DOES THE REGULATION OF THE INSURANCE INDUSTRY HAVE A PERNICIOUS EFFECT ON INNOVATION BY THE SECTOR IN SOUTH AFRICA?

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Abstract

Financial regulation could be a double edged sword in that despite its major thrust being that to secure the financial sector and bring about financial stability; it might have the unintended consequence of stifling innovation by the sector. We investigate the nexus between financial regulation and innovation by specifically focusing on the insurance industry in South Africa. We demonstrate that there are plethora pieces of legislation that govern the insurance industry in South Africa. As such this has driven the cost of compliance to unsustainable levels thereby curtailing the spending by companies on innovation. We thus would like to caution the policy makers' that this "heavy-touch" regulatory mode is having a pernicious effect on research and development by the insurance sector. As such we encourage them to embrace the "light-touch" regulatory mode whereby self-regulation and moral suasion are other avenues to be considered.

Keywords: Financial Regulation, Innovation, Pernicious, Compliance, Insurance, South Africa

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Introduction

The financial regulatory landscape in South Africa has experienced a significant evolution over years with more requirements being placed on the industry, companies and employees alike. This has led to an outcry that financial regulation is stifling the prospects for financial innovation. The financial crisis of 2007 to 2009 proved beyond doubt that if markets are left to themselves, they can be self-destructive. Biener, Eling and Schmit (2014) acknowledge that regulation can either impede or promote the development of financial services. Less regulation was preferred in Benston and Kaufman (1996). They recommended that markets must be left to operate freely with little regulation to manage the externalities that may arise in the markets. In the absence of regulation, consumers will not realise the intended benefits from their products and investors lose out on their investments. However, it would appear that the level of reaction by regulators to shocks such as the 2007 to 2009 financial crisis or major failures by institutions tends to overwhelm the markets (financial institutions). Whereas regulation should be viewed positively, it gets viewed as an impediment. In this paper we explore the extent to which regulation is an inhibitor of financial innovation in the insurance industry.

At the centre of financial regulation is the need to protect consumers and investors by ensuring that there is financial stability. The other pertinent goals of regulation are; removal of barriers to entry, providing for recovery in the event of a market or institution failure, promotion of competition, avoiding of negative externalities from the markets. Most regulatory instruments seem to focus on the aforementioned objectives. It is noteworthy that in South Africa, of the thirteen Acts that specifically govern the financial services sector, only two make reference to the importance of encouraging development in the markets. Of all the Acts, none specifically speaks to promotion of financial innovation. Notwithstanding the lack of reference to financial innovation, the Acts, according to the literature are achieving what they are meant for. However there is scant research that seeks to quantify the impact of regulation in the financial services sector, from a product development and innovation perspective. This paper seeks to unravel the impact of regulation on the development of products and innovation in the financial services sector. This will be done by establishing whether there exists a nexus between the costs of regulation and financial innovation in the insurance markets. It is our contention that regulation has many benefits as well as costs. We go on to approximate these costs and then show whether the costs are indeed an impediment or not.

Costs of regulation are not only borne by the financial companies. Consumers pay in the form of having to meet the regulatory requirements such as Financial Intelligence Centre Act (Act 38 of 2001), (FICA) that requires consumers to submit certain documents for identification and proof of income. For companies costs can be direct or indirect. They include the cost of running the departments/agencies, levies, fees, litigation and arbitration, sanctions and transfer fees (Jackson 2007 and Franks; Schaefer and Staunton 1998). Regulation increases cost of operation. The regulated institutions need to invest in technology if it was absent, report certain transactions and keep records for a certain periods among many other requirements (Hernández-Coss, Egwuagu, Isern and Porteous, 2005). Lee and Chih (2013) stated that strict rules could dampen the economy. Information costs, compliance, duplication and surprise costs were identified in Bouvatier (2014). Regulation also has an opportunity cost (Franks, Schaefer and Staunton 1998). Further they cite a study by the American Bankers Association, which showed that compliance cost were $10.7 billion, which was equivalent to 59% of the industry’s net income. Unnecessary costs, complexity led to loss of the firm’s time. In addition they gave minimum capital requirements and barriers to new business as costs.

It is business logic that whatever cost that are incurred by the companies must be passed on to the consumers. Thus it is possible that costs borne by consumers for the products can go up if the costs of operation go up. We also note the nature of financial services to give a complete picture of the product that is at hand. At the core of financial services development is the existence of a need for the specific product. Financial services are not purchased for their sake; they are bought for the benefits that they offer to consumers. In a fast changing world where globalisation, regulation, deregulation, technological, economic, social, demographic, increased consumerism, courts that are pro-consumers among other factors have brought rapid changes to the needs and the financial services arena, companies are constantly faced with the need to remain relevant by adapting their products to such change. Research and development involves investment of time and money by these institutions. We will seek to address the extent to which resources meant for innovation are diverted or faced with competition by the need to be compliant with the different pieces of regulation.

This paper is arranged as follows; section 1 provides a literature background to financial innovation and regulation, section 2 provides an overview of the insurance industry in South Africa, while section 3 provides an overview of the regulation of the insurance industry in South Africa, section 4 gives an approximate cost of compliance to FAIS regulation and Section 5 concludes.

1 Review of related literature

1.1 The objectives of financial regulation

The objectives of financial regulation are varied and amongst others can be enumerated as follows; protection of the general public, elimination of public externalities from financial failures advancing various equitable and redistributive goals and promoting the political economy (Jackson, 2007). According to Lee and Chih (2013), notwithstanding that bank regulation seeks to improve liquidity and solvency, it does not promote efficiency. Leaving the market to itself can lead to economic growth problems and instability (Vashishtha and Sharma, 2012). Giogio, Noia, Carmine and Piatt (2000) cited stability, transparency, proper behaviour and competition as objectives of financial regulation. The respondents in Vashishtha and Sharma (2012) ranked the protection against systemic risk as the most important regulatory objective followed by the prevention of financial crimes as well as creating and sustaining a fair market. The objectives of financial regulation as summarised by Briault (1999) for the Financial Services Authority are; (1) maintaining confidence in the financial system, (2) promoting understanding of financial system as well as risks and benefits associated with different products, (3) consumer protection and (4) reducing financial crimes by preventing, detecting and monitoring the incidence of crime. In the next paragraph we highlight some of the objectives that are contained in the South African legislation. The idea is to reveal what the regulators intend to achieve using regulation.

The Financial Markets Act 19 of 2012 seeks to ensure efficient and transparent financial markets in South Africa, boost confidence in the market, protect regulated persons, reduce systemic risk and promote domestic and international competiveness of South African financial markets. On the other hand, the Financial Intelligence Centre Act 38 of 2001 has identification of unlawful proceeds, combating money laundering and funding of terrorist activities, providing information to investigating authorities and collaborating with similar bodies in other countries as the main objectives. The all-encompassing Financial Advisory and Intermediaries Services (FAIS) Act of 2002 lists protection of consumers, regulation of selling and giving financial advice activities, provision of adequate information to consumers and establishment of a properly regulated financial services profession as its core purpose. Another Act of interest is the Credit Rating Services Act 24 of 2012. Its objectives are; (1) ensuring responsible and accountable credit rating agencies, (2) protect the integrity and transparency of credit rating processes, (3) protect investors, (4) improve fairness, efficiency and transparency of financial markets and (5) reducing systemic risk.

From the above foregoing, it is evident that the goals of financial regulation are dichotomous. Nonetheless it can be noted that there is no outright objective to promote research and innovation in the financial services entrenched by any of the Acts in South Africa. However reference to promoting competition indirectly suggests that the Acts seek to promote innovation through increased competition. Effectiveness and efficiency of markets and companies is also alluded to. However the Acts do not define what that means. Thus it remains open to any interpretation. We cannot however say that legislation completely ignores or negates issues of innovation, research and development.

