Corporate Governance Lessons from the Financial Crisis. *Financial Market Trends*, Vol 2009/1.

A company is a legal person with legal personality⁸⁷. This means that a company is independent of its owners, and the persons who manage the company are not the owners in most circumstances. In huge companies such as insurance companies, the management is usually different from the ownership, although at times the majority stakeholder may hold a managerial position⁸⁸. However, scholars have raised concerns with non separation of the ownership and control of corporations, especially in huge corporations with many shareholders who cannot control the corporation as a whole⁸⁹. According to Vermeulen, the status of ownership and control in an organization should be in such a way that there is transparency. The persons who control the organization must be able to work in a transparent manner for the sake of all the other shareholders of the company. This can bring a bottleneck if the majority shareholders also exercise control of the corporation. It is to be noted that decisions are made in companies during general meetings through voting. Each share held by shareholders equals to one vote. Therefore, if the managers are the ones who also own the company, there will be much bias when it comes to voting because there are conflicts of interests. If this is not properly regulated in an insurance company, it can lead to mismanagement of funds which in turn lead to insolvency of the insurance companies.

2.2.4 Fraudulent activities in the PSV insurance sector

The insurance business by its very nature is susceptible to fraud. This is more so for the general insurance sector, and the PSV insurance in particular, because the PSV underwriting is short term. The insurance business is all about accumulating liquid reserves which will be used in turn

⁸⁷ Salomon v A Salomon & Co Ltd [1897] AC 22

⁸⁸ This was noted in the management of United Assurance Kenya Limited.

⁸⁹ Vermeulen, E. 2013, "Beneficial Ownership and Control: A Comparative Study - Disclosure, Information and Enforcement", OECD Corporate Governance Working Paper. [Online]. Available at <http://www.oecd-ilibrary.org/docserver/download/5k4dkhwckbzbv.pdf?expires=1380264645&id=id&accname=guest&checksum=6B30DFD1A4C696C42DD0DF75B7A55D43> (Accessed September 9, 2013)

to settle the claims which are presented by the policyholders. The insurance companies also generate considerable amounts of steady cash flows from the premiums of risks undertaken. These premiums can easily be diverted before it even reaches the insurance company, if there is no strong fraud management policy in place⁹⁰. Another reason why the companies specializing in PSV insurance have been a major target of fraudulent activities is because of the number of players who are involved in a tortuous liability system like the one being operated in Kenya⁹¹. The tortuous liability system is a system which does not allow a third party to claim from a third party insurance before the liability of the insured in the accident is established. The process to the proving of the claim is a long one and involves many players, who are susceptible to collusion⁹². Fraud is a criminal act which entails an intentional misrepresentation in order to defraud⁹³. The contract of insurance is one of utmost good faith and not governed by the doctrine of caveat emptor as most commercial contracts are. The implications of the utmost good faith doctrine arise out of the imbalance in the knowledge of material information which is held by each party to the policy. This doctrine will prevent the insured or the insurer from gaining from the knowledge which he had deliberately kept from the other party⁹⁴. This means that when fraud is established in an insurance contract, either at the point of inception of the contract, or at the point of claiming, the effect is to make the insurance contract void, and the insured will not be able to claim⁹⁵.

⁹⁰ Association of Certified Fraud Examiners. 2009. *Insurance Fraud Handbook*. Texas:ACFE

⁹¹ PWC. 2010. Face to Face Fraudulent Relationships in Insurance. [Online]. Available at http://www.pwc.com/jm/en/research-publications/pdf/F2F_FraudRelationships.pdf. (Accessed October 1, 2013)

⁹² See streets on Tort

⁹³ North America Training Group. n.d. Definition of Insurance Fraud.[Online]. Available at <http://www.fraudeducation.com/uploads/PDF/TheDefinitionofInsuranceFraudRedFlags.pdf>. (Accessed October 2, 2012)

⁹⁴ See Ivamy, H. general principles of Insurance Law.

⁹⁵ Lord Blackburn in *Brownlie v Campbell* (1880) 5 App Cas 925

The burden of proving fraudulent misrepresentation lies on the person alleging it. In the case of *Derry v Peek*⁹⁶, the plaintiff company issued a prospectus that they had a license to operate steam driven trams. The plaintiff bought shares in that believe. The defendant was denied the license to operate the steam powered engine, and he instituted a suit for fraudulent misrepresentation. Lord Herschell defined fraudulent misrepresentation as a statement which is made knowing it to be false, or made without believe in its truth, or made recklessly or carelessly whether it be true or false. Therefore, the burden of proving fraud is a heavy burden which cannot be easily discharged by the person alleging it unless he has enough evidence. It is not enough that the person is speculating. There are a number of cases which have been dismissed for failure to adduce enough evidence to prove the case. In the case of *Credit Kenya Limited v Gateway Assurance Kenya Limited*⁹⁷, the defendant refused to pay the insurance policy after the plaintiff's car was stolen. The insurance company suspected fraud on the part of the plaintiff, and that there was a scam to evade the vehicle and have the insurance company pay the claim. The insurance company adduced evidence of the relationship between the plaintiff and the person who sold him the car, and the way in which the motor vehicle was never returned to the parking bay by the driver. Justice Ang'awa in her judgment, awarded judgment to the Plaintiff for the value of the stolen vehicle, on the ground that the defendants failed to adduce enough evidence to prove fraud. This is a case in point which shows how difficult it is to prove fraud by insurance companies. From the interviews which were conducted, the major complaint which is attributed to the difficulties harbored by insurance companies is insurance fraud. This is in the form of fraudulent claims and collusions.

⁹⁶ (1889) 5 T.L.R. 625

⁹⁷ Civil case 1549 of 1994

Some jurisdictions have enacted insurance specific laws which address the notion of fraud. The United States Section 1347 of Title 18 of the United States Code provides that every person who defrauds a health care scheme is guilty of a crime and is liable to up to 10 years imprisonment. Insurance fraud is also listed as a crime in all states. In Canada, the Traffic Safety Statutes Amendment Act of 1997 specifically provides for crime on motor vehicle insurance. It is classified as a crime and the person can be fined up to \$50,000 if found to be guilty⁹⁸.

Forms of motor insurance fraud in the PSV industry in Kenya

a) Fraudulent claims

This is the major form of fraud which is practiced in case of PSV insurance according to the interviews which were conducted. This is mainly because it is thought by many that insurance fraud is a victimless fraud, and that all it does is to poke holes in the pockets of the 'big fat' corporations⁹⁹. The fraudulent claims are instituted in the same way in which genuine claims are, and documentary evidence is provided to prove the alleged accident. According to the traffic commandant, when an accident occurs, there are persons who will approach the police station to fill the occurrence book, that they were involved in a certain accident. These people will have done a thorough investigation of the alleged accident, and will have details of where the vehicle was going, the registration details of the vehicle, the insurance company insuring the PSV vehicle, and the circumstances surrounding the accident. Such people will normally have various complaints like broken legs, bandaged faces and other accident like injuries. Therefore, it is very

⁹⁸ Clarke, Michael. "The Control of Insurance Fraud, A Comparative View." *The British Journal of Criminology*. 30.1 (1990): 1-23.

⁹⁹ Neave, D. 2012. Crash for Cash: Putting the brakes on fraud. [Online]. Available at http://www.insurancefraudbureau.org/files/misc_pdfs/ifb_crash_for_cash_report_online.pdf (Accessed October 2, 2013)

difficult to tell who was indeed involved in the accident and who was not. This is coupled with the PSV sector's weakness of not offering receipts to the passengers who travel in the motor vehicles. It is also noted that when an accident occurs, at times it may take the police long time to get to the place of the accident, and by the time the police get there, the injured may have been taken by good Samaritans to hospital. The fact that the police get to the accident scene after some people have already been taken to hospital, creates a loophole whereby false claimants will claim that they were part of the accident when in essence they were not.

False claims also arise as a result of persons selling their vehicles, or disposing them off in the form of scrap metals or spare parts and then claiming from the insurance company for theft. This is usually a very well crafted theft whereby the motor vehicle is completely chopped off. The owner of the vehicle benefits from the proceeds of the sale, as well as the claims from the insurance company. In the end they benefit twice from the same car.

Fraudulent and false claims also arise in cases where the alleged victims of accidents report pre-accident or subsequent defects as injuries which were obtained during the accident. Since no examination of victims was done at the time they are entering the vehicles as passengers, such victims will usually exaggerate the injuries when an accident occurs and if they succeed in their claims, the insurance company will pay for injuries which were not occasioned through the accident.

b) Collusion

The interviews conducted also pointed out to collusion as another reason why fraudulent claims arise, and also why they end up succeeding in court. The first instance of collusion arises

between the fraudulent claimant and a lawyer. These lawyers have been branded the name ambulance chasers by the public. The reason behind the name is that they are on the lookout for any ambulance carrying accident victims. When they notice one, they will do a background check to know the exact details of the accident and who might have been injured. They will then go ahead instituting suits on behalf of the accident victims even without the knowledge of the victims. These same lawyers are very susceptible to fraudulent activities, and they will easily collude with persons to defraud an insurance company. The lawyers will have police officers who are standing ready to give them police abstracts and P3 forms¹⁰⁰ so as to institute claims on behalf of the false claimants with an aim of defrauding the insurance companies. The lawyers will incur all the costs of instituting the suit until the conclusion of the suit, and will take a higher percentage of the award.

The second instance of collusion occurs between the traffic police and the alleged victims of the accidents. In exchange for a small bribe, as small as five hundred shillings, the police will give a police abstract and a P3 form to a complainant who was not involved in the alleged accident. Depending on the length of time which the accident has taken place, the police can put the name of the victim in the occurrence book. However, the Traffic commandant pointed out that the collusion by the police and insurance fraud is on the decrease because of the stringent measures which are taken by the police department if such a discovery is made. The police will be forced to resign from employment with immediate effect. Therefore, those who were keen on perpetrating insurance fraud have gotten the habit of carrying more than one identity cards, and at the occurrence of an accident, they would throw one or more identification cards belonging to unaware persons, who are at times non-existent on the accident scene. When police come to

¹⁰⁰ These have been defined in chapter 2 above

comb the accident scene, they will discover identity cards thrown all over, and they will assume that the persons were involved in the accident. Soon afterwards the persons will go to the police station to report involvement in the accident, and the police will believe their story based on the identity cards which were found at the scene of the accident.

The other form of collusion to defraud an insurance company, is between the alleged victims of the accident and doctors. There are doctors who agree to fill in the P3 forms for a small fee. All the doctors need is to have access to the hospital stamp, and also to deliver the document as evidence to court according to the rules of evidence. When this happens, the doctor will fill the P3 form indicating the nature of the injury which the accident victim sustained and at times these are scars which have already healed from past injuries. It is to be noted that the information in the P3 form which is submitted by the doctors is not a conclusive evidence that an accident happened, and it is merely an indication that the person who the P3 relates got injured at some point, and the nature of injuries which were incurred in the accident. It does not connect to the alleged accident in any way, unless when the doctor estimates the age of the injury to be almost similar to the dates of the accident.

