The Dark Sides of Institutionalized Informal Connections: Evidence from the Japanese Banking Sector in the Post-bubble Crisis Era

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ABSTRACT

This study focuses on the role of corporate political resources in shaping firm strategy in an extension of resource dependence theory. Using a sample of 92 regional banks for the period 1997-2004 in Japan, this paper explores the effect of amakudari (translated as the appointment of former bureaucrats to the boards of directors of private organizations) on the performance and managerial risk-taking of banks. We found that amakudari networks have a negative impact on a bank's profitability in the post-bubble crisis era when firm-specific and other variables are controlled. In addition, the evidence shows that a bank appointing more ex-bureaucrats to its board of directors has a tendency to get involved in more risky lending activities. Furthermore, the empirical results of this study are also found to be robust using the Arellano-Bond GMM estimator.

JEL Classifications: *E58, G21, G28*

Keywords: *Amakudari practice; bank profitability; bank risk taking*

I.   INTRODUCTION

Appointing former government officials to the board of directors of a private enterprise has attracted considerable attention from strategic management scholars and business leaders (Hillman, 2005; Hillman et al., 1999; Lester et al., 2008). According to the literature, firms often have incentives to accumulate corporate political ties with the government since the government shapes domestic market rules that affect firms' business activities and their market performance (Hillman, 2003; Schuler, 1996). There are those who argue that having former government officials on the board of directors is a means to create and develop corporate political strategies (e.g., Hillman, 2005). Schuler (1996) argues that cultivating inter-organizational linkages between a firm and the government is a source of firm-specific competitive advantage to buffer the firm against environmental uncertainties such as intense international and domestic competition. Along with the resource-based view of the firm (Dyer and Singh, 1998), management scholars have acknowledged that the access to public decision-makers cannot always be imitated by competitors (Hillman et al., 1999). Corporate political strategies play a crucial role in strengthening a firm's own resource position and capabilities to outperform rivals. One of the most widely cited motives for the acceptance of former top civil servants as board directors is the establishment of political access to gain desired strategic information on public policy issues, which in turn enables firms to prosper and minimize the chances of bankruptcy (Hillman, 2005; Lester et al., 2008).

A substantial body of empirical studies have directed their focus on the relevance of former government officials on the board to the behavior of firms, in particular the survival time of former government officials as outside directors (Lester et al. 2008), firm performance (Hillman, 2005; Moerke, 2005; van Rixtel, 2002; van Rixtel and Hassink, 2002; Yamori, 1998) and risk-taking behavior (Horiuchi and Shimizu, 2001). An empirical consensus on the positive impact of board interlocks in the state-business interplay on firm performance in the United States can be seen in resource dependence theory (Pfeffer and Salancik, 1978). For example, Hillman (2005) found out that the number of politicians on a board is positively related to adjusted market capitalization and adjusted market to book, especially in regulated industries. Similarly, using a sample of 605 German firms in 2006, Niessen and Ruenzi's (2010) study discovered that politically connected firms achieve higher stock market returns compared to politically unconnected firms.

However, in the Japanese context, the previous literature has revealed ambivalent results in terms of the impact on a firm's profit maximization (e.g., Horiuchi and Shimizu, 2001; Suzuki, 2001; van Rixtel, 2002; van Rixtel and Hassink, 2002; Yamori, 1998) of board participation by ex-bureaucrats either from the Ministry of Finance (MOF) or from the Bank of Japan (BOJ). The inflow of officials from regulatory authorities onto corporate boards could be valuable to private corporations with poor management as they could seek regulatory support at the expense of high salary (van Rixtel and Hassink, 2002). For troubled banks, the cultivation of board interlocks in the state-business relationship would serