Corporate Governance with Capability, Integrity and Accountability of Regulators and Supervisors: An Examination of the Financial Supervisory Commission in Taiwan

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Abstract
The Asian financial crises and large numbers of scandals and widespread corruption within securities markets provided lessons for Taiwan in the importance of corporate governance. As a result, the Taiwan securities regulator (the Financial Supervisory Commission, FSC) was created and succeeded the former Securities and Futures Commission (renamed as Securities and Futures Bureau) to advocate corporate governance since 1998 to public companies. Most countries agree that governance principles such as greater transparency, protection of shareholders and strengthening the responsibility of directors are essential to enhance corporate governance. However, the responsibility and control mechanisms of regulators and supervisors (R&Ss) are seldom discussed. An R&S plays an important role in the success of corporate governance and governance capability, as integrity and accountability are strongly associated with its execution of related policies. To strengthen the capability, integrity and accountability of R&Ss, this paper not only takes Taiwan’s R&S as an example, but also defines and explains ways to ensure reaching the three main goals from a theoretical point of view. To make corporate governance workable in Asian countries, R&Ss should focus evenly on regulations and the compliance of companies.

Key words: Regulators, Supervisors, Capability, Integrity, Accountability

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Introduction

Owing to the reaction to corporate failure and governance scandals, i.e. the Enron case, corporate governance has become a worldwide issue. Many international organizations, such as OECD, have started research and reinforced the essential role of regulators or supervisors in ensuring good corporate governance.

Corporate governance can be summarized as concerning the following five issues: shareholders’ rights, equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board (OECD, 2004). To achieve better corporate governance, a regulation-based economy dominates the process of market liberalization. Regulators and supervisors (the execution and enforcement authorities) provide standards and rules for all parties in the capital market. The capability of regulators and supervisors (R&Fs) can have a great influence on the effectiveness of corporate governance; however, this facet is seldom discussed in related research.

Many countries have traditionally regulated and supervised their financial intermediaries through multiple authorities, including a ministry of finance, or a central bank, as well as specialized supervisory agencies, such as banking, securities and insurance commissions (Martinez and Rose, 2004). Over the years, some countries have adopted the model of unified or integrated supervision by either establishing a single supervisor for their entire financial sector or by centralizing in one agency the powers to supervise at least two of their main financial intermediaries.

However, a mega-regulator may become excessively bureaucratic and neglect the unique characteristics of the banking, securities and insurance industries. Also, the lack of information sharing and collaboration among existing agencies may result in less effective supervision. Finally, in some cases the ability to monitor the risks of financial conglomerates and of complicated financial products is also doubtful. Therefore, the endowment of extensive power to regulators and supervisors of financial sectors may hinder the growth of financial sectors and the development of capital markets.

Many scholars have noticed the importance of single supervision and discussed its strengths and weaknesses, while the maintenance of effective integrated supervision is still largely unexplored. This paper analyzes the question in terms of human resources, the basic unit of measurement. This paper sees the strengthening of the capability, integrity and accountability of integrated supervisory organizations as the main method to achieve effective supervision. Finally, we explain ways to achieve capability, integrity and accountability based on many theoretical approaches, such as a resource-based view, a trust-based view, and transaction cost economics. Our points are also consistent with the concept of corporate governance, and shed light on internal compliance against fraud.

In this paper, we take the Taiwan Financial Supervisory Commission as an example, which enables a clearer understanding of each issue.
Our study makes contributions to the management of human resources in the context of financial supervision and adds to the general knowledge of corporate governance.

**Regulators in Taiwan**

The Ministry of Finance was in charge of the supervision of Taiwan’s securities, banks and insurance sectors separately through three major subordinate agencies, the Securities and Futures Commission, the Bureau of Monetary Affairs, and the Department of Insurance (Figure 1). In order to promote the liberalization and globalization of the financial market and to lift restrictions on financial products, Taiwan has been planning consolidated financial supervision since the 1990s. This aims at solving the problem emerging from financial consolidation and the mixture of different financial sectors and markets which make the supervision of the financial industry more challenging and complex.

With a view to enhancing the efficiency and effectiveness of financial market regulation, and increasing the number of cross-operations conducted by businesses in the financial industry, Taiwan inaugurated the Financial Supervisory Commission (FSC) on July 1, 2004 for the purpose of unifying financial supervision.

The FSC incorporates policy formulation and supervision over the securities, futures, banking and insurance industries. It includes four bureaus and five supporting departments. The Securities and Futures Bureau, the Banking Bureau, and the Insurance Bureau are responsible for the supervision of financial institutions. The Inspection Bureau is in charge of the inspection of all financial institutions.

**Regulation and Supervision – For Development and Against Fraud**

The regulation and supervision of financial markets can be divided into three layers (Figure 1). The first layer is supervision from regulators and supervisors (R&Ss) by the enactment of financial laws, regulations and rules. In addition, the R&Ss can also regulate financial institutions by their power to enforce, such as through financial examination, inspections, investigations, and corrective actions, when necessary.

The second layer is supervision from the markets, which includes disciplining from self-regulatory organizations, credit ratings, and disclosure of market information.

The third layer is internal compliance of financial institutions. This kind of supervision is deemed as the most effective one, and includes at least three mechanisms: internal audit, internal control, and risk management.
Figure 1 Three Layers of the Financial Supervisory Mechanism

The Asian financial crises showed Taiwan the importance of corporate governance. Knowing that inadequate corporate governance had been identified as a key factor behind the inability of Asian corporations to compete in world financial markets, since 1998 the Taiwan regulator has tried its best to emphasize to public companies the importance of corporate governance. With the intense competition arising from the globalization and liberalization of the financial market as well as the rapid transformation of financial sectors, domestic financial institutions can only survive by constantly improving their business structure together with the help of the national regulator and those who set international standards.

The main challenge of the FSC in ensuring a sound and comprehensive financial supervisory mechanism is to encourage financial institutions to enhance their governance from layer one to layer three. Therefore, the FSC has several main tasks. First, the FSC reviews related regulations of the financial sectors and updates them to bring them into line with international practices and trends, with the aim of assisting financial institutions in enhancing their competitiveness. Second, the FSC’s operation will be based on the principle of “face facts and find solutions,” and will avoid unnecessary bureaucratic procedures. Third and most important, the FSC requests that a high standard of professional work ethic is maintained by all persons, whether they work for regulators or in the industries. This is not only to protect the general investing public from the negligence or misleading opinions of independent professionals, but also to solve problems resulting from the opportunism of market practitioners. These three main tasks are also the principles of implementing corporate governance.

To strengthen the internal control and internal auditing of corporations and to effectively implement mechanisms of supervision, the crucial issue of corporate governance is humans.

We have previously taken humans in the field of corporate governance to include company participants (directors, supervisors, managers and employees), professionals

1 Securities and Futures Institute (2002). Corporate Governance in Taiwan. Taiwan.
(accountants, financial analysts and lawyers), and financial intermediaries (underwriters, banks, institutional investors and sale groups), whose acts and behavior are regulated by many rules and monitored by their companies, market participants and regulators. Here we would like to emphasize another group – the rule makers. These are the people on the push side of corporate governance, i.e. those in R&Ss.

R&Ss play an important role in advocating and implementing corporate governance. They not only make the principles and rules of corporate governance, but also monitor, evaluate and audit each market player. The capability, integrity and accountability of R&Ss are even more important than the capability, integrity and accountability of market players, and should therefore be emphasized.

Who are R&Ss?

R&Ss should at least include the competent authorities, the exchanges and self-regulatory organizations (SROs).

In Taiwan the FSC is the highest policymaker for the financial sectors. In addition to making financial policy and regulations, the FSC’s responsibility includes maintaining the stability of the financial market, promoting the development of financial industries, and enhancing the transparency, efficiency and soundness of the financial environment. The four bureaus, i.e. the Securities and Futures Bureau, the Banking Bureau, the Insurance Bureau, and the Inspection Bureau, are in charge of overseeing the development, maintenance, administration, and examination of the financial service industries. These bureaus are responsible for regulating the operations of financial institutions, maintaining financial stability, and promoting the development of the financial market.

Besides, the Taiwan Stock Exchange Corporation, Gre Tai Securities Market, Taiwan Futures Exchange and Taiwan Securities Central Depository Co., Ltd. are in charge of the listing, trading and central depository of the capital market. Moreover, there are SROs in Taiwan in the form of associations, i.e. the Chinese Securities Association, the Securities Investment Trust & Consulting Association and the Taipei Futures Association, which deal with negotiations between and self-regulation of their members.

Furthermore, the Securities & Futures Institute in Taiwan is also an important R&S. It plans and promotes a sound financial market through research and service activities to help the securities and futures industry and investors. To protect our investors and to strengthen external supervision, Taiwan established the Securities and Futures Investors Protection Center in 2002. This Center provides consulting, mediation, class-action lawsuits, compensation and other related services to investors, assists the regulator with

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indicating the crux of the problem, suggests to the administrator amendments to regulations, and enhances the implementation of corporation governance.

All staff and members of the above-mentioned organizations play important roles in the governance of our financial markets and we regard them as our R&Ss.

**Definitions of Capability, Integrity and Accountability**

Many scholars have emphasized the importance of corporate ethics. Richter & Mar (2003) provided a unique framework for recreating an ethical dimension for Asian business. We thus shift our attention away from total quality management to their concept of total ethical management as a way of dealing with corruption.

With a view to making corporate governance an internal compliance mechanism at the top layer of Figure 1, the first step should be to embed ethics into the company through operations, reputation, and overall management. For businesses, the capability, integrity and accountability of corporate participants are strongly associated with the fulfillment of corporate governance principles. As for the R&Ss, capability, integrity and accountability are even more important due to the lack of a timely monitoring mechanism and their dominant affect on capital markets.

**Capability**

Capability is the ability to complete a mission. It derives from the capability of humans, which not only includes the skill, expertise and ability possessed before entering an organization, but also that developed through education or training in the organization. A core administrative capability for good regulation is the ability to choose the most efficient and effective policy tool, whether regulatory or non-regulatory.\(^3\)

Capability is strongly associated with the performance of an organization (Edstroom and Lorange, 1984; Lorange and Murphy, 1984); therefore, the capability of R&Ss is an essential element for planning, implementing and enforcing corporate governance, and enhancing corporate governance in a country. Capability stems from a workforce that is part of the resources of an organization (Grant, 1991; Lado and Wilson, 1994; Seetoo, 1995).

**Integrity**

Integrity is the quality of being honest and having strong moral principles. It is one facet of personality derived from a person’s self-regulation, which determines the person’s loyalty, dedication, effort, and initiative with regard to the organization, and facilitates

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implementation of the organization’s goals (Barney, 1986; Eisenberger et al., 1987; Barney and Hansen, 1994).

Evidence has shown that integrity is not cultivated purely by training or education (Caligiuri & Di Santo, 2001). The integrity of R&Rs is strongly connected with effectiveness in following necessary procedures to promote corporate governance, and it thus determines the public’s level of trust in and respect for the government.

**Accountability**

Accountability is measured by the difference between performance and the requirements or expectations of others. Therefore, a person’s level of accountability should be evaluated by another person or by other groups based on that person’s ability, the quality with which the person completes specific tasks, and the value of the evaluator(s) (Dicke, 2000).

![Figure 2 Relationship among Capability, Integrity and Accountability of an R&S](image)

The accountability of an R&S depends on at least two things. First, the capability of the R&S, which is essential to establish the corporate governance mechanism; and second, the integrity of the R&S, which ensures the procedures the R&S employs are fair, transparent, and legal. Therefore, we propose the following function:

\[
A = f(C, I)
\]

A: accountability of the R&S  
C: Capability of the R&S  
I: Integrity of the R&S  

Whether or not the R&S is accountable shall be evaluated by companies, financial intermediaries, experts, professionals, investors, and the public. Figure 2 shows that we reduced the number of factors of accountability for R&Rs to just two: capability and integrity, as in the proposed function.
ENSURANCE MECHANISMS

Since the accountability of an R&S depends on its capability and integrity (Figure 2), and is evaluated by others, here we discuss only an approach to ensure an R&S’s capability and integrity.

Guaranteeing Capability

From the resource-based view, human capital is one of the basic resources of an organization, especially when a person has a specific or core competence (Barnard, 1938; Chandler, 1962; Rumelt, 1974; Prahalad and Hamel, 1990; Grant, 1991).

A workforce with capability may serve as a valuable, scarce, non-imitable resource that can help government plan and execute appropriate measures to achieve goals, i.e. promoting corporate governance (Lado and Wilson, 1994).

There are three ways to guarantee the capability of an R&S: ex-ante control through recruiting, training or education, and designing incentives and inducements to keep staff (Figure 3).

Figure 3  Elements Guarantee Capability

Recruiting

Regulatory agencies can set requirements and qualifications when recruiting staff (Dessler, 1994). Take Taiwan for example, most staff serving in the FSC, the most important financial policy making agency, shall pass the civil service examination according to the Civil Service Employment Act, and written or verbal tests. The FSC has demanding requirements for its recruits and high standards for its staff. Moreover, to maintain the professionalism of the FSC, the Act Governing the Establishment and Organization of the Financial Supervisory Commission of the Executive Yuan stipulates that Commissioners must have a thorough knowledge of and experience in law, economics, finance, accounting or management.
Job Development

Appropriate training or education is essential to enhance the capability of the workforce of any organization (Dessler, 1994). Any staff initially lacking capability can acquire it through learning according to the notion of “absorptive capability” (Cohen and Levinthal, 1990).