1.2 The cost of financial regulation

Governments need to ensure that regulation is cost effective (Jackson, 2007). He goes on to say that the cost of regulation is easier to measure. However it is almost difficult to measure the benefits. Measuring the benefits of regulation is almost an impossible task. He however acknowledges that regulation does have benefits. Further he says that in the United States the discussion on cost benefits of regulation has been non-existent. Franks, Schaefer and Staunton (1998) concurred with Jackson 2007 that costs of regulation in the UK were not taken into account when regulation was introduced or reviewed. Herring (1994) and Ferguson (2000) cited in Vashishtha and Sharma (2012) contend that the financial crises and increase in scams as have their origins in regulation. Heterogeneity of legislation across jurisdictions impedes the export of financial services. Bouvatier (2014) and Copeland and Mattoo (2007) noted that global development of financial services could improve efficiency through increased competition. This can result in economic growth. Bouvatier (2014) further avers that restrictions and prohibitions are a trade barrier on international trade in financial services. However he concluded that it is heterogeneity in private monitoring that impeded cross-border trade in financial services. Berger, DeYoung and Udell (2001) were in unison with the sentiments echoed by Bouvatier (2014). They postulate that efficiency barriers make it difficult to own and operate a financial firm in another country. Among the barriers identified were; distance, language, culture, currency, and regulation and well as deliberate and non-deliberate rules to exclude foreign businesses. The benefits of cross border trade in financial services were outweighed by the barriers that they identified.

Combined budgets by treasury departments, costs that could be incurred in the absence of regulation, additional costs such as litigation and arbitrations and the difficulty in showing the incremental costs all make the measurement of costs of regulation more difficult if not impossible (Jackson, 2007). Internal costs, difficulty in showing the incremental cost as a result of regulation and difficulty in distinguishing between transfer payments and deadweight costs to the community make the determination of costs of regulation an almost impossible task.

Costs can be direct or indirect. They include the cost of running the departments/agencies, levies, fees, litigation and arbitration, sanctions and transfer fees (Jackson, 2007; Franks, Schaefer and Staunton, 1998). Regulation increases cost of operation. The regulated institutions need to invest in technology if it was absent, keep records for a certain period and identify and report certain transactions among many other (Hernández-Coss etal, 2005). Lee and Chih (2013) stated that strict rules could dampen the economy. Information costs, compliance, duplication and surprise costs were identified in Bouvatier (2014). Regulation also has an opportunity cost (Franks, Schaefer and Staunton, 1998). Further they cite a study by the American Bankers Association, which showed that compliance cost were \$10.7 billion, which was equivalent to 59% of the industry's net income. Unnecessary costs, complexity led to loss of the firm's time. In addition they classify minimum capital requirements and barriers to new business as costs. However they concluded that regulation has both benefits and costs. Ren (2011) contends that financial regulation as magnifies the procyclical nature of financial services. Procyclicality is defined as the ability of finance to amplify the dynamics of the business cycle (Ren, 2011). Forker and Ward (2012) suggested that self-regulation could substitute or complement external regulation and therefore lead to a reduction in compliance costs. These savings they argue could lead to better monitoring by the external regulators.

1.3 The challenges posed by multiple regulatory regimes

Overlaps and conflict were inevitable and ubiquitous due to lack of clear-cut demarcations in the financial services sector (Jackson, 1999). This showed a trend in the financial markets where the difference between institutions seems to have ceased to exist. Financial services can now be found even in a supermarket. While Jackson (1999) does not advocate for a single regulator, but simply warns of the challenges associated with multiple legislations in a market where there is convergence of financial services in one institution, other authors are outright proponents of single regulatory authorities. In their conclusion, Biener, Eling and Schmit (2014), suggested regulation for micro-insurance that does not offer opportunities for regulatory arbitrage, separation of insurance and micro-insurance regulation. A piece-meal approach to regulation has the tendency to create opportunities for regulatory arbitrage. Vashishtha and Sharma (2012) advocate for a mixed approach to regulation where there is a mixture between single and multiple agencies. They contend that overlapping jurisdictions, too much influence from the government and lack of communication and coordination are the major obstacles in the effectiveness of legislation. Briault (1999) indicated that a few countries had single regulators for the whole financial services industry. In the UK the government had argued that the use of multiple regulators was costly, inefficient and confusing both to the customer and the firms that are regulated. Overlaps, inconsistencies and inflexibility would be removed by having a single regulator. Hoshi and Ito (2004) echoed the same view as Briault (1999) by advocating for a single Financial Services Agency.

The motives for the change in the structure of the regulation in Japan sought to remove the political interventions, handle insolvencies, separate financial authority from fiscal authority, address corruption, improve central bank independence and make easier coordination (Hoshi and Ito, 2004). Scott (1994) on the other hand argues that there should be consolidated supervision when it comes to conglomerates. That would allow the identification and assessment of all risks in the companies that make up the group. There is also a need for autonomous regulators who have not political interests (World Bank, 2006).

1.4 The benefits of financial regulation

The regulation of financial services reduces market failures and improves liquidity and solvency (Lee and Chih, 2013). Awdeh, El-Moussawi and Machrouh (2007) discovered the existence of a positive correlation between bank capital and efficiency. This contradicts the conclusions by Lee and Chih (2013) who stressed that stricter regulation did not improve bank efficiency. Lee and Chih (2013) however acknowledge that there are mixed results from different studies. Herring (1994) and Ferguson (2000) contend that regulation bring about reduction in transport cost, computation costs, improvement in innovation and marketing. Regulation of disclosures, licensing, reporting and examination requirement could improve the image of the industry and make small loan businesses more appealing. Price caps and prohibitions can reduce welfare when they result in lower product use (McKernan, Tatcliffe and Kuehn 2013). Vittas (1991) stated that free markets have been proven not to be inefficient and ineffective. Further the markets suffer from moral hazard, adverse selection, free rider problems, and susceptibility to imprudent and fraudulent behaviour, instability and crisis. Demiriguc-Kunt, Laeven and Levine (2003) found out that when legislation restricts entry, bank activities and inhibit freedom of banks, higher net interest margins will be experienced. Small banks, they concluded also had higher net interest margins as well as higher overhead expenditures. They however did not attribute these higher expenditures to regulation.

Bouvatier (2014) adds to the list of benefits of financial regulation by stating that regulation improves the monitoring of private sector banks. Regulation can compel life insurers to disclose dealing costs. Authorization and monitoring procedures and systems assist in prevention of fraud and financial failure. Franks, Schaefer and Staunton (1998) also cite the reduction of bank failures as an important benefit that may negate the arguments against the costs of regulation. Though Claessens (2006) does not allude to regulation, she stated that access to financial services was on the increase. This development seemed to coincide with the growth of financial services. The strongest economies with well-developed and stable financial services sectors owe it to a strong tradition of financial regulation (Stiglitz, 2001). He further argues that financial failures have strong spill over or externalities. Commenting on the impact of the interventions by governments, after the 2007 to 2009 financial crisis, Pennathur, Smith and Subrahmanyam (2014), were surprised that legislation was one of the two out nine factor that had a positive impact on the markets. Vitta (1991) concurs with Stiglits (2001) and identifies some of the externalities such as systemic failure, inflation effects, allocative inefficiency and higher prices. More and more people and institutions will suffer if a market failure occurs and therefore the government must regulate financial services provision. Vittas (1991) was in unison with Benston and Kaufman (1996) when he concluded that competition was the most efficient catalyst for innovation and efficiency. Claessens and Klingebiel (2001) also agreed that competition improves efficiency, improves access to credit and lowers the risk of financial crises. They go on to say that competition encourages low costs as well as innovation in financial services. However competition must not be left to itself, it needs a monitor.

1.5 How much regulation is optimal?

Jackson (2007) refers to level of regulation as the intensity of regulation. He says that the optimal level of regulation is when the marginal cost is equal to the marginal benefits. Intensity varies across different economies. Too long and too flexible legislation has both produced sub-optimal results (Vashishtha and Sharma, 2012). According to Demiriguc-Kunt, Laeven and Levine (2003), theory provides contradicting relationships on regulation, concentration and efficiency. Their findings also confirmed the mixed outcomes. International agencies such as Bassel try to stipulate a level of regulation that is fair for competition and prudential for regulation (Bouvatier, 2014). “The only major threat to the future health of the financial services industry in the UK is that of excessive and inappropriate regulation”, posit Franks, Schaefer and Staunton (1998). They further argue that if legislation manages to prevent fraud or bad practices, then such costs were justified and inevitable. However if the costs did not result in value for money, then these costs would harm small firms and hinder new entrants into the market.

According to Stiglitz (2001), the 1997 to 1999 financial crises were as a result of inadequate financial regulation. However in developing countries he says that the problem is that of overregulation with emphasis on capital adequacy. He goes on to emphasize that regulation must not only regulate but must empower financial institutions to absorb risks. Regulation of financial institutions must be neutral to all markets and institutions. That would result in higher efficiency and stability in the markets (Vittas, 1991). According to Benston and Kaufman (1996), less regulation and government is ideal. Markets must be less regulated because they have performed better without the government intervention. While they do not supply an actual measure, they contend that regulation must only address externalities, which could harm markets and consumers if there was no government intervention. The results of Vashishtha and Sharma (2012) confirmed that legislation evolves over time in response to market trends. According to Bouvatier (2014) emerging economies needed to be involved in the international integration of legislation if all benefits were to be realised. The optimal level of regulation is less obvious (Claessens and Klingebiel , 2001).

1.6 The impact of regulation on consumers

"We have shown that this regulation does not serve the purpose of reducing uncertainty with respect to the value of money. In addition, regulation increases banks' costs and, hence, increases the cost to users of bank money and reduces the efficiency of the banking system without necessarily increasing safety", observed Benston and Kaufman (1996). What is instructive is that they contend that regulation increases costs and that is ultimately borne by the customer. Jackson (2007) mentions that consumers pay an indirect tax when regulation works as an extraction of wealth from the consumers. Further he alludes to the fact that when consumers are asked to supply additional information, then they incur additional costs through supplying more information. Unnecessary costs are imposed on consumers and the banks when excessive capital requirements are made (Lee and Chih, 2013). Warren (2008) called for the formation of a product safety regulation for financial services. She argues that financial products may turn put out be very unsafe for consumers. She cites the home loan as being capable of leaving your family on the streets. Further she argues that 40% of Americans worry if they can service their debt every month. Disclosures in financial products obfuscate rather than inform. She goes on to note that long contracts are not helping the consumers. Standard, clear and timely disclosures could assist consumers in comparing products and coming up with the best choice (McKernan, Tatcliffe and Kuehn, 2013). Barr (2008) concluded that there was need for regulation that realised social failures that emanated from the interaction between individual psychology and industrial organisation. Vittas (1991) argues that while market failure is a condition for regulation, the other condition is that regulation must correct market failure in an effective and efficient way. Further he argues that a sound regulation system is not about placing heavy burdens on organisations. Rather it must define the ability of financial institutions to exploit economies of scale and scope and thus result in efficient operations.

2 An overview of the insurance industry in South Africa

The insurance sector in South Africa comprises of 79 long-term insurers and 7 long-term reinsurers, 100 short-term insurance companies and 8 short-term reinsurance companies (FSB, 2012). In South Africa the insurance companies that transact life insurance business are referred to as long-term insurers. Similarly the companies that transact non-life (property) insurance are referred to as short-term insurers.

The key metrics of the insurance companies for the period 2011 to 2013 are given in Tables 1 and 2 below. The gross premiums of long-term insurance companies show a remarkable growth of 43% from about R301 billion registered in 2011 to roughly R430 billion registered in 2013. On the other hand the premiums of short-term insurance companies show steady growth of 19% from about R81 billion registered in 2011 to the levels of about R96 billion registered in 2013. A similar trend is observed when evaluating the total assets with the long-term insurance industry registering a phenomenon growth in total assets of 32% from roughly R1, 7 trillion in 2011 to R2, 3 trillion in 2013 as compared to the short-term insurance industry which shows steady growth of about 23% from roughly R90 billion in 2011 to R112 billion in 2013.

The information provided in Table 2 depicts the investment vehicles of the insurance companies. Thus it would seem that the insurance companies both long and short-term play a critical role in intermediation, savings and resource mobilisation.

