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Unintended consequences of financial regulations: a study of corporate compliance burdens: A conceptual review

Abetoh Nyiawung Fobellah *

Independent Researcher.

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Abstract

This conceptual review examines the unintended consequences of financial regulations, focusing specifically on the compliance burdens imposed on firms. Although ensuring stability, showing what happens in markets and building trust in the financial industry, these regulations tend to harm small and medium-sized enterprises (SMEs). Using theories of regulation, institutions, cost-benefit analysis and choice, the study examines how companies handle rules that are difficult to follow and shows how important it is for firms to find a balance between the expenses of obeying the law and the time and effort wasted on extra paperwork. An analysis of various sources highlights that due to the extra expense of complying with regulations, big firms survive whereas small firms (may) disappear, impacting innovation, leaving their markets or bending the rules.

Emerging issues identified include the limited exploration of non-financial burdens such as cultural and reputational impacts — and the lack of consistent, multidimensional metrics to capture the full scope of compliance costs. The review emphasises that more research is needed to see how rules influence businesses in newly developed economies. It further emphasises the need to make regulation that is structured, flexible and fits both policy and economic purposes. The analysis helps regulators in developing strategies to make compliance easier while still following the regulations and it shows companies how best to deal with compliance challenges. Generally, the analysis provides a broader perspective on the effects of financial rules on corporate behaviours, expenses and the long-run survival of organisations.

Keywords: Financial Regulations; Unintended Consequences; Corporate Compliance Burdens; Cost-Benefit Analysis; Small and Medium-Sized Enterprises (SMES)

1. Introduction

Lately, the field of corporate governance has been deeply impacted by adding and strengthening financial regulations to secure the economy, look after company stakeholders and promote honest business (Aguilera & Cuervo-Cazurra, 2009; Avgouleas, 2012). Even though Basel III, the Dodd-Frank Act and GDPR are meant to address problems in the market and reduce serious risks such rules may end up affecting different industries in unpredictable ways (Arner, Barberis, & Buckley, 2016). Many times such regulations cost businesses a lot because they are not flexible enough to consider the differences among organisations and operations (Carpenter, 2014; Ferran & Ho, 2014). This paper aims to look at the connection between financial rules, surprising outcomes and the extra challenges faced by companies in complying with regulations, so that future studies on this topic have a strong base.

The aim of this review is three things: it maps and clears up the central concepts for understanding why regulations can turn into compliance costs, investigates the theories behind those unintended outcomes and points out what isn't yet

* Corresponding author: Abetoh Nyiawung Fobellah

fully understood in this area. This means the review adds value to research on the business and regulatory environment and it also provides useful tips for deciding how rules should be put into practise.

Why do financial regulations generate unplanned challenges for companies in complying? Why do these outcomes happen and which theories clarify this the best? How do modern studies miss some of the major roles financial rules and policies play in corporate management? They guide the review in how to look at the topic and what to offer to the ongoing discussion on regulatory and compliance studies.

1.1. Key Concepts and Definitions

In order to analyse the unexpected results of financial regulations on corporate compliance, the main concepts must first be defined. A central point of the debate is financial regulations which are standards made by government or international organisations to watch over financial markets, institutions and what they do (Avgouleas, 2012; Barth et al., 2012). Some examples of major regulatory laws are Basel III which establishes worldwide banking standards for capital, risk assessment and market liquidity, the Dodd-Frank Act from the United States which improves responsibility and transparency in the financial sector after the 2008 crisis (2010) and the GDPR, introduced in the EU to secure data protection and privacy for their residents (European Parliament & Council of the European Union, 2016). Even though regulations are put in place to support stability and avoid consumer harm, firms have to comply with these requirements which often take considerable time and money.

Regulation often leads to effects that were not intended and this is a main idea in regulating society. The unforeseen effects that sometimes happen because of laws are called unintended consequences. They can lead to economic problems (higher running costs or becoming less competitive), need updates in internal procedures or lead to changes in the way the company positions itself in the market through mergers or possibly opting out (Arner et al., 2016; Carpenter, 2014). Let it be known, unintended consequences are not always harmful, but they most often create difficulties for organisations in compliance by impeding their performance and creative development (Coglianese, 2012). Noticing these outcomes matters a lot because it brings attention to the gap that exists between what regulators intend and what actually takes place (Sunstein, 2015).

Another essential idea is corporate compliance burdens which describe the many difficulties firms have in following rules set by regulators. There are many ways compliance can be difficult for a company. The direct and indirect expenses connected with meeting regulations are called cost burdens and these include hiring staff for compliance, setting up reporting systems and covering lawyer fees (KPMG, 2021; Laux & Leuz, 2010). Administrative workload involves managers and employees juggling many and at times conflicting lawful responsibilities which means spending a lot of time preparing documents and reports (OECD, 2020). Many organisations find they need to change their behaviour or strategies because of regulations such as becoming more cautious, focusing more on near-term compliance goals or making the corporate culture risk-averse (Aguilera et al., 2015; Edelman & Talesh, 2011). All these ongoing pressures can both change how companies operate inside and alter their standing among competitors (Deloitte, 2022).