2.2.5 Arbitrary awards on insurance claims

Kenya follows the tortious liability model for third party motor vehicle insurance. What this means is that before a claimant can be compensated by an insurance company, he has to prove that he was indeed involved in the alleged accident, and that the accident was caused by the negligence of the insured. This also means that the claimant has to institute a suit for negligence

against the insured and his insurance company for compensation¹⁰¹. This is a rigorous process which may take a long time to complete.

However, there is also a major impediment in this liability model, because the courts have been noted to award arbitrary awards to victims of third party liability¹⁰². The awards are given based on the medical reports which are submitted in court, and which at times have been doctored by fraudulent doctors.

2.3 Conclusion

From the above analysis of the various players in the third party PSV motor vehicle insurance, it is noted that the field has many players who contribute in one way or another to the success or otherwise of the PSV insurance sector. These players play a crucial role in the determination of the amount of value to be insured and the amount of money to be compensated in case of occurrence of the insured event. However these players also contribute in one way or another to the increasing failure of the PSV insurance sector in Kenya. Therefore, there is a need that the players be brought within the ambit of insurance regulation if success is to be felt in the insurance sector. Some of the players who are noted above such as the police, courts, lawyers and medical doctors do not fall in the financial sector, and therefore, they have different regulators who regulate their day to day conduct of their services.

The challenges which are faced in the in the PSV insurance sector are also attributed to many factors as discussed above. The collapse of an insurance company can be caused by more than one factor, and hence the need to ensure that all the salient issues which contribute to insolvency are regulated.

¹⁰¹ Section 10(1) of the Insurance (Motor Vehicle Third Party) Insurance Act Cap 405 of the laws of Kenya

¹⁰² This allegation came out clearly from the interviews which were conducted

CHAPTER THREE

ADEQUACY OF THE LAW IN PSV INSURANCE SECTOR IN KENYA

The aim of this chapter is to investigate the statutory provisions addressing the causes of solvency and liquidity challenges of PSV insurance companies in Kenya and their adequacy thereof.

The major problem which has been identified in the previous chapter is the liquidity challenge of the insurance companies providing PSV insurance. Many factors have been identified to cause liquidity and solvency challenges. This chapter will focus on solvency and capital adequacy provisions, reinsurance provisions, corporate management provisions, the law dealing with fraud, and the Insurance (Motor Vehicle Third Party Risks) Amendment Bill, 2013, which introduces structured compensation packages for claims.

The final part of this chapter will consider the adequacy of the consumer protection mechanisms in the PSV insurance sector in Kenya. It is noted that when an insurance company faces liquidity and solvency challenges, it is the policyholder and anyone else entitled under the policy who will suffer the consequences of the liquidity crisis. The term ‘consumer’ will be used to mean both the policyholders and third parties who are not privy to the insurance contract but who are entitled to claim in the PSV motor insurance.

3.1 Legal framework

a) Insurance Act

This is the main act governing the Insurance industry in Kenya¹⁰³. The Act was enacted in 1984, and became operational in January 1987. The Act creates various institutions which regulate the day to day running of the insurance companies and intermediaries. These are the Commissioner of Insurance, Insurance Regulatory Authority which is the main body in charge of licensing and regulating intermediaries in the insurance sector¹⁰⁴. The Act also maintains the position of the Commissioner of Insurance and gives power to the minister of Finance¹⁰⁵. The insurance Act was amended in 2006, an amendment which was the creation of Insurance Regulatory Authority, an institution whose functions replaced the functions of the Commissioner of Insurance. This Act also provides for the administrative mechanism of governing the insurance sector. It controls the entry and behavior of various actors in the insurance sector. Most of the challenges are addressed in this Act.

b) Insurance (Motor Vehicles Third Party Risks) Act¹⁰⁶

This is an Act of parliament which was enacted to provide for compulsory third party motor insurance in Kenya¹⁰⁷. Another salient feature of the Act is that it imposes a duty to the insurance companies to satisfy judgments arising from insurance contracts which have been passed against them¹⁰⁸.

¹⁰³ Cap 487 of the Laws of Kenya

¹⁰⁴ Section 3 of the Insurance Act

¹⁰⁵ Section 3E of the Insurance Act, Cap 487

¹⁰⁶ Cap 405 of the Laws of Kenya

¹⁰⁷ Section 4 of the Insurance Motor Vehicles Third Party Risks Act, Cap 405 of the Laws of Kenya

¹⁰⁸ Section 10 of the Insurance Motor Vehicles Third Party Risks Act, Cap 405 of the Laws of Kenya

3.2 Adequacy of the Law

This section will explore the various ways in which the insurance law seeks to protect the insurance companies from financial and operational difficulties in a bid to keep them going concerns.

3.2.1. Adequacy of the law in promoting diversification of risk by an insurance company

The insurance business is a risk taking business. The provision which enables a company to diversify its risks is captured under the reinsurance provisions.

Reinsurance has been defined as the business of undertaking liability to pay money to an insurer or reinsurers in respect of contractual liabilities in respect of insurance business incurred by insurers or reinsurer and include a retrocession¹⁰⁹. Reinsurance businesses aid insurance companies in diversifying the notion of risk and will come to the companies' aid when it is faced with a challenge. The main reinsurance company in Kenya is the Kenya Reinsurance Corporation¹¹⁰. Section 3 of the Insurance Act confers the authority of overseeing reinsurance businesses in Kenya to the Insurance Regulatory Authority¹¹¹. Insurance companies enter into reinsurance contracts when they feel that the amount of risks which they have undertaken is much more than the amount of risk they wish to undertake¹¹². They then pass on some of the risks to reinsurance companies¹¹³. Therefore, reinsurance companies play a crucial risk in redistribution of risk by insurance companies. Its role is to ensure that the insurance company is

¹⁰⁹109 Section 2 of the Insurance Act Cap 487 of the Laws of Kenya

¹¹⁰ This is a statutory corporation which is formed under the Kenya Reinsurance Act

¹¹¹ Section 3 of the Insurance Act

¹¹² Undertaking reinsurance is also mandatory for companies wishing to commence insurance businesses in Kenya, or those seeking renewal of operating licences.

¹¹³ Pearlman, M. J. & Minkin, J. P. 2003. E Role of Reinsurance Intermediaries: Duties and responsibilities. *Coverage*. Vol 13: 2. [Online]. Available at http://www.kfplegal.com/articles/docs/Reinsurance_Intermediary.pdf. (Accessed September 29, 2013)

not overwhelmed with claims which it may not be able to pay. This in turn helps the insurance company to undertake more business with the same capital. The excess risk which is passed on to the reinsurer depends on the nature of agreements between the insurer and the reinsurer. In some cases the reinsurance company will undertake only specified risks¹¹⁴.

In a volatile market like the PSV insurance sector in Kenya, reinsurance business is very important judging from the numerous claims which are launched with insurance companies undertaking PSV insurance. When a company decides to reinsure excess risks it has, it will enable the company to be able to pay all the claims which are brought its way, and at the same time maintaining its solvency. The Insurance Act provides that the Commissioner is to examine reinsurance treatise which are entered into by various insurance companies¹¹⁵. The Commissioner in his analysis of the treaties is to ensure that the treaties which are entered into between the insurance company and the reinsurance companies to ensure that the treaties are in the interests of the insurance company and the insurance industry as a whole. The Commissioner will advise the insurance companies on the modifications which are to be made on the treatise during renewal. The commissioner can also advise the insurance companies not to renew any treatise if in his opinion they are not for the good of the insurance company. Reinsurance business can also be placed with companies which are not registered in Kenya¹¹⁶. This is to allow the insurance companies to diversify their risks even further when they cannot find a suitable reinsurance business in Kenya.

¹¹⁴ Group of Thirty. 2006. Reinsurance and International Financial Markets. [Online]. Available at <http://www.group30.org/images/PDF/Reinsurance%20and%20International%20Financial%20Markets.pdf>. (Accessed September 29, 2013).

¹¹⁵ Section 8 of the Insurance Act

¹¹⁶ Section 20 of the Insurance Act

Questions have, however, arisen as to the effectiveness of reinsurance companies in averting risks and the chances of them introducing systemic risks in the system¹¹⁷. This is because of regulatory gaps when it comes to reinsurance businesses. Reinsurance companies, such as Kenya Re, are corporate bodies, and therefore, subject to its own management. The Kenya reinsurance Corporation has its own board to manage it, and it is not the duty of the insurance companies which are being reinsured to manage the business. This brings in issues of transparency, and the safety of the business which has been reinsured with the reinsurance company. The regulation of the Kenya Reinsurance companies in Kenya lies solely with the Insurance Regulatory Authority, and the Authority can be said to be the watchdog for other insurance companies. However, to the financial services sector, the collapse of an insurance or reinsurance company has never caused a contagion or panic attack as in the case of banks. It is only the policyholders and other stakeholders to the insurance business who face hardships and challenges in case of such a collapse¹¹⁸.

The Insurance Act provides that an insurance company must have reinsurance arrangements if it is to be registered to carry on insurance business. This acts as a protection mechanism against excessive risks which the company may undertake, and end up compromising the going concern of the entity. There also ought to be certainty as to the premiums and commissions which is to be earned in the process of reinsurance¹¹⁹. The certainty is very useful when it comes to payment of claims. When the risk and premiums are certain, there will be minimal procedures and resistance

¹¹⁷ Group of Thirty. 2006. Reinsurance and International Financial Markets. [Online]. Available at <http://www.group30.org/images/PDF/Reinsurance%20and%20International%20Financial%20Markets.pdf>. (Accessed September 29, 2013).

¹¹⁸ Reuber, L. 2000. *International Financial Stability: What Risks Arise from the Reinsurance Industry in Offshore Centers and How Might these be Reduced*. Canada: Office of the Superintendent of Financial Institutions.

¹¹⁹ Section 29 of the Insurance Act.

to the payment of claims by the reinsurance company. The insurance companies are also mandated by the Insurance Act to place a certain amount of business with the Kenya Reinsurance Corporation, and also international Reinsurance companies¹²⁰.

The above reinsurance provisions in the Insurance Act are beneficial for a company which wants to conduct insurance business. The insurance companies can undertake as much business as possible and reinsure the excess risks. However, in Kenya the reinsurance regulations only allow insurance companies to reinsure based on a single accident. In case of a fatal accident, the insurance company will only be liable to pay three million shillings in case the insured person is held to be liable. If the awarded amount in court is over three million shillings, the reinsurance company will be compelled to pay additional three million shillings to the decretal amount. Any judgment above six million shillings, will have the policyholder pay the amount in excess of the six million. However, this hardly happens as most awards fall below six million shillings¹²¹.

From the above analysis reinsurance enables an insurance company to transfer excess risks to a reinsurance body which will take excess liability in case of the occurrence of the insured event. This means that it shields the insurance company against excess liability thus reducing its risks. The provisions regarding reinsurance in the Insurance Act are sufficient to enable an insurance company to transfer the excess risks with regard to an individual accident to reinsurance. However, these do not shield the company from any possible collapse or hardship. This is because the reinsurance is with regards to just one claim which is instituted against an insurance company for claims above three million shillings. Therefore, if an insurance company receives

¹²⁰ Section 145 of the Insurance Act

¹²¹ Simon Kimutai, Chairman Matatu Owners association, and Chairman Board of Directors of Invesco Assurance Company limited

many judgments for amounts equal to or below three million shillings, the reinsurance company may not be able to help. These claims may affect the solvency of the insurance company, and lead to the ultimate collapse even if it had reinsurance. The reinsurance contract in Kenya is basically a contract of indemnity and not a risk transfer contract. This leaves the insurance companies with all the risks of the policies underwritten. According to Financial Accounting Standard (FAS) 113 for GAAP¹²² Accounting, a contract can only be that of transfer of risk if the contract transfers all or substantially all the risks to the other party¹²³. Therefore since there is no transfer of all or substantial risk to reinsurance, reinsurance contracts are contracts of indemnity¹²⁴.

Another provision of the Insurance Act with regards to risk, is section 57, but this is in respect to Insurance companies carrying out long term insurance business. The section provides for actuarial valuation of assets and liabilities of companies carrying out long term insurance business as at 31st December every year. This is in a bid to determine the actual value of the assets or liabilities of the company. This is a good move by the law to regulate the risk of long term investments by insurance companies. However, it would be desirable for PSV insurance companies to also undertake actuarial valuation at certain intervals, like every two years, to determine the real value of their assets and liabilities.

Therefore, it would be prudent if the law were to be amended so as to allow an insurance company to reinsure all its claims above a certain amount. This will ensure that the insurance

¹²² Generally Accepted Accounting Practice

¹²³ Brehem, P. & Ruhm, D. n.d. *Risk Transfer Testing of Reinsurance Contracts*. [Online]. Available at <http://www.variancejournal.org/issues/01-01/009.pdf>. (Accessed October 4, 2013)

¹²⁴ IRA. 2013. *Guideline to the Insurance Industry on Reinsurance Arrangements*. [Online]. Available at www.ira.go.ke/index.php?option=com_docman&task=doc. (Accessed October 4, 2013)

company is able to manage its claim payment schedules and no insurance company can be liable to claims to an extent it was not aware of.

3.2.2 Adequacy of the Law in Corporate Management of PSV Insurance Companies

Adam Smith had this to say about the directors of companies-

The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private company frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company¹²⁵.

The collapse of PSV insurance Companies in Kenya has been attributed to poor management¹²⁶. This means that the stakeholder's funds were not directed in the way in which the same should have been directed.

The Insurance Act creates the Insurance regulatory Authority (IRA) to oversee the supervision and regulation of the insurance industry in Kenya¹²⁷. The IRA regulates and approves the appointment of directors and managers of the insurance companies. This is to ensure that they

¹²⁵ Smith, A. 2009. *The Wealth of Nations*. Amazon: Thrifty Books

¹²⁶ See above on United Assurance Company Limited

¹²⁷ Section 3 of the Insurance Act

are qualified with both knowledge and experience to manage the insurance companies¹²⁸. The persons who are appointed to serve on the Board of any insurance company at any one time should not be less than five. The persons should also get approval by the IRA, and should submit their letters of acceptance to the IRA. This in essence means that the employment of the board members has to be approved by the IRA. The Insurance Act further provides that the at least a third of the board members should be Kenyan citizens¹²⁹.

To protect the shareholders and the company further from manipulation from the directors for personal interests, the Act stipulates that the remuneration of directors or any employee whatsoever of the insurance company cannot be based on the long term valuation surplus of the company¹³⁰. This prevents the manipulation of company accounts to show the best pay so as to pay higher salaries and commission. The Managing Director of an insurance company, cannot be the Managing Director of any other insurance company or bank¹³¹. This move is a move towards the protection of financial institutions, including insurance companies, from systemic failures. The Managing Director through the Board of Governors, is the ultimate authority of any company, and therefore, there is need that if unrealistic decisions are made in one financial institution, they will not also be made on any other financial institution because of sharing heads.

The Act also protects the insurance company from the continuing influence of agents or brokers. This is in a bid to reduce conflict of interests in the agency relationship. This conflict of interest is called an agency problem and it can lead to a paralysis in the system. Walter (2003), attributes conflict of interests in financial intermediation to market imperfections and information

¹²⁸ Section 27A of the Insurance Act.

¹²⁹ Section 27 of the Insurance Act

¹³⁰ Section 69(1) of the Insurance Act

¹³¹ Section 69(4) of the Insurance Act

asymmetries¹³². Promoting market discipline and transparency are the only ways to reduce agency problems, and hence raise the public confidence in financial institutions. The Insurance Act, in its bid to promote market discipline, prohibits an agent or broker to act as a director of an insurer. Further, the agent is prohibited from holding more than one percent share or controlling interests of an insurance company¹³³. The law also prohibits an insurer, an employee or a director of an insurer to have any controlling interests or hold shares in an insurance broker or agent¹³⁴.

The Insurance regulatory Authority through the mandate provided under the Insurance Act¹³⁵ has issued a publication on good corporate governance which is to be practiced by organizations. Principles of corporate governance are principles of good conduct which are to be practiced by companies to ensure that they secure their going concern and also protect the interests of various stakeholders of the organizations. The Global Corporate Governance Forum states as follows in its mission;

“Corporate Governance has become an issue of worldwide importance. The Corporation has a vital role to play in promoting economic development and social progress. It is the engine of growth internationally, and increasingly responsible for providing employment, public and private services, goods and infrastructure. The efficiency and accountability of the corporation is now a matter of both private and

¹³² Walter, Y. 2003. *Conflicts of Interest and Market Discipline Among Financial Service Firms*. A paper presented Paper presented at a Federal Reserve of Chicago - Bank for International Settlements conference on “Market Discipline: Evidence Across Countries and Industries,” October 30 - November 1, 2003. [Online]. Available at <http://pages.stern.nyu.edu/~iwalter/conflict.pdf>. (Accessed October 1, 2013)

¹³³ Section 89(4) of the Insurance Act, Cap 487 of the Laws of Kenya

¹³⁴ Section 89(5) of the Insurance Act, Cap 487 of the Laws of Kenya

¹³⁵ Section 3A of the Insurance Act, Cap 487 of the Laws of Kenya

*public interest, and governance has, thereby, come to the head of the international agenda.”*¹³⁶

Corporate governance is a vital element in the management of companies, and it will go a long way in salvaging the Insurance companies majoring in PSV insurance in Kenya. However, the principles are just guidelines and principles with no legal backing. They cannot be legally enforced in a court of law, and it is upon the company as a whole to be committed and ensure compliance. The guidelines which are given by IRA¹³⁷ provide that the Board shall ensure that the functions of the board and those of the management should be separated to ensure that the board is able to supervise the management. It also mandates the IRA to appoint an alternate director in cases where the articles of the company allow them to have alternate directors.

From the above analysis of the adequacy of management provisions, the insurance Act provides for independence of the management of any insurance company. The directors should not hold any shares or controlling interests in agency or brokerage firms. The managing director of any insurance company cannot be the managing director of any insurance company or financial institution. This ensures that the management is conducted with utmost independence and it also prevents conflict of interests from arising.

The guidelines on corporate governance are also sufficient to ensure that the company is run by a competent management.

¹³⁶ Private Sector Initiative for Corporate Governance. n.d. Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance. [Online]. Available at http://www.ecgi.org/codes/documents/principles_2.pdf. (Accessed September 20, 2013)

¹³⁷ IRA. 2011. *Corporate Governance Guidelines for Insurance and Reinsurance Companies*. [Online]. Available at http://www.ira.go.ke/index.php?searchword=corporate%20governance&searchphrase=all&Itemid=435&option=com_search. (Accessed September 20, 2013).

3.2.3 Adequacy of the Law in Promoting Capital and Solvency Requirements in a PSV Insurance Company

The capital of a company is the money which the shareholders inject into the company for the purposes of running the company. When the PSV insurance company has not made any profits, the directors of the company can go back into the shareholders wealth so as to pay the company's claims. Therefore, it is important that a company has adequate capital requirements. What is adequate is very subjective and can only be determined with accuracy through complex actuarial calculations. The Act provides that in the case of an insurer dealing with general insurance business, its paid-up capital should be at least three hundred million Kenya shillings; In case of an insurer dealing with life insurance business, its paid-up capital should be least one hundred and fifty million Kenyan shillings; and in the case of an insurer dealing with composite insurance business, its paid-up share capital is at least four hundred and fifty million Kenya Shillings. It is, therefore, noted that the long term insurance sector is cushioned from excessive claims. The capital is adequate if the correct solvency margins are maintained by the PSV insurance company.

The solvency of an insurance company is defined as the ability of the insurance company to meet its obligations as they arise. Solvency, therefore, is the ability to meet the payment of its claims and other operational expenses. The solvency ratio is calculated through a comparison between the assets which the company has, and the liabilities which the company has¹³⁸. PSV insurance sector falls under the financial institutions sector, and thus there is a need for prudential supervision, because they are entrusted with funds by individuals. If the funds are

¹³⁸ European Commission. 2002. *Study into the methodologies to assess the overall financial position of an insurance undertaking from the perspective of Prudential Supervision*. [Online]. Available at http://ec.europa.eu/internal_market/insurance/docs/solvency/solvency2-study-kpmg_en.pdf. (Accessed October, 1 2013)

misappropriated, or if the institution is not run in such a way that there will be promotion of the company's well being, then it will lead to a detrimental loss to the clients and the sector as a whole. Supervision seeks to eliminate the possibility of failure, and one cause of this failure is the inability to pay its liabilities¹³⁹. The solvency requirements which will contribute to a sound financial system include the quality of its management, organizational structure, system controls and risk management. The prudential regulation of insurance companies in Kenya has been left with the Insurance Regulatory Authority which is formed under the Insurance Act¹⁴⁰. The Insurance Act provides a different margin of solvencies between the long term and general insurance companies¹⁴¹. General Insurance companies, which deal with PSV underwriting are mandated to keep a margin of solvency equal to its admitted liabilities, and 15% of premium which was admitted the previous year¹⁴². Margin of solvency has been defined as the difference between the value of assets and the expected value of the liabilities of an insurance company¹⁴³. The margin of solvency is what prevents an insurance company from being declared insolvent. When a company has no margin of solvency, then it will be unable to pay its liabilities as they fall due and can be declared insolvent. The insurance Act further provides that the commissioner may give an insurance company whose margin of solvency has fallen below a certain point some

¹³⁹ Many PSV Insurance companies have gone to court to seek protection from their creditors and claimant through moratoriums. An Example is Blue Shield Insurance Company Limited, whose moratorium is till in force at the moment.

¹⁴⁰ Section 3 of the Insurance Act

¹⁴¹ Section 46 of the Insurance Act, cap 487 of the Laws of Kenya

¹⁴² The long term insurance companies are mandated by the same provision to keep a margin of solvency equal to the admitted liabilities, and an additional ten million shillings or 5% of its total liabilities whichever is higher.

¹⁴³ Helsinki. n.d. Of Solvency of Insurance Companies. [Online]. Available at <http://www.actuaries.org/LIBRARY/ASTIN/vol4no3/236.pdf>. (Accessed October 1, 2013)

time in which it can adjust its margin of solvency before the commissioner can declare it insolvent¹⁴⁴.

The Insurance Act also regulates the amount of paid up capital which an insurance company is supposed to have at any point in time. The Act provides that the paid up capital of a general insurance company at any period of time should not be less than 10% of its total gross premium underwritten in the previous year¹⁴⁵. If an insurance company is found to have paid up capital which falls below the prescribed ratio, the insurance company will be mandated to increase such capital within six months after the end of its financial year. This is a further move which is undertaken by the Act to ensure that the insurance companies have enough paid up capital and adequate solvency margins to benefit policyholders. Failure to have such a rectification done will attract a fine of one hundred thousand shillings, and an additional five thousand shillings for every day when such a deficiency stands¹⁴⁶. Every insurance company is to make a return of its accounts indicating the total assets which the company has, total liabilities, and total admitted assets. The report is to be signed by the auditor and the principal officer of the insurance company and it should be submitted on or before 30th June the following year¹⁴⁷. The supervisory powers are vested with the Commissioner of Insurance, who can place the insurance company under statutory management for a period of twelve months, if the solvency requirements are not met, and the commissioner is satisfied that the continuance conduct of the insurance company in the way it is not beneficial to the policy holders. The commissioner can

¹⁴⁴ Section 41(6) of the Insurance Company. However, when determining such leave, the Commissioner is to consider factors such as the period the insurer has been in operation.

¹⁴⁵ Section 41(10) of the Insurance Act, Cap 487 of the Laws of Kenya.

¹⁴⁶ Section 41(11) of the Insurance Act, Cap 487 of the Laws of Kenya

¹⁴⁷ Section 41(12) of the Insurance Act, Cap 487 of the Laws of Kenya

also rearrange the board of directors, remove some of its senior officers from office and also appoint some additional members into the board of the insurance company¹⁴⁸.

IAIS Guidelines on Solvency requirements

International Association of Insurance Supervisors (IAIS) is a body which formed through the association of various insurance supervisors and regulators all over the world. The body was formed in 1994, with its main objective as “ *The promotion of effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability*¹⁴⁹”

Insurance Regulatory Authority subscribes to IAIS guidelines. It should be noted, however, that the regulations are just guidelines and do not have any legal force in the Insurance Sector in Kenya. However, the guidelines act as guidelines and have persuasive force in Kenya.

From the above analysis of the solvency requirements in the Insurance Act, it is noted that the provisions regarding solvency are adequate as the insurance company is under the close monitoring of the Insurance Regulatory authority. This way, if the capital falls below the required threshold, the insurance company is given a maximum of six months to rectify the inadequacy. Six months is a good time in which a company can structure its affairs so as to meet the regulator’s requirement. From the analysis above, regarding reinsurance, solvency, and management, it is noted that the problem of the PSV sector is something outside the ambits of the IRA. If an insurance company maintains adequate solvency margins, undertakes adequate

¹⁴⁸ Section 67C(2) of the Insurance Act, Cap 487 of the Laws of Kenya

¹⁴⁹ IAIS website, available at <http://www.iaisweb.org/>. (Accessed October 1, 2013)

reinsurance of its risks, and practices proper management procedures, the company will not collapse. The PSV insurance companies maintain all the above requirements, and yet it still has difficulties. An interview was conducted with some stakeholders of the PSV insurance industry to determine their take on the challenges facing the PSV insurance sector in Kenya, and they said they were content with the law as it was, save for the passing of the The Insurance (Motor Vehicle Third Party Risks) Amendment Bill, 2013 which allows structured compensation for claims. They pointed out a number of problems specific to the PSV insurance sector, and which problems they attribute the collapse of the PSV insurance companies.

3.2.4 Adequacy of the Law Tackling Insurance Fraud in Kenya

a) Penal Code

The basic law which aids in deterrence of fraud in Kenya is the Penal Code¹⁵⁰. The Insurance Act seems to be concerned with the concept of fraud only during the appointment of principal officers¹⁵¹, Board of Directors of the Insurance regulatory Authority¹⁵², registration of brokers, agents, risk managers, loss assessors, loss adjustors, and insurance settling agents¹⁵³. Therefore, since fraud is a criminal offence, it is tackled under the penal code.

The fraudulent claims which are made against insurance PSV companies can be captured under the offence of false pretence¹⁵⁴. The provision provides that;

Any person who by any false pretence, and with intent to defraud, obtains from any other person anything capable of being stolen, or induces any other person to deliver to any

¹⁵⁰ Cap 63 of the Laws of Kenya.

¹⁵¹ Section 68 of the Insurance Act

¹⁵² Section 3(B) (3) (a) of the Insurance Act

¹⁵³ Section 152 of the Insurance Act

¹⁵⁴ Section 303 of the penal Code

person anything capable of being stolen, is guilty of a misdemeanour and is liable to imprisonment for three years.

When a person pretends to have been injured in an accident which the insured vehicle was involved in, with the intention of receiving money from the insurance company, then he is capable of being charged with false pretence.

Another provision which can capture the fraudulent claims which are launched against PSV insurance companies is the provision dealing with cheating¹⁵⁵. The provision provides that;

Any person who by means of any fraudulent trick or device obtains from any other person anything capable of being stolen, or induces any other person to deliver to any person anything capable of being stolen or to pay or deliver to any person any money or goods or any greater sum of money or greater quantity of goods than he would have paid or delivered but for such trick or device, is guilty of a misdemeanour and is liable to imprisonment for three years.

This provision can be used to curb those who use forged police abstracts and P3 forms to claim from the PSV insurance companies.

The collusions which are undertaken by the various players in the PSV insurance process can be nabbed vide the provision on conspiracy to defraud¹⁵⁶. The provision provides that;

Any person who conspires with another by deceit or any fraudulent means to affect the market price of anything publicly sold, or to defraud the public or any person, whether a

¹⁵⁵ Section 305 of the penal Code

¹⁵⁶ Section 317 of the Penal Code

particular person or not, or to extort any property from any person, is guilty of a misdemeanour and is liable to imprisonment for three years.

These collusions are made in a bid to defraud the insurance company. The collusions are made intentionally with the aim of being paid money in the form of claim settlement.

The Insurance Regulatory Authority in conjunction with the Kenya Police have launched the Insurance Fraud Investigation Unit which is geared towards the investigation, regulation and elimination of the issue of fraud in the insurance sector¹⁵⁷. The launch of the investigation unit was done with the understanding that insurance fraud in Kenya is very complex and difficult to unearth. The unit has 20 officers who are specially trained to deal with insurance fraud¹⁵⁸. However, according to the Traffic Commandant, the impact of the unit in curbing insurance fraud has not been felt because of poor funding of the unit, lack of sufficient equipment by the forces attached to the unit, and the rampant corruption.

From the above analysis on the solvency provisions in the insurance law, it is noted that the law which deals with insurance fraud in Kenya is found in the general provisions relating to fraud in the Penal Code. However, upon a close analysis of the elements of fraud, it is seen that the elements of fraud are industry specific, and the general provisions in the Penal Code may not be able to adequately address it. Therefore, it will be very helpful if provisions addressing elements of fraud in the PSV insurance sector are etched in the insurance law in Kenya.

¹⁵⁷ IRA. 2011. Launch of Insurance Fraud Investigation Unit. [Online]. Available at http://www.ira.go.ke/index.php?searchword=fraud&searchphrase=all&itemid=435&option=com_search. (Accessed October 4, 2013)

¹⁵⁸ Musyoka, D. 2011. *Kenya's insurance industry gets police anti-fraud unit*. [Online]. Available at <http://businesstoday.co.ke/node/110>. (Accessed October 4, 2013)

It is also noted that the provisions of the Penal Code are punitive in nature, and only provides for punishments when the accused person has already committed the alleged act. This may not suit the insurance industry because of the detrimental effects which may have already occurred at the discovery of such fraudulent activities. The system which will suit the PSV insurance industry is a deterrent system, whereby the law prescribes various ways to curb fraudulent claims and collusions to defraud. The three year imprisonment may also not be punitive enough, especially when the fraudster has gained millions of money in the fraud scheme. There should be a system whereby the person convicted of fraud is compelled to return the money which has been gained on top of being imprisoned.

b) Tort of Deceit

“[F]raud is infinite in variety. Sometimes it is audacious and unblushing; sometimes it pays a sort of homage to virtue, and then it is modest and retiring; it would be honesty itself if it could only afford it” - Lord MacNaghten in ***Reddaway v Banham***¹⁵⁹

A tort is a civil wrong, and as such it is between two individuals. Civil law is not punitive and it aims at compensating the person who has been wronged through compensatory damages¹⁶⁰. Therefore, it would be more beneficial for an insurance company to bring suits against fraudsters under the law of tort than under the penal code because the insurance company would be compensated under tort, while the penal code is only punitive. However, proving the deceit

¹⁵⁹ 1896 AC 199 at 221

¹⁶⁰ Fleming, J. G. 1998. *The Law of Torts*. NWS: LBC Information Services

under fraud is very difficult¹⁶¹. There are four elements which have to be established by a claimant in order to prove deceit.

In the case of *Peek v Gunney*¹⁶², it was held that the defendant must have made a misstatement of fact, and not an opinion or a statement of law. It is irrelevant that the maker of the statement did not know it to be false, it is enough that he did not believe in its truth or that he made the statement reckless not caring whether it was true or not. It must also be shown that the claimant relied on the statement and that the statement occasioned him loss. Therefore this is a recourse which can be taken by the insurance company against fraudulent third parties who claim from the insurance company when in fact they have no claim. The insurance company will be able to recover the money which was paid to the fraudster.

In the Canadian case of *Sanghera v. Thind*¹⁶³, the defendants committed fraud against Insurance Corporation of British Columbia. The court held that the defendants were liable for deceit, and awarded a judgment of \$25,000 to the insurance company.

From the above brief analysis of the tort of deceit and its applicability to the question of insurance fraud, it is noted that it is a viable way in which the insurance companies can circumvent insurance fraud. however, it should be appreciated that establishing the elements of deceit is very difficult, and the insurance companies may not be able to adequately discharge the burden of proving it.

¹⁶¹ See *Derry v Peek* above

¹⁶² (1873) LR 6 HL 377 at 403

¹⁶³ (1996) O.R. (3d) 479, 132 (Ont. Crt. Gen. Div.).

3.2.5 Addressing the challenge of arbitrary awards by the courts

The insurance companies are lobbying for the passing of the Insurance (Motor Vehicle Third Party Risks) Amendment Bill, 2013. This bill was introduced in parliament in 2011 but it was defeated. It is hoped that the current introduction in parliament will be successful, as it is thought by the insurers that it will solve the problem of arbitrary claim awards in the courts. The bill proposes that when an accident occurs, and where an insurance company is to pay through the third party insurance liability, it will be a no fault system whereby the insurance companies will pay the victims a percentage of the Ksh. 3,000,000 payable by the insurance companies at the moment. Only death and total blindness will be eligible for the award of the three million maximum compensation. Others will attract from 1% to 99% of the maximum compensation payable.