3 The regulation of the insurance industry in South Africa

The South African insurance sector (both long-term and short-term) is regulated by the Financial Services Board (FSB). Principally the Short Term Insurance Act of 1998 (STIA), the Long-Term Insurance Act of 1998 (LTIA) the Insurance Laws Amendment Act of 2008 and the Companies Act of 2008 govern the transaction of insurance business in South Africa. The thrust in insurance regulation has been to enhance the solvency margins of insurance companies through prudential (financial soundness) regulations and to foster market conduct. A raft of reforms has been implemented and include amongst others, the Solvency Assessment Management (SAM) regime whose main aim is to improve the capital and solvency levels of insurance companies. This is risk based solvency assessment management that comes into operation in 2016. Market conduct regulation is geared towards policyholder protection. Under this category, Treating Customers Fairly (TCF) regulations have been enacted. These are similar to those developed in the UK. Further the Financial Advisory and Intermediary Services (FAIS) Act promulgated in 2002 makes it mandatory for any person providing financial advice to have passed the regulatory examination and hence deemed “Fit and Proper” to proffer financial advice.

Table 1. Gross premiums and total assets of insurance companies in South Africa

	2011		**2012**		**2013**	
	Long-Term Insurers	**Short-Term Insurers**	**Long-Term Insurers**	**Short-Term Insurers**	**Long-Term Insurers**	**Short-Term Insurers**
Gross Premiums / R’mil	300 650	80 951	358 967	87 675	429 703	96 178
Total Assets / R’mil	1 722 777	90 472	2 000 555	101 547	2 278 148	111 686

Source: authors’ own compilation, data from FSB (2013)

Table 2. The investments composition of insurance companies in South Africa

	2011		**2012**		**2013**	
	Long-Term Insurers	**Short-Term Insurers**	**Long-Term Insurers**	**Short-Term Insurers**	**Long-Term Insurers**	**Short-Term Insurers**
Cash and deposits / R’mil	205 790	37 634	221 377	41 780	193 901	42 224
Government and semi-government / R’mil	191 549	6 963	173 874	9 597	178 194	11 888
Equities /R’mil	862 648	25 813	1 221 629	28 605	1 470 533	29 946
Debentures and loan stock / R’mil	128 379	1 666	176 585	1833	215 743	1903
Immovable Property / R’mil	58 833	-	58 152	-	49 571	-
Fixed Assets / R’mil	181 838	1 004	2 112	842	2 367	1 091
Debtors / R’mil	94 965	7 265	118 589	7 980	133 930	9 027
Outstanding Premiums / R’mil	-	5 815	-	7 016	-	8 375
Other Assets / R’mil	0	4 311	28 235	3 893	33 909	7 231
Total Assets / R’mil	1 724 002	90 472	2 000 555	101 547	2 278 148	111 686

Source: authors’ own compilation, data from FSB (2013)

Table 3 below summarises the Acts under the auspices of the FSB. The idea is to show their emphases or lack thereof on financial services innovation and development. It can be confirmed that whilst the FSB, through the Financial Advisory and Intermediary Services (FAIS) Act is able to manage the provision of financial services, the financial institutions have a long list of Acts that they are faced with over and above the FAIS Act. The number only can present a challenge from a time allocation point of view. It goes without saying that all the Acts have a financial cost of compliance that can be attributed to them, though quantifying such costs remains a challenge.

Table 3. A summary of the Acts governing the Insurance Industry in South Africa. Source: authors' own compilation (various Acts)