It is just as important to outline how broad the review will be, because the amount of compliance required by financial regulations depends on the business or industry. Big multinational companies can usually meet compliance requirements without great difficulty, but this is more of a problem for small and medium-sized enterprises (SMEs), who may see their growth and earnings suffer (Beck et al., 2013; Demirgüç-Kunt et al., 2020). Banking, insurance and asset management require much more compliance from businesses than retail or manufacturing because of how tightly regulated they are (FSB, 2019). Taking into account that rules can differ from one country to another, firms working internationally have to handle many different legal expectations which complicates their efforts to comply (Claessens & Kodres, 2014). This review looks closely at the financial services industry, especially banking, investment and insurance companies, since these sectors are under the most watchful eye from regulators. Even so, some of the main insights discussed here could be relevant to sectors not directly related to finance, when they must meet regulatory rules such as GDPR or AML directives (FATF, 2018). The analysis is not restricted to one area, since mistakes in lawmaking affect the world and are formed by international standards and local practices (Ho, 2017). It aims to draw on studies done in different parts of the world and fields to illustrate how business practises and compliance are shaped by financial rules.

2. Theoretical Foundations

Knowing about the extra costs of financial rules on corporate compliance needs you to understand various important theories. They give reasons for companies' behaviours after being regulated and also explain how rules intended to help can sometimes cause harm. The regulatory environment is more fully understood and its effects on corporations can be

appreciated by applying regulatory compliance theory, institutional theory, public choice theory and cost-benefit ideas like the burden of compliance model (Abbott et al., 2017; Baldwin et al., 2012). A lot of the existing research on how organisations deal with external rules and standards is built on regulatory compliance theory. Firms, according to this theory, work to comply with regulation to prevent risks of penalties, negative reputation or stopped operations (Gunningham & Sinclair, 2017; Parker & Nielsen, 2011). Some scholars believe that when organisations weigh the costs of being found non-compliant (fines, for example) against the expenses involved in complying, they decide whether to follow or break the law. But regulatory compliance theory points out that simply applying the letter of the law isn't enough; interpretations, judgments and handling unclear rules are also needed (Black, 2008). When complying with rules turns out to cost more than was thought or when rules bring undesired complications such as a greater need for paperwork or less freedom to change, this is described as an unintended consequence (Coglianese, 2012; Sunstein, 2015).

Institutional theory complements by pointing out that companies are affected by factors other than costs when making behavioural choices. Organisations every day are seen as operating within broad institutional environments which are shaped by norms, values and legitimacy issues, according to institutional theory (DiMaggio & Powell, 1983; Meyer & Rowan, 1977). Besides looking for ways to avoid getting caught, many organisations comply with rules to establish and keep a good reputation among investors, customers, regulators and the community (Suchman, 1995). Sometimes, to seem legitimate, a firm adopts more rules than required by law, like industry standards, certifications and extra reports that confirm they follow good governance rules (Edelman & Talesh, 2011). Not surprisingly, as a result of such pressures, companies tend to work harder to show they are complying instead of actually following and implementing rules meant to achieve the stated objectives (Power, 2007). It gives an economic and political viewpoint to explain how rules are shaped and sometimes generate effects that were not intended. In this theory, regulation is said to arise from bargaining between politicians, bureaucrats, industry groups and public advocacy groups (as described by Buchanan & Tullock in 1962 and by Stigler in 1971). The rules made by the government may be the result of conflicts, unequal influence or outside pressure instead of just being based on pure expertise (Peltzman, 1976). For this reason, the final set of rules might end up being very complex, unclear or not suited for how companies actually operate (Posner, 2014). A case in point is large firms lobbying for special regulations that curtail small firms' opportunities (Dal Bó, 2006) and rules that overlook different sectors in the industry can be put in place because of political pressures (Hertog, 2010). So, the compliance pressures that businesses experience are not limited to receiving instructions from regulators; they are also a result of the ways in which regulations are formed.

In addition, the burden of compliance models and using wider cost-benefit frameworks make it possible to analyse the pros and cons of regulation. In these models, compliance is considered as a set of expenses (such as for administration and finances) that businesses must bear next to the important benefits they might receive which are usually reduced risk, reputable market presence and social welfare (Hopkins, 2011; OECD, 2020). If the rules and regulations become too strong, companies can suffer by becoming less competitive, experiencing slow growth or quitting some markets (say Djankov et al., 2002). In important cases, these frameworks make it possible to spot points at which following strict regulations is unfair and leads to things like avoidance of the law, a halt in innovations or moving to areas with fewer rules (regulatory arbitrage). Combining these theories helps experts to see the various reasons why financial regulations can cause additional compliance pressure on firms. Being aware of these issues, experts and specialists have the chance to advise on regulations that both achieve their intended goals and don't burden firms unnecessarily.

2.1. Synthesis of Existing Literature

Canada's updated financial regulations after 2008, as investigated by Coolidge and Mintz (2016), are praised for making the financial system stronger, though they feel that smaller firms suffer from additional costs and lost market opportunity. The study highlights that Canada's regulatory-impact analysis (RIA) system fails to ensure transparency and does not evaluate newly passed regulations after the fact which could let special interests overpower the forces of competition. Large banks are frequently favoured by firms which raises obstacles for new, smaller competitors. They propose actions like using performance-based standards, involving multiple parties and standardising ways the provinces and the federal government work to address these inefficiencies. In trying to maintain strict rules for stability and support innovation, some argue that using principles-based approaches (like those in Canada) is better than rules-based ones (as in the EU). The conflict is in trying to enforce laws without overwhelming companies with rules (Coolidge & Mintz, 2016).

In their study, Cordes et al. (2022) discuss how much firms must spend on regulations and which expenses involve wasteful steps. They observe that small firms and the development of new ideas often suffer the most from excessive administration, pointing out that countries in the OECD that improved processes (e.g., one-stop shops) saw GDP rise. Consequences not planned by lawmakers are that business less often starts up, productivity goes down and firms may

outsource or stop participating in certain markets. The reaction to the crisis depends on the business: big businesses can cover the costs, but it's much harder for small ones. Options like deregulation or smarter regulation (such as basing regulatory actions on performance) are both endorsed by different authors. For example, strict guidelines make it simpler to enforce the rules, but they can be more costly, whereas market solutions (such as emissions trading) help bring down the costs but need strong supervision. An important issue is to unite effective regulations with the freedom to act economically (Cordes et al. 2022).

2.2. Emerging Issues and Conceptual Gaps

Although there have been many helpful studies, there are still important aspects of the unintended effects of financial regulations that are not fully understood. The works of most prior researchers, among them Coolidge and Mintz (2016) and Cordes et al. (2022), have mainly studied advanced economies, with not enough emphasis on emerging markets and developing areas. Because of weak government systems, limited compliance support and different regulations, some compliance pressures in these countries can be greater, making some current findings questionable for the whole global market. It is easy to miss other forms of burden like adjustments in company culture and the concern about firm reputation. Complying with rules may make businesses more risk-averse which can slow down new ideas and flexible solutions. Not only direct breakages in regulations, but also unethical actions that may seem shady, can result in tough pressures, mainly for small organisations. It is also true that there are not enough effective and thorough assessments for understanding compliance burdens. The main focus of most tools is on shrinking the negative impacts on the finances and important aspects such as organisational strength, employee mood and strategic flexibility are hardly taken into account. This research will help fill these gaps by using a wider approach, including regions that have been overlooked, various effects besides financial ones and better output measures, to explain financial regulations and their impact on companies' sustainability.

3. Implications for Research and Practice

Experts can now look at different ways to study and work with this theory after this conceptual review. It brings to researchers' attention that reviewing how different types of unintended outcomes happen in different places and in both advanced and emerging economies, is particularly important. Studies using empirical methods might analyse the relationship between a firm's size, its type of business and compliance regulations to identify which are the most important in causing compliance burdens. Also, researchers can explore creating new standards that reflect both the money lost as well as the cultural, organisational and reputational elements related to regulation. According to the review, people making regulations should make them flexible, proportional and suitable for the situation. Experience from literature encourages regulators to use flexible rules that attain goals and minimise the burden on stakeholders. Consulting stakeholders in the rule-making process, with a focus on small and medium-sized enterprises (SMEs), ensures that rules are usable by all types of businesses. Firms can use the review to judge how to manage costs related to compliance such as introducing digital solutions or joining efforts with other companies in their industry.

4. Conclusion

It has analysed the unexpected effects of financial regulations, particularly how they lead to greater corporate compliance obligations than first intended. It has recognised, with the help of known theories and studies, that there are many demanding issues in regulatory design, enforcement and the behaviour of firms. It points out the financial costs as well as the other challenges businesses can experience culturally, strategically and in terms of reputation. Recognising these problems means bringing together several viewpoints to make regulations that can be followed, yet are able to adapt.

Recommendations

Using the information from this review, it is suggested that new regulations give priority to being more proportionate and less restrictive to accommodate different firm realities, mainly for SMEs. After a competition has finished, regulators need to check and discuss its outcomes with stakeholders to detect and resolve any inefficient processes early. Besides, trying out innovative regulation models such as sandbox environments or adaptable rules, lets companies test new things while not making them strictly follow all standard rules. Firms ought to make sure that regulations are a key focus in their strategy and by using technology and working with others, they can keep costs under control. All in all such actions can help design rules that are fair to the public and useful for the management of banks.

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