Insurers have welcomed this bill saying that it will make the third party motor insurance risks to be more predictable by the insurance companies, and thus more manageable. The insurers also claim that it will lead to a more efficient claim settlement system because it enables the insurance companies to pay out claims after the confirmation that accidents indeed occurred and that the claimants were occasioned injuries because of the same. The rigorous court process of proving liability will be eliminated¹⁶⁴.

The table below shows the compensation amounts for some injuries in the proposed structured compensation Bill.

¹⁶⁴ Juma, V. 2013. Law sets fixed rates to pay traffic accident victims. [Online]. Available at <http://www.businessdailyafrica.com/Corporate-News/Law-sets-fixed-rates-to-pay-traffic-accident-victims/-/539550/1892206/-/item/1/-/ad6ihd/-/index.html>. (Accessed October 4, 2013)

Injury	Compensation (Sh)
Death	3,000,000
Loss of right arm	1,950,000
Stiff hip	750,000
Loss of eye	900,000
Loss of all toes	450,000
Total blindness	3,000,000
Loss of thumb	150,000
Scalp injury	30,000-150,000
Loss of nose	190,000

3.2.6 Consumer protection mechanisms

Consumer protection concerns are deeply etched in the Constitution of Kenya. Article 46 of the constitution states that: *Consumers have the right—*

- (a) to goods and services of reasonable quality;*
- (b) to the information necessary for them to gain full benefit from goods and services;*
- (c) to the protection of their health, safety, and economic interests; and*
- (d) to compensation for loss or injury arising from defects in*

goods or services.

(2) Parliament shall enact legislation to provide for consumer protection and for fair, honest and decent advertising.

(3) This Article applies to goods and services offered by public entities or private persons.

This provision in the constitution covers consumers in both private and public entities offering goods and services to the public. Consumer protection is, therefore, a vital element in trading in Kenya.

Consumer protection is a very wide notion, and the element of consumer protection to be dealt with in this paper deals with the consumer protection in a volatile market such as the third party PSV insurance sector in Kenya.

Consumer protection in the financial service sector and in particular the insurance sector aims to ensure that there is adequate information to policyholders before they enter into a contract of insurance. Once such a contract is entered into, the consumer protection mechanisms are to ensure that the consumer is accorded his rights and benefits which arise from the contract. The purpose of consumer protection, especially in the insurance sector, is mainly to remedy imbalance of information.

By consumer protection, it is meant those structures which have been put in place to safeguard the policyholder's interests in the insurance environment. This is furthered by the stringent regulations which have been put in place in the insurance Act on entry of new insurance companies and how the existing ones are regulated. The transparency mechanism has not been put into law, save for the fact that any non disclosure of material facts by the policyholders makes the insurance contract void. This is because the insurance contract is a contract of good

faith whereby utmost disclosure by both parties is critical. The policyholders compensation fund was set up so as to compensate policyholders when the insurance companies collapse and the policyholders lose money.

a) Effects of collapse on policyholders

The contract of insurance is like any other contract whereby the parties are accorded duties, obligations and rights under the contract. It is the policyholders right under the insurance contract that they be compensated in case of occurrence of the insured event. However, for this to be done, the insurance company should be solvent to be able to discharge its liabilities as and when they arise. Therefore, there is a great detriment on the part of the policyholder when the insurance company is unable to undertake its part of the bargain¹⁶⁵.

In Kenya, the insurance model which is undertaken for auto insurance is a liability model. What this means is that third parties have to establish liability of the policyholder before they are compensated on third party motor insurance. Therefore, when the insurance company is unable to pay its claims, and liability has been established against the policyholder, then the policyholder will be personally liable for the judgment.

Insurance claims run into millions of shillings depending on the level nature of accident which occurred and the amount of claimants who are involved. Third party motor vehicle insurance involves personal injuries and property damage which occur to third parties. This can run into millions of shillings when it comes to auto insurance especially the PSV sector because the vehicles carry passengers.

¹⁶⁵ Keah, J. 2011. *Client's Compensation*. [Online]. Available at <
http://webcache.googleusercontent.com/search?q=cache:cySWFAjDecJ:www.ira.go.ke/index.php%3Foption%3Dcom_docman%26task%3Ddoc_download%26gid%3D30%26Itemid%3D485+policyholders+compensation+fund+kenya&cd=3&hl=en&ct=clnk&g=ke> (Accessed 7 September 2013)

Policyholders Compensation Fund is a fund which has been created in the Insurance Act to cushion policyholders against any losses should the insurance company face financial challenges. When a general insurance company faces financial challenges to the point it cannot honour the claims presented to it by the insured's, the persons who are insured by the insurance company face third party risks. They also face asset losses which arise from the accident, when the motor vehicles have been damaged¹⁶⁶.

The Fund is set up under the insurance Act so as to compensate the policyholders of an insolvent insurer¹⁶⁷. The fund is run by a Board of Trustee which is set up by the Minister of Finance¹⁶⁸. The Board is vested with wide functions of providing compensation to the policyholders of an insolvent insurer, monitoring the risk profile of any insurer, and advising the Minister on matters relating to policyholders compensation¹⁶⁹.

The Policyholders Compensation Fund gets its funding from annual contributions from insurance companies and policyholders¹⁷⁰. If an insurer fails to remit its annual contribution to the Fund, it will be charged an interest on the amount payable¹⁷¹. Further delay or refusal by the insurance company to pay the contribution and the interests charged will attract individual liability of the directors of the insurance company after 90 days of such refusal¹⁷². The Fund also receives funds

¹⁶⁶ Keah, J. 2011. *Client's Compensation*. [Online]. Available at <
http://webcache.googleusercontent.com/search?q=cache:cySWFAjDeJ:www.ira.go.ke/index.php%3Foption%3Dcom_docman%26task%3Ddoc_download%26gid%3D30%26Itemid%3D485+policyholders+compensation+fund+kenya&cd=3&hl=en&ct=clnk&gl=ke> (Accessed 7 September 2013)

¹⁶⁷ Section 179 of the Insurance Act

¹⁶⁸ Section 179(2) of the Insurance Act

¹⁶⁹ Section 179(2A) of the Insurance Act

¹⁷⁰ Section 179(6) of the Insurance Act. Further, under the regulations, the amount payable as contribution is 0.25% of the premium by both the Insurer and the policyholder. The insurer collects and remits the contributions on behalf of the policyholder.

¹⁷¹ Section 179(8) of the Insurance Act

¹⁷² Section 179(9) of the Insurance Act

through appropriations from parliament, grants and donations to the Fund¹⁷³, and returns from investments by the Board¹⁷⁴.

The major impediment of the Fund is that it is not authorized to compensate the policyholders until the insured company has become insolvent¹⁷⁵, and the insolvency must have occurred after 1st of January 2005¹⁷⁶. The two year time limit is also another impediment which may prevent policyholders from benefiting from the Fund¹⁷⁷. The maximum compensation which can be paid out by the fund to any one claim to the insolvent insurer is limited to one hundred thousand shillings¹⁷⁸. It is also noted that the claims which are entertained by the Fund are those claims which arose before the insurer became insolvent¹⁷⁹. Therefore, the fund is only adequate as a mechanism after the complete breakdown of the insurance company.

b) Bail-out mechanisms

Bail-out is the process in which a financial institution is given money by an external third party to prevent it from being wound up. This can be done by the government or private institutions. Bailout mechanisms are very beneficial when the financial entity in question is facing financial challenges, and the policyholder's interests are at stake.

In Kenya, the government has not exercised bail out mechanisms to save insurance companies from collapse. This is a mechanism which has been exercised in other countries, especially the US after the 2008-2010 financial crisis. In 2008, the US government injected \$85 billion to

¹⁷³ Section 3 of Insurance (Policyholders' Compensation Fund) Regulations, 2010

¹⁷⁴ Section 179(3) of the Insurance Act

¹⁷⁵ Section 11 of Insurance (Policyholders' Compensation Fund) Regulations, 2010

¹⁷⁶ Section 11(3) of the Insurance (Policyholders' Compensation Fund) Regulations, 2010

¹⁷⁷ Section 15 of the Insurance (Policyholders' Compensation Fund) Regulations, 2010

¹⁷⁸ Section 13(3) of the Insurance (Policyholders' Compensation Fund) Regulations, 2004, vide legal notice number 105 of 2004

¹⁷⁹ Section 14(1) of the Insurance (Policyholders' Compensation Fund) Regulations, 2004, vide legal notice number 105 of 2004

American International Group (AIG), one of the biggest insurers in the US¹⁸⁰. The government would get equity participation notes from the insurer. This decision was apparently reached after considering that the insurer was too big to fail and its fall would cause detriment to the US economy.

However, this bail out mechanisms has not been experienced in the insurance sector in Kenya. The viability of bail out mechanisms was tested by the Matatu Owners Association on Invesco Assurance Company. The Matatu Owners Association injected over 80% stake into Invesco, and took an active part in the management of the insurance company. The company has been able to pay over two-thirds of its previous debts, and from the interview which was conducted on one of its directors, the company is financially sound, and its going concern is certain. However, the Matatu Owners Association hasn't only injected capital into the insurance company facing problems, but is also actively involved in the management of risks. This is done through prompt investigation of accident claims¹⁸¹.

3.4 Conclusion

The law regulating the PSV insurance companies in Kenya is inadequate to curb the issue of collapse of the insurance companies. There are adequate legal provisions to ensure that the companies have enough capital to operate, and that their solvency margins are well addressed. The Insurance Act and the IRA regulations on corporate governance also ensure that a company has a sound management in place, and that the management is able to make sound managerial decisions free of conflict of interests. However, the law is silent on fraud and other unethical acts

¹⁸⁰ Sjoström, W. 2009. AIG Bailout. 66 *Washington and Lee Law Review*, pp. 943-991

¹⁸¹ Njenga, G. 2012. *Thriving on Borrowed Time: Reviving Invesco Assurance: Case for Reforming the Insurance Industry*. Nairobi: Hope centre International

which act to the detriment of the PSV insurance companies. The reinsurance provisions for risk diversifications are also not adequate as they attach to only one claim, and may not aid a company which is experiencing many claims below the Ksh. 3 million threshold.