Act	Objectives	Innovation and Development Emphasis (Yes/No)
Collective Investment Schemes Control Act (Act 45 of 2002)	To regulate and control the establishment and administration of collective investment schemes; to amend or repeal certain laws; and to provide for incidental matters.	No
Credit Rating Services Act (Act 24 of 2012)	To ensure responsible and accountable credit rating agencies; protect the integrity, transparency and reliability of the credit rating process and credit ratings; improve investor protection; improve the fairness, efficiency and transparency of financial markets and reduce systemic risk.	No
Financial Services Board Act (Act 97 of 1990)	To provide for the establishment of a board to supervise compliance with laws regulating financial institutions and the provision of financial services; and for matters connected therewith. (Among the issues addressed is the process for the setting of levies that financial institutions must pay).	No
Financial Intelligence Centre Act (Act 38 of 2001)	To establish a Financial Intelligence Centre and a Money Laundering Advisory Council in order to combat money laundering activities and the financing of terrorist and related activities; to impose certain duties on institutions and other persons who might be used for money laundering purposes and the financing of terrorist and related activities; to amend the Prevention of Organised Crime Act, 1998, and the Promotion of Access to Information Act, 2000; and to provide for matters connected therewith.	No
Financial Advisory and Intermediary Services Act (Act 37 of 2002)	The Protection of the consumer, the financial services industry and all staff employed therein, whether they render advice or not, the creation of a profession within the financial services industry and to regulate the giving of advice.	No
Financial Institutions (Protection of Funds) (Act 28 of 2001)	To provide for, and consolidate the laws relating to, the investment, safe custody; and administration of funds and trust property by financial institutions; to enable the registrar to protect such funds and trust property; to repeal the Financial Institutions (Investment of Funds) Act, 1984 (Acct No. 39 of 1984); to improve the enforcement powers of the registrar; and to provide for matters incidental.	No
Financial Markets Act (19 of 2012)	To ensure that the South African financial markets are fair, efficient and transparent; increase confidence in the South African financial markets by; (i) requiring that securities services be provided in a fair, efficient and transparent manner; and (ii) contributing to the maintenance of a stable financial market environment; promote the protection of regulated persons, clients and investors; reduce systemic risk; and promote the international and domestic competitiveness of the South African financial markets and of securities services in the Republic.	Yes
Financial Supervision of the Road Accident Fund Act (Act 8 of 1993)	To further regulate the affairs of the Road Accident Fund; and to provide for matters connected therewith.	No

Table 3. A summary of the Acts governing the Insurance Industry in South Africa. Source: authors' own compilation (various Acts)

Act	Objectives	Innovation and Development Emphasis (Yes/No)
Friendly Societies Act (Act 25 of 1956)	To provide for the registration, incorporation, regulation and dissolution of friendly societies and for matters incidental thereto.	No
Inspection of Financial Institutions Act (Act 80 of 1998)	To provide for the inspection of the affairs of financial institutions; the inspection of the affairs of unregistered entities conducting the business of financial institutions; and for matters connected therewith.	
Long Term Insurance Act (Act 52 of 1998)	To provide for the registration of long-term insurers; for the control of certain activities of long-term insurers and intermediaries; and for matters connected therewith.	No
Pensions Funds Act (Act 24 of 1956)	To provide for the registration, incorporation, regulation and dissolution of pension funds and for matters incidental thereto.	No
Short Term Insurance Act (53 of 1998)	To provide for the registration of short-term insurers; for the control of certain activities of short- term insurers and intermediaries; and for matters connected therewith.	No.
Financial Services Ombudsman Schemes Act (37 of 2004)	To provide for the recognition of financial services ombudsman schemes; to lay down minimum requirements for ombudsman schemes; to promote consumer education with regard to ombudsman schemes; to co-ordinate the activities of ombudsman of recognised schemes with the activities of the Pension Funds Adjudicator and the Ombudsman for Financial Services Providers; to develop and promote best practices for complaint resolution; to empower the Ombudsman for Financial Services Providers to act as a statutory ombudsman in certain cases; and to provide for matters connected therewith.	No
Security Services Act	Increase confidence in the South African financial markets by- o requiring that securities services be provided in a fair, efficient and transparent manner; and o contributing to the maintenance of a stable financial market environment; Promote the protection of regulated persons and clients; reduce systemic risk; and promote the international competitiveness of securities services in the Republic of South Africa.	Yes

From Table 3, it can be deduced that most of the Acts, do not speak to the issue of financial services innovation. The main focus is on stability, solvency, consumer protection, registration and deregistration and efficient operation of markets and institutions. However the Acts stipulate the parameters within which financial innovation takes place. Further it creates a favourable environment for the operation of financial institutions. Briault (1999) confirms that regulation must assist in creating competition, which is good for financial innovation. He goes on to emphasise that legislation must be flexible and reflective for the developments in financial markets.

It is hoped that the regulators will benefit from this work in approximating a level of regulation that approaches optimum regulation. This paper however, does not stipulate a level of regulation that is optimum.

4 The cost of compliance

We wish to highlight the cost of compliance is very difficult to quantify. This is so because there are so many aspects that are covered by the Acts regulating the insurance sector in South Africa. As such we shall only consider the costs brought to bear upon the financial services industry by the FAIS Act. This is based on a survey undertaken by The Institute of Practice Management done in 2012. This relates to the cost of compliance in respect of conforming to the regulatory requirements relating to the provision of financial advice. Table 4 depicts the average levies paid by the financial institutions. These levels are paid as follows: (1) he levy charged per financial service provider (FSP) for the provision of financial services; (2) the levy charged for each Key Individual (KI)-referring to people in management roles; (3) the levy charged for each representative-referring to all the employees who render financial advice and lastly; (4) the levy charged per FSP to fund the office of the Ombudsman.

Table 4. Average cost of Financial Services Board Levies

Description	Amount	Number	Cost
Levy per FSP	R2960-00	1200 FSP’s	R3 552 000
Representatives Levy	R257-00	107 734	R27 687 638
Key Individual Levy	R473-00	12 645	R5 981 085
FAIS Ombud levy/ FSP	R675-00	12 000	R8 100 000

Source: The Institute of Practice Management (2012)

Over and above the levies the financial service sector has to content with the burden of the regulatory exams. The average costs incurred by the industry are depicted in Table 5 below. Notwithstanding that it draws from best practice that, individuals providing financial advice must write regulatory exams and be deemed competent, the downside to this has been that an additional cost has to be incurred by the FSP. Companies have to fund their employees to sit for these exams. The pass rate is on average 60% and hence the 40% have to rewrite the exams. There is also the additional cost of preparing for the exam requiring that the companies hire educational facilitators to workshop their employees. Ultimately if the employee concerned fails repeatedly, they are made redundant in their job of providing financial service. Since it is difficult to terminate employment, this might mean that the FSP up-skill the concerned individual who will then be absorbed into a role where they would not proffer financial advice, such as accounting or human resources.

Table 5. Average cost of Regulatory Exams to Financial Services Industry 2011/2012

Amount	Number	Amount	Cost
Key Individuals	12 645	R900	R11 380 500
Representatives	107 734	R900	R96 960 600
40% KI and Rep Rewrite Exams	48 151	R900	R43 335 900
Attend RE course	107 734 + 12645/2	R1 000	R60 189 500

Source: The Institute of Practice Management (2012)

The summary of the costs of compliance as highlighted in the above foregoing are given in Table 6. Suffice to say that it would seem that the cost of compliance for financial services provider is very high. It is open to conjecture to say that the opportunity cost of compliance is the innovation foregone.

Table 6. Assumed Average Cost of Compliance for a Key Individual, Sole Proprietor or Close Corporation in the 2011/2012 financial year

Description	Action	Amount	Total Cost
Regulatory Exams	2 exams	R900	R1 800
Course material	2 courses	R1000	R2 000
Study time	35 hours	R250	R8 750
Compliance-related activities	35 hours	R9500	R114 000
Compliance officer	4 on-site visits plus reports and advice	R1000	R12 000
FSP levies	Average per sole proprietor	R2960+473+675	R4 108
CPD	10 notional hours p.a.	Min R100	R1 000
FSB Audit			R8 750
Accounting	Full financials for FSB	Min R3500 per month	R42 000
Record-keeping and back- ups		R250 per month	R3000

Source: The Institute of Practice Management (2012)

5 Conclusion

The nexus between financial regulation and innovation is a pervasive one. In the present study we have demonstrated that the cost of compliance by the financial services industry is very high. There have been so many regulations that have been imposed on the insurance industry in the aftermath of the financial crises. Amongst them include the solvency regulation (SAM), Treating Customers Fairly (TCF) and Binder regulations, amongst a litany of regulations. Noble as they are, alas they could be curtailing innovation and the development of the financial sector.

We have conjectured that the opportunity cost of regulation is the financial innovation forgone in the sector. During the period 2011/2012 the approximate cost of sitting for financial advisory regulatory exams in South Africa was close to R100 million, which money could have been put into productive use. As such we wish to proffer policy advice and assert that overburdening the financial sector, specifically the insurance sector somewhat curtails financial innovation. This is at the detriment of the consumer, who does not benefit from a better financial product let-alone who also bears the brunt, in that the cost of compliance is actually transmitted down the value chain by way of higher premiums. We thus urge the regulatory authorities to embrace “light-touch” regulation whereby self-regulation and moral suasion take centre stage.

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