To keep up with global trends in financial product innovation, new practices, and supervisory principles, the FSC needs sufficient resources for training and research. The FSC is authorized to raise funds by levying fees on the entities it supervises. Its main legitimate uses of funds include: research into new derivatives and other financial products, training of personnel, promotion of consumer protection, enhancement of financial institutions’ transparency, and participation in international financial organizations and activities.

The FSC not only encourages its staff to join training programs and participate in international meetings concerning corporate governance issues, but also arranges internal training programs for its executive bureaus.

Incentives

Incentives include pecuniary and non-pecuniary reward systems (Pucik, 1985; Dessler, 1994). Pecuniary reward mechanisms in R&SSs are usually inflexible. Moreover, the promotion line in the vast majority of R&SSs in most countries is unattractive, and subsequent experience and training of staff would not equip them sufficiently to be in top positions. Therefore, non-pecuniary incentives are the main incentives R&SSs can offer to instil in staff a commitment to their agencies.

The commitment of employees is critical to enlisting their best efforts at execution, and recent contributions to the resource-based view designate the social climate within the organization as a vital competence-building resource (Lado and Wilson, 1994; Prahalad and Hamel, 1990; Barney, 1991; Lee and Miller, 1999).

In most cases, bureaucracies are very conservative, and there are typically strong disincentives for public servants to be innovative. A clear leading role – supportive of innovation and policy learning – must be taken by reform authorities if alternatives to traditional regulation are to make serious headway into the policy system (OECD, 1999).

Due to the sophisticated and innovative nature of the financial industry, the rewards for financial institutions’ employees are greater than those for civil servants. Acknowledging that the supervisors of financial institutions must have competent expertise, the FSC provides reasonable remuneration and good opportunities for career development for its workforce. A professional workforce is expected to strengthen the quality of financial supervision.
Staff can be a great asset if they are motivated to take initiative for the benefit of the organization and if they demonstrate loyalty to the organization (Barney, 1986; Fiol, 1991; Lee and Miller, 1999). The FSC commits to staff in many ways: employee development, job protection, ample and fair financial compensation and pension plan, growth potential, and job security. Furthermore, in addition to an official budget, a Financial Supervisory Fund was established for the FSC, which can serve as another source of rewards for excellent R&SSs.

Many domestic financial groups have started cross-industry operations since the Financial Holding Company Act was passed in 2001. In view of this transformation, the need for high capability in R&SSs is rising. Consequently, the FSC may, in consideration of operational needs, recruit 60 to 100 researchers with professional knowledge and expertise in financial fields so as to amplify manpower and resources of the Commission according to the Organization Act of the Financial Supervisory Commission, Executive Yuan. In addition, the FSC can also honor employees through awards according to the Regulation for Inspiration of Civil Servant's Morality, Self-Cultivation, and Work Potential.

**Guaranteeing Integrity**

To make anti-corruption initiatives a success, there must be sufficient support and commitment from the public (Witherell, 2002). This is a question of leadership, which is an essential pre-requisite for success in eliminating corruption (O'Keefe, 2002). The integrity of R&SSs is the basic element needed to win the public’s trust in and commitment to government leadership.

Based on transaction cost economics (TCE), opportunism embedded in human nature is predicted to lead to corruption, and thus governance mechanisms, i.e. fiat, monitoring, punishment, and control, are the best way to prevent members from causing damage through opportunistic behavior and dishonesty (Williamson, 1975, 1979, 1981).

Hierarchical control has been criticized as creating negative feeling towards the entity, which increases individuals’ propensity to behave opportunistically, i.e. engaging in dishonest behaviour and corruption (Ghoshal and Moran, 1996). Instead of hierarchical control mechanisms, some scholars have proposed the concept of social control (Ouchi, 1980; Hennart, 1991; Das and Teng, 1998).
The concept of trust is one element of social control. Trust is one’s belief and expectation about the likelihood of having a desirable action performed by the trustee, which leads to commitment to the organization, and results in self-developed integrity (Sitkin and Roth, 1993; Das and Teng, 1998).

Socialization of individuals into an organization is another method of achieving social control. For example, Japanese firms rely to a great extent upon hiring inexperienced workers, socializing them to accept the company’s goals as their own, and compensating them according to length of service, number of dependents, and other non-performance criteria (Nakane, 1973; Ouchi, 1980).

According to the theories of TCE and social control, there are two ways to enhance integrity: governance and self-commitment, which are shown in Figure 4.

Taiwan has emphasized the importance of integrity for R&Ss for many years, as can be seen in the Criminal Law, the Civil Servant Work Act, the Civil Service Employment Act and all kinds of Codes of Conduct. For example, the code of conduct for employees of the SFB prohibits them from engaging in any kind of business or holding securities positions. In addition, the Civil Servant Work Act prohibits those serving in government agencies from being employed by any company which was related to their five-year original post in three years.

**Guaranteeing Accountability**

Corporate governance has become a matter of public interest around the world since it concerns accountability to shareholders for corporate performance (Smith, 1998). Hence, the accountability of R&Ss is the key to the legitimacy of the corporate system and public confidence.
We propose that the accountability of R&Ss is strongly associated with their capability and integrity. The public, including companies, investors, financial intermediaries, and professionals, evaluates if an R&S has capability or integrity. Therefore, sufficient communication, demonstration and disclosure is the main method of ensuring the transparency of an R&S and enhancing accountability of the public to the R&S.

The FSC has made efforts to enhance communication between financial industries and the public. Regulation and the regulatory process have been made highly transparent through public hearings. To ensure the accountability of R&Ss, FSC policies are required to be formulated based on the Commission’s decision. Furthermore, minutes of weekly commission meetings and important measures are required to be announced to the public to ensure the transparency of operations.

**SUMMARY**

Taiwan has promoted the concept of corporate governance for many years; however, it still suffered recently from some corporate corruption cases, i.e. the cases of Procomp Informatics Co. and Infodisc Tech Company. The recent spate of corporate failures and breakdowns in truthful accounting has undermined people’s faith in financial reporting, corporate leadership and the integrity of our capital markets. To eradicate corruption, the abuse of power and malpractice, we have set up the necessary legislation against corruption.

Based on the principle of “relaxed regulation with strengthened enforcement,” the priority of the FSC now is to strengthen enforcement under the “Securities and Exchange Act” and “Certified Public Accountant Act,” due to the impact of the recent Procomp Corporation scandal. These measures are expected to bring our regulations governing public companies and the accountancy industry more in line with international standards. In addition, to prevent further scandals, we will request public-held companies to further strengthen their corporate governance, as well as to promote a sound and trustworthy CPA audit system in order to enhance the CPAs’ responsibilities and accountability.

The success of anti-corruption initiatives is dependent on a number of factors. Principal among these are the capability, integrity and accountability of R&Ss, as these can lead to a belief in and commitment to corporate governance.

This paper discussed ways to ensure the capability, integrity and accountability of R&Ss. We proposed that accountability is the function of the capability and integrity of R&Ss.
Recommendations

An R&S is composed of different types of members. We have recommended ways to ensure the capability, integrity and, as a result, accountability of R&Ss, but what can we do for different members, or what kinds of members should we choose, especially when their capability and integrity are incompatible? Figure 5 illustrates this question.

Figure 5  Different Types of R&S Members

Successful recruitment may filter out those with neither capability nor integrity, as shown at the lower left of Figure 5. The cost of monitoring or damage would be enormous if an R&S consisted of many members of this type.

A condition illustrated at the upper left in Figure 5 is a member with a high level of integrity but little capability. In such a case, education, training and adequate motivation may result in a better situation, i.e. lead toward the upper right of the figure.

The opposite situation is a member with a high level of capability but little integrity (at the lower right of Figure 5). This would be dangerous when the control mechanism ensuring integrity fails. Our suggestion is that when there is a mismatch between capability and integrity, it is better to choose a member with a high level of integrity even if they lack some degree of capability. An R&S cannot risk any corruption which may harm public confidence and hence damage the capital market.

The best candidate, of course, has both capability and integrity, as indicated at the upper right of Figure 5. The only question regarding such a member is how to keep them. Therefore, incentives, both pecuniary and non-pecuniary, are important.
Conclusion

The concept of corporate governance has been emerging since the early 1970s in response to a perceived lack of effective board oversight that was thought to contribute to the poor performance. In 1997 there were a number of scandals and corruption cases within Asian financial markets that led to severe Asian financial crises. Inadequate corporate governance has been identified as the major reason for these crises. The impact from Enron and Corporate America put the issue under the spotlight. The OECD, in its 1998 ministerial meeting, also pointed to a lack of corporate governance as one of the root causes of the recent Asian financial crisis.\(^4\)

Corruption in the public sector is seen as a serious issue in all countries, and the impact of corruption in an R&S is far more serious than corporate corruption.

The capability, integrity and accountability of R&S are recognized to be important but have rarely been discussed. We have included in this paper some suggestions to ensure the capability, integrity and accountability of R&Ss, and made recommendations on how to deal with members who are lacking in either capability or integrity. This paper discussed measures taken by Taiwan as examples. We hope this will be of practical use to R&Ss in other countries.

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