When the PSV insurance industry is looked as a whole, in consideration of the other players in the PSV insurance sector, it is seen that the law is not adequate. The major issues which were established through the interviews conducted indicate that the problem is in fraudulent claims, collusions, and arbitrary awards by the courts. These are players who are outside of the insurance company. The law which tackles the issue of fraud is the Penal Code which provide general provisions on the issue of fraud, and which provisions may not specifically address the fraud details found in PSV insurance fraud. This means that the law should be amended to ensure that the proper conducts of these other players are captured in the insurance law, and there should be punitive as well as deterrent provisions. The civil law of tort and contract is not effective in curbing the question of fraud. The insurance contract is a contract between a policyholder and the insurance company. However, when it comes to claims of third party PSV insurance, the claimants are usually passengers who were travelling in the vehicle and pedestrians who may have been injured by the accident or their representatives. These persons are not privy to the insurance contract, and therefore, the insurance company may not be able to sue them. The tort of deceit has been resorted to in other jurisdictions to address fraud, but this has not been experienced in Kenya. It should, however, be noted that proving fraudulent misrepresentation is a very heavy burden which may not be easily dispensed with by insurance companies.

The institutional arrangements which have been established to address consumer protection are not also sufficient enough to shield consumers from detrimental effects of the collapse of

insurance companies. The Policyholders Compensation Fund does not offer adequate compensation because it is appreciated that insurance claims can be higher than Ksh. 100,000 and putting a ceiling at Ksh. 100,000 mark means that some claimants will be partially compensated. The Policyholders Compensation Fund can only be accessed by claimants once the insurance company has been declared insolvent. What this means is that it is not a readily available mechanism which claimants can resort to anytime in cases where the insurance company is unable to discharge its legal obligation of settling claims. Another aspect of inadequacy of consumer protection is the fact that the government has not been able to exercise bailout actions on any insurance company which has collapsed. Investors are profit seeking, and therefore will not invest in a company which is not doing well financially. Therefore, it leaves the companies at the mercy of government to inject capital to sustain them in case of financial difficulties. A bailout mechanism was practiced on Invesco Assurance by the Matatu Owners Association and it was revived. This shows that bailout can be viable in Kenyan insurance sector.

CHAPTER FOUR

MOTOR INSURANCE MODELS IN OTHER JURISDICTIONS

4.0- Introduction

This chapter considers auto insurance models which are undertaken in other jurisdictions with regards to motor vehicle risks. In Kenya, the model which is undertaken is the tort liability model. This chapter will consider the no-fault insurance model as practiced in jurisdictions such as Ontario-Canada and Michigan. The paper will also consider the declined motor vehicle pool which is practiced in India. The aim of this chapter is to explore other models which can be embraced by Kenya's PSV insurance sector, in a bid to improve the performance of the sector and act as a bar to any further collapse. Canada was considered in this chapter because it is thought to have been the first jurisdiction to address the no fault model of insurance. This provides an interesting analysis on the reasons which were taken into consideration before a no fault system of insurance was considered. The reasons can be identified with our own reasons of wanting to adopt such a model. However, it is appreciated that Canada has since advanced economically and technologically, and it is not a 3rd world country like Kenya. It is also appreciated that the no-fault insurance model was set up for motor vehicle insurance generally, and not necessarily the PSV insurance sector.

On the second part of the paper, India was considered because it is a third world country like Kenya. The country has also gone through a phase of PSV insurance related difficulties to the point that some PSV vehicles are declined insurance because of the risks involved. This

identifies with our own situation where high premiums for PSV vehicles were declined insurance in the early 1980s and a motor insurance pool created.

4.1 The fault system- Liability model

When the insured incident occurs in a motor insurance, the recourse for the injured third parties is to claim from the insurance company under the compulsory third party motor vehicle cover.

The process of claiming for an insured peril can be determined by whether the insurance system in question is a pure tort system, or whether it is a no fault system or a blend of both¹⁸².

In a pure tort system such as Kenya, the claimant in a third party cover has to prove the defendant's liability under the tort of negligence. In order to prove liability in a negligence in the claim, they have to establish the three elements of negligence. The first element is the duty of care. The person claiming to have been injured must prove that the insurer through its insured owed him a duty of care. This duty arises through the neighbor's principle¹⁸³. A person is to act in such a way that those people in the proximity of his action do not get injured. The victim also has to prove breach of duty. Breach is going against what the law expects of a person. The presence of a duty is well established by the traffic Act, which requires all drivers to drive with the utmost care not to cause accidents and injuries to passengers and pedestrians¹⁸⁴. The duty is

¹⁸² A pure tort system uses the concept of negligence to determine whether the driver of the motor vehicle (insured) was negligent or it was a pure accident. The no fault system only considers the accident which occurred and whether the same occasioned injury to the victim.

¹⁸³ The neighbour's principle was conceived by Lord Atkin in the case of *Donoghue v Stevenson* (1932) AC 562, 580. This principle was introduced to overcome the hurdle which was brought by the privity of contract in tort cases. A neighbour was defined by Lord Atkin in the same case as someone who is closely and directly affected by one's actions that they ought to be considered before any action is undertaken by the plaintiff.

¹⁸⁴ Part 4 of the Traffic Act, Cap 483 of the Laws of Kenya.

implied through the restrictions which are imposed on drivers when driving motor vehicles. The Act criminalizes drunk driving¹⁸⁵, speeding¹⁸⁶, reckless driving¹⁸⁷ and finally, careless driving¹⁸⁸. Therefore, when a victim is forced to prove the existence of a duty, they have to produce evidence that they indeed travelled in a particular motor vehicle. This is sometimes considered very problematic because of the tradition of not issuing travel receipts by motor vehicle owners and their agents when travelling on Kenyan roads.

4.2- No Fault System of Liability

A no fault insurance system has been defined as an insurance system, where one ought to deal with their insurer in case of the occurrence of the insured event¹⁸⁹. What this means is that there is no doctrine of subrogation in play and that every insured deal with their insurer. This is a departure from the fault system whereby the insured has a recourse against the person who cause the accident, through his insurance company¹⁹⁰. No time will be spent waiting for the determination of the person who was at wrong, as everyone claims from their insurance company.

It is believed that the no fault insurance system began in Canada in North America, in Saskatchewan Province in 1946¹⁹¹. This was a departure from the tort fault system whereby

¹⁸⁵ Section 44 of the Traffic Act

¹⁸⁶ Section 42 of the Traffic Act

¹⁸⁷ Section 47 of the Traffic Act

¹⁸⁸ Section 49 of the Traffic Act

¹⁸⁹ Matheson, L. (1972). *No Fault Auto Insurance in Canada. The Journal of Risk and Insurance* Vol. 39,pp. 27-29

¹⁹⁰ This should be understood from the angle of claims. The insured person will not be let to go scot free if he caused the accident. His insurance company reserves the rights of any penalties like increase of subsequent premiums and payment of policy excess.

¹⁹¹ Sugarman, S. D.(n.d). *Quebec's Comprehensive Auto No-Fault Scheme and the Failure of Any of the United States to Follow*. Retrieved July 31, 2013 from http://www.law.berkeley.edu/faculty/sugarmans/Quebec309.htm#N_1

negligent drivers were compelled by the law to pay for their negligent acts. This is because it was realized that very large amount of costs, time and energy were used in the determination of fault at negligence, and this caused a backlog of cases in courts¹⁹². Another justification for the adoption of the no fault system was that justice was delayed and at times never dispensed, because one would be found to be at fault. The court system was such that a party could be found to have been at fault, yet the accident was caused by the inherent weaknesses of driving. The no fault insurance scheme is a way to do away with negligence of the other party when claiming for insurance compensation by a victim. The concept of contributory negligence is also done away with and everyone who is involved in an accident will be able to be compensated by the insurer by virtue of the accident which occurred. The only way in which the negligence can be invoked after an accident is by the compensating insurance company through the doctrine of subrogation. This doctrine will apply after the victims have been compensated, and the insurance companies are claiming against each other. This can be considered fine because the victims will have been treated, and no human right violation will be occasioned. The tort system places the liability on the shoulders of negligent drivers and their insurers. However, this brings in an additional party to the insurance process, and this is the judicial mechanism.

A tort is a wrong which no one would normally admit and they can only be declared to be negligent by a court of competent jurisdiction. It is also a well known tradition for insurance companies to warn their clients, that they are not to admit liability at all costs in case of an accident. When an accident occurs, there are a number of actions which ought be taken by parties who are involved in the accident, depending on the nature of the accident and the effects of the

¹⁹² Kozyrin, J. (1972). No-Fault Automobile Insurance And The Conflict Of Laws-Cutting The Gordian Knot Home-Style. *Duke Law Journal*. Vol 1972, pp 331-406

same. The sick need to be treated, and the vehicles need to be repaired. Human health is of paramount importance, and it should be treated with urgency. It cannot wait for the court process to be completed, and declare any of the insureds negligent. Vehicles also depreciate in value, and the owners lose business. Therefore, it would be prudent if such occurrences would be settled with immediate effect. This clearly shows that the liability insurance system is not the most efficient.

4.2.1 Reasons for the introduction of no fault insurance system in Ontario Canada

There are many reasons which have been advanced by scholars as to why the no fault insurance system was introduced in Canada. However all of them agree that the move was geared towards efficiency in a system which had become quite inefficient. According to Thiel¹⁹³, the same was introduced because the system had been marred by corruption and delay. The scraping of the fault nature of auto insurance assured that the insured persons were paid claims regardless of whether they were fault or not. This would also reduce the number of players which are encountered in the process, and would lead to greater efficiency¹⁹⁴.

According to Sugarman¹⁹⁵, the introduction of the no fault insurance was politically accepted in the US because of the small claims cases. The small claims cases involving auto insurance were clogging the system, and causing inefficiency in the way the judicial system operated. According to him, it was this that made the majority of US legislators change heart towards the tort system

¹⁹³ Thiel, J. W. 1969. Keeton, O'Connell, and McCord: Crisis in Car Insurance. *Valparaiso University Law Review*, 235-237

¹⁹⁴ As noted in chapter 2 above, there are a number of players which are encountered by an insured person through the insurance process. The parties encountered after an accident determine the success or otherwise of a claim.

¹⁹⁵ Sugarman, S. D. (n.d). Quebec's Comprehensive Auto No-Fault Scheme and the Failure of Any of the United States to Follow. Retrieved August 27, 2013 from http://webcache.googleusercontent.com/search?q=cache:L3LF6IJCHYJ:www.law.berkeley.edu/sugarman/Quebec_Revised.doc+no+fault+auto+insurance+in+canada&cd=7&hl=en&ct=clnk&gl=ke

of auto insurance. It was the contention that the small cases took a very long time to finish, and the results were not proportionate. Some claims ended up with a substantial amount of damages, for injuries which were long healed, and sometimes the victims had also also forgotten all about the trauma. Other cases led to no compensation at all yet it was evident that injuries were occasioned, and huge legal fees expended. The result was as a result of the ability or the inability of the plaintiff to prove negligence on the part of the insured, yet the system was adversarial. The cases were decided on a balance of probabilities.

4.2.2 Benefits of no-fault insurance

As described above, no fault auto insurance places the burden of paying the accident damage on the insurance company of the insured's motor vehicle regardless of whether it is negligent or not. There is no chance of proving the negligence bit in court in a no fault system. Some companies and vehicle owners have been able to evade liability because they can afford smart lawyers who can convince the court otherwise. Therefore, with this protection gone, the insured's and their drivers tend to be more careful when driving so as to limit their liability¹⁹⁶. This effectiveness and carefulness when driving the motor vehicles is of economic benefit to the society because it leads to the protection of life.

It has also been argued that a pure no fault system leads to greater justice to the injured because it removes the error which the courts can make in a negligence action. According to Edlin¹⁹⁷, pure no fault system cuts out many third parties in the process of claiming once an accident occurs. This is beneficial to the victims because they are assured that they can get some

¹⁹⁶ Shavell, S. 1987. *Economic Analysis of Accident Law*. Cambridge: Harvard University Press

¹⁹⁷ Edlin, A. 1994. Efficient Standards of Due Care: Should courts find More Parties Negligent Under Comparative Negligence?. 14 (1) *International Review of Law & Economics* 24-31

compensation, albeit fixed, as a result of the injury occasioned by the insured's vehicle. It is to be noted that victims in countries which follow adversarial judicial systems have an inherent risk of not convincing the courts enough that they are not negligent. The cases are decided on a balance of probabilities, and this means that there is a chance that the court can wrongly decide a case.

4.2.3 Case study: No fault insurance in Michigan

In Michigan, the law requires every motor vehicle owner to have insurance on no fault benefits to be paid to third parties in cases of accident¹⁹⁸. Failure to have this insurance or security when driving a motor vehicle in Michigan amounts to a misdemeanor which one can be fined for up to \$500 or imprisoned for up to one year¹⁹⁹. However, there are times when a person will be denied auto insurance in Michigan. Such circumstances arise when the person seeking insurance has been found to be guilty of fraud over the last five years, or when the insured was denied insurance claims because of an insurance fraud. A person can also be denied an insurance cover in Michigan if the person had committed a traffic offense over the past three years such as drunken driving. There are three parts of no-fault insurance in Michigan.

4.2.3.1 Personal Injury no-fault Protection

This is that part of Michigan's motor insurance which is responsible for paying reasonable medical expenses in cases of an accident. When an accident occurs, and the person gets injured, this insurance will pay all the necessary medical expenses and also the wages which have been lost as a result of the accident, but this is only payable up to a certain extent. The maximum amount of wages payable in 2013 is \$5,189 for lost wages. In case of death, the defendants will

¹⁹⁸ Michican Kegislation section 500:3001 Act 294

¹⁹⁹ http://www.michigan.gov/documents/dleg/08_auto_buyer_guide_ENTIRETY_243180_7.pdf

be paid up to three year's upkeep of the amount of allowances which they received from the deceased. The person is also entitled to up to \$20 service charge because of the inability to do the simplest home responsibilities such as housekeeping which they had previously done.

4.2.3.2 Property Protection no-fault Insurance

When an insured vehicle is involved in an accident, and it destroys other persons property or vehicles, the third parties will be eligible to be paid up to \$1 million cumulatively in claims²⁰⁰.

4.2.3.3 Residual Liability Insurance — Bodily Injury and Property Damage

The purpose of no-fault insurance is to prevent a the insured person from being sued as a result of an accident caused. However, there are some instances where the no-fault insurance does not protect the insured from being sued, but will aid the insured when paying the decreatal sum. Such instances include instances where the insured is involved in a very serious accident whereby a person is killed or seriously injured, where the insured is involved in an accident outside Michigan, and where the insured person is involved in an accident with a non-resident. There are limits which are imposed on the amount one can recover from no-fault insurance if one is found to have been liable for an accident. Any excess amount which is adjudged by the court above the policy provision will be borne by the insured²⁰¹.

4.2.4 Drawbacks of no-fault insurance system.

No-fault insurance is the opposite of liability insurance, and it is meant to eliminate the drawbacks of liability insurance. However, being a no-fault insurance does not mean that the

²⁰⁰ http://www.michigan.gov/documents/dleg/08_auto_buyer_guide_ENTIRETY_243180_7.pdf

²⁰¹ In 2013, the maximum claim for liability of killing someone is \$20,000, in any one accident is \$40,000, and for property damage in another state is \$10,000.

issue of liability is completely done away with. No-fault insurance has limits on the amount which can be claimed at any single point. Therefore, if the hospital bills of the insured, or repair charges exceed the limits of the no-fault system, it will force the insured to sue the owner of the third party motor vehicle for the excess. This means that the liability issue of the insurance is not completely done away with. It also means that the system cannot be purely no fault, and it can only be a hybrid between no fault insurance and liability insurance.

No fault insurance is also expensive to run and maintain²⁰². The premiums which are paid by the insured at the inception of the insurance contract are higher than those paid in cases of liability insurance. This is attributed to the fact that the insurance company is certain that it will bear some form of liability in case of the occurrence of the insured event whether the insured is the one on the wrong or not²⁰³. In Florida, for example, insurance companies have opted to calculating the premium payable by taking into consideration the claim severity rate and the frequency of occurrence of accidents. These factors combined have increased the amount of pure premium²⁰⁴ which is payable for an insurance contract in Florida.

The no-fault system of insurance has also been coupled with claim fraud. This is combined with collusion with the various service providers. This has necessitated most countries who run no fault system of insurance to call for anti-fraud investigators in the insurance sector. In Florida, the Anti-Fraud statute mandates insurance companies with more than \$10 million in direct premiums to have an investigation unit either in-house or outsourced to deal with fraud issues.

²⁰² Harrington, Scott, 1991, Auto Insurance in Michigan: Regulation, No-Fault and Affordability, *Journal of Insurance regulation*, 10:144-183.

²⁰³ McChristian, L. 2011. *No-Fault Auto Insurance In Florida: Trends, Challenges & Cost*. Available at <http://www.doh.state.fl.us/demo/BrainSC/AdvCouncil/NoFaultPaper0125111.pdf> (accessed September 9, 2013)

²⁰⁴ Pure premium is the premium which is taken by the insurance company to cover for pure loss which arises out of the no-fault system. This is in total disregard of other costs of doing business by the insurance company.

The insurance companies with less than \$10 million in direct premiums are only mandated to have an anti-fraud plan in its strategies. The insurers are also allowed to report accidents to the National Insurance Crime Bureau. If an insurer suspects concerns of staged accidents, pre accident injuries, excessive medical treatment, faked injury or solicitation, they will refer the matter to the NICB²⁰⁵. The increase in fraud in no-fault systems may be as a result of the fact that there is no rigorous court process of proving that an accident actually occurred, and the insurance company is mandated by law to pay any claims arising out of accidents.

The no-fault system does not also provide for compensation for pain and suffering which is faced by a person in the occurrence of an accident. This means that the person who faced pain and suffering has to go through the judicial process to claim for this from the person who is to blame for the accident. Damages for pain and suffering are damages which are awarded in a court of law for physical and mental anguish which a person went through because of the occurrence of an event. These damages are very subjective, and the reason why they are not provided in a no-fault system is because of the subjectivity and the difficulty which will be faced when computing.

Finally no fault insurance is very complex and requires a lot of documentation and paper work before a claim is processed.

4.3 Motor Pool System and the Declined Pool System in India

The motor pool system in India was designed in such a way that a single pool of insurance was set up. All third party premiums were paid into the pool, and the insurance companies used the

²⁰⁵ McChristian, L. 2011. *No-Fault Auto Insurance In Florida: Trends, Challenges & Cost*. Available at <http://www.doh.state.fl.us/demo/BrainSC/AdvCouncil/NoFaultPaper0125111.pdf> (accessed September 9, 2013)

pool to settle their claims according to their percentage market share. What this means, is the policyholders would be assured of compensation as long as there were funds in the pool. Their risk was not in the custody of a single insurance company, but rather, it was in a pool.

Another reason why the third party motor pool was introduced in India, is because third party commercial insurance was considered to be a high risk sector, and thus it could derail the performance of insurance companies if it was not held in a pool. Therefore, the pool was meant to ensure that all insurance companies shared in the commercial third party motor vehicle risks²⁰⁶.

However, the increasing losses in the pool compelled the regulator, Insurance Regulatory and Development Authority (IRDA), to consider changing the insurance system into a declined motor pool system²⁰⁷. It is to be noted that the initial system was set up as a pool because of the imbalance which was faced in the demand and supply of third party motor insurance. The shortcomings of this imbalance would be well sorted with the establishment of a pool whereby the various insurance companies covered the policyholders as a whole. However, as time progressed there was a balance in the demand and supply of third party motor vehicle insurance and the IRDA found it safer to make changes in the same so as increase its efficiency. The pool made a loss of 122% in 2007-2008 financial year, 124% in 2008-2009 financial year, and 127%

²⁰⁶ Rastogy, A. n.d. Implications of Motor TP Pool & Declined Risk Pool. [Online]. Available at <http://www.actuariesindia.org/GI/TP%20Pool%20Implications%20CIGI%202011.pdf> (Accessed September 20, 2013)

²⁰⁷ Ramana, K. V. 2011. *Motor insurance may move to declined pool system*. [Online]. Available at <http://www.dnaindia.com/money/1609694/report-motor-insurance-may-move-to-declined-pool-system> (Accessed September, 9 2013)

in 2009-2010 financial year²⁰⁸. it was also thought that the commercial vehicle third party insurance motor pool breed inefficiency in the system because no insurance company associated itself with it, and it also became a hub of fraud. no efforts were taken by the individual insurance companies to investigate and address the question of fraud²⁰⁹.

Under the declined pool system, individual insurance companies are able to individually underwrite third party risks according to their terms and also prices. The vehicles which are denied third party cover by the insurance companies because of various reasons will be covered under a declined pool system, which will be operated as the previous third party pool. This is by insurance companies paying out claims according to their market share, but out of the third party motor pool²¹⁰.

Insurers in India are optimistic that the declined pool system will be able to solve the various shortcomings which are experienced in the third party motor pool²¹¹. The losses from the pool are currently shared among the insurance companies in proportion to their market share. This means that the insurance companies only share the losses or benefits of the pool, but do not have any control over the way the pool is managed. When the pool is mismanaged, then the insurance companies will bear the losses of a fund they did not get a chance to manage. The declined pool

²⁰⁸ Rastogy, A. n.d. Implications of Motor TP Pool & Declined Risk Pool. [Online]. Available at <http://www.actuariesindia.org/GI/TP%20Pool%20Implications%20CIGI%202011.pdf> (Accessed September 20, 2013)

²⁰⁹ Rastogy, A. n.d. Implications of Motor TP Pool & Declined Risk Pool. [Online]. Available at <http://www.actuariesindia.org/GI/TP%20Pool%20Implications%20CIGI%202011.pdf> (Accessed September 20, 2013)

²¹⁰ Ramana, K. V. 2011. *Motor insurance may move to declined pool system*. [Online]. Available at <http://www.dnaindia.com/money/1609694/report-motor-insurance-may-move-to-declined-pool-system> (Accessed September, 9 2013)

²¹¹ Nyman, F. 2012. Declined risk pool aims to reduce losses for India's motor sector. [Online]. Available at <http://www.insuranceinsight.com/insurance-insight/news/2163593/declined-risk-pool-aims-reduce-losses-indias-motor-sector>. (Accessed September 20, 2013)

system will give the insurance companies a chance to manage the various third party risks they underwrite, and therefore, there is a chance that the same will result in success. The declined pool system is also beneficial because it accommodates the risks which have been taken by the various insurance companies. Before an insurance company underwrites a risk, it has to do an analysis of the level of risk it is undertaking, and whether it falls under its terms and conditions. Therefore, there is always a possibility that some third party risks are left uninsured by insured companies. The declined pool system accommodates these unsecured risks ensuring that they are protected under the common pool which is then shared by all insurance companies in relation to their proportion of third party market shares.

4.3 Conclusion

From the above discussion, it is noted that the above two models are very different from the model currently in place in Kenya. Kenya follows a tort liability system of insurance whereby a person has to establish liability before the insurance company can compensate third party risks. This is thought to have led to inefficiency in claim procedure, with various claims taking very long to come to a conclusion.

The no-fault insurance system as practiced in Canada and Michigan does not place any fault on the insured person. Therefore, claimants can be compensated regardless of the fact that they might have been at fault. The major advantages which are associated with the no-fault system of insurance is that the claim process is faster and claimants get to be compensated earlier as compared to the fault system which is practiced in Kenya. The system is also cheaper for the claimants because they do not have to institute liability claims against the insured persons. Finally, the system has fewer players, and hence the procedure is more straightforward when

claiming from an auto accident. This eliminates the chances of collusion by the various players to defraud the insurance company as is the Kenyan case. However, the no-fault insurance system is a very complex process and requires a lot of documentation. It's efficacy has not been tested in a third world country.

The third party insurance pool system which is practiced in India is akin to the motor pool system which was established in Kenya in the 1980s. The pool was established twice, but it collapsed at both instances due to mismanagement of the fund. The advantage of the declined pool system is that it allows the insurance companies to share in underwriting the insurance cases which have been declined by the insurance companies because they are high risk. Therefore it ensures that the risk is distributed among the various insurance companies which are undertaking auto insurance.

However, none of the above cases can be implemented purely in Kenya. What can be done in Kenya, is to borrow elements from each of the above insurance system so as to custom make the insurance system in Kenya. If the structured claim compensation amendment in The Insurance (Motor Vehicle Third Party Risks) Amendment Bill, 2013 is passed, it will introduce some elements of the no fault system and the Kenyan system will be able to reap the benefits of such a system without overhauling the whole insurance system.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

This chapter is a summary of findings. The study is concerned with the PSV insurance sector, and why it has been faced with constant solvency challenges over the last decade. This study is a legal enquiry into the applicable law and institutional arrangement of the sector, and whether the law is sufficient to run the sector. The questions were sufficiently answered in the study. The hypothesis of the researcher was proved, as it would seem that there is inadequate legal and institutional framework in the sector.

This chapter also makes appropriate recommendations which if adopted would go a long way towards the realization of stability in the PSV insurance sector in Kenya.

5.1 Conclusion

Chapter one laid down the study to be undertaken together with its objectives and importance of the study. The problem statement tackled in this project is the adequacy of the law in dealing with the collapse of PSV insurance companies in Kenya.

Chapter two gives an overview of the public service insurance sector. It is noted from the discussion on actors that there are many actors in the PSV insurance sector who are regulated by different regulatory bodies. Some of the actor are involved in fraudulent collusions to defraud the PSV insurance companies in Kenya.

The problem which comes out clearly is liquidity challenges. A further inquiry reveals that the liquidity and solvency challenges of the PSV insurance companies are attributed to fraudulent claims and collusions, arbitrary awards by the courts, Excessive risks, and capital adequacy.

Chapter three of the study is an inquiry into the applicable law, and the adequacy of the law thereof to address the liquidity and solvency challenges. There are many statutory provisions which touch on the issue of PSV insurance in Kenya. The main statute which regulates the players of the insurance companies in Kenya is the Insurance Act. The areas which were deliberated on are the reinsurance provisions, the solvency provisions, the corporate management provisions, the law addressing insurance fraud, and the law addressing arbitrary awards on insurance claims. The conclusion of this chapter is that Kenya lacks adequate statutory provisions to promote adequate reinsurance and to curb the fraudulent claims and collusions in the PSV insurance sector. The problem of arbitrary awards would be solved with the passing of the structured compensation claim amendments in the Insurance (Motor Vehicle Third Party Insurance) Act, which introduces a no fault element in the in Kenya's auto insurance claims.

Chapter four of this study is an inquiry into two auto insurance models which are practiced in other jurisdiction. The no-fault model has beneficial elements which can be incorporated in the Kenyan PSV insurance sector and it will eliminate the threat of fraudulent claims and collusions. The no-fault element will be introduced with the passing of the Insurance (Motor Vehicle Third Party Risks) Amendment, 2013.

All the research questions were answered sufficiently in the research. The research which was conducted was both theoretical and practical. On the question on whether the legal framework is adequate, the researcher found out that the law was inadequate as far as the successful operation

of the PSV insurance companies was concerned. The insurance law in Kenya is tailored in such a way that the PSV insurance companies would be able to operate successfully in a vacuum. The insurance companies will also operate well in a flawless market where there are no externalities. This is because the management, solvency requirements and distribution of risks through reinsurance has been catered for by the Insurance Act. It does not take into consideration the fact that the sector has many stakeholders many of whom affect the success or otherwise of the PSV insurance companies to a greater extent. These stakeholders have not been catered for in the Insurance law.

However, this is not normally the case because the PSV insurance sector is marred with anomalies, and market imperfections. The imperfections come in the form of extortionists, and persons who want to reap where they are not supposed to. The interviews which were performed to prove that the major problem in the PSV insurance sector was actually fraud and collusion among the various parties involved. The fraudulent activities, and collusion usually cost the insurance companies in the form of false claims and has led to loses.

The institutional arrangement in the insurance sector is insufficient to shield the PSV insurance from difficulties. The working of the some of the institutions has not been enhanced to ensure a successful operation of the PSV insurance sector. Some of these institutions are the Policyholders Compensation Fund and the Insurance Fraud Investigation Unit. The Policyholders Compensation Fund was established to create a shield to policyholders in case of the dissolution of an insurance company. However, the amount which the policyholder can get from the compensation fund is very minimal, and it cannot be able to adequately compensate the policyholder in case of insolvency of an insurance company. Another challenge of the

policyholders compensation fund, is that the amount can only be due to be payable if the insurance company has been dissolved. It is not enough that the insurance company has been placed under a statutory manager and a moratorium has been issued on all its claims. The policyholder must await the dissolution of the insurance company before he can claim. The maximum compensation payable under the fund is one hundred thousand Kenya shillings.

The insurance Fraud Investigation Unit is also another institution which was created with the best of intentions for the PSV insurance sector. The Investigation Unit was created so as to enable the insurance company form a collaboration with the police so as to unearth the fraudulent activities going on within the industry.

5.2 Recommendations

The following recommendations have been suggested by the writer to be applied in complementarity with the existing PSV insurance law in Kenya.

(i). Passing of the proposed amendment to the Insurance (Motor Vehicle Third Party Risks) Amendment Bill, 2013

The Insurance (Motor Vehicle Third Party Risks) Act, was passed on 24th December 2013 and became operational on 28th January 2014 to bring the structured compensation liability schedule into force in Kenya. However, the Law Society of Kenya moved to court through petition number 148 of 2014 to put a stay on the application of the Law. The stay was granted and its application is suspended. The Law society of Kenya argued that the law was unconstitutional as it provides a cap on the amount of damages which can be claimed by an individual. This is against the consumer protection article (46) of

the constitution. Their argument is that consumers risk inadequate compensation in case of an insurance claim. The society also claims that a blanket structure on the compensation of claims is unreasonable since not all persons have a similar use of their body parts. They argue that some people, like surgeons for example, value their hands much more than other people such as interpreters. Therefore, in their view the Act should be amended in such a way that there will be no blanket compensation structure for everyone.

Lifting the stay on the Insurance (Motor Vehicle Third Party Risks) Act will mean that third party motor vehicle insurance in Kenya will not be enforced through the tortuous process which is currently undertaken. It will mean that the claim process will be akin to the no fault compensation system whereby the insurance company will compensate any third party injured by the insured vehicle regardless of whether the insured was negligent or not.

This will be beneficial to the PSV insurance underwriting companies because it will remove the long and tedious wait of conclusion of court cases. It will also enable the companies underwriting third party insurance to predict the risks it faces, and thus plan ahead. It will also aid evading the insurance companies from the arbitrary awards which are awarded by the Kenyan courts.

This is also a move which will benefit the policyholders and third party motor insurance claimants. This is because it makes it clear how much one is to be compensated in case they receive an injury through an accident. The claimants will know how much claim to lodge, when they will also be spared the long wait which is usually felt before the conclusion of third party insurance claim cases. They will also be spared legal costs

which they are required to pay to advocates for representations in the courts. This will increase the economic benefit of the compensations to people who are injured in case of accidents.

(ii). Amendment to the Insurance (Motor Vehicle Third Party Risks) Act, to bring about provisions which address the issue of Fraud

The provisions addressing fraud and collusion to commit fraudulent activities are found in the penal Code. However, the Penal Code contains general provisions of substantive law which are applied across the legal framework in Kenya. Therefore, there is a need that the issue of insurance fraud, which is very specific to the PSV insurance industry, be recognized in an insurance specific law. Since the fraud and collusion take place between persons across various professions, and who touch on the enforcement of the third party insurance contract, the insurance law should be amended to regulate the insurance dealings of these parties. The ideal statute to address these provisions is the Insurance (Motor Vehicle Third Party Risks) Act, because it specifically deals with motor insurance. The provision should criminalize fraudulent collusion on a PSV insurance claim to defraud an insurance company. The provision should also criminalize the submission of false information on PSV insurance claim with the aim of defrauding a PSV insurance company. The punishment provided should be composed of both a fine and imprisonment, and the courts should have discretion of awarding both. The Insurance Act should also be amended to give the IRA a statutory mandate of tackling financial services fraud in the insurance sector. Since the IRA is the body which has been given the mandate of overseeing the well being of the insurance industry in Kenya, it will be in a

better position to put down guidelines which will eliminate the instances of fraud if followed. The guidelines should cover all the players in the insurance sector. In addition with the mandate of investigating insurance Fraud, IRA should be given the locus to prosecute suspects of insurance fraud.

- (iii). The **Traffic Act** should be amended to regulate the conduct of pedestrians on the Kenyan roads. According to the police, pedestrians contribute to a large extend to traffic accidents which are reported on the roads on a daily basis, yet there is no regulatory mechanism for them. The specific provision should criminalize any act by pedestrians of crossing the roads at undesignated places.
- (iv). The **insurance Act** should also be amended to mandate accident victims and their representatives report the occurrence of an accident within a very short time after the occurrence of the accident. This will prevent many fraudsters from claiming in accidents they were never part of. The time frame is within 24 hours but it should be reduced to at most 6 hours. To make it practical, any complain of PSV insurance 6 hours after the accident should be corroborated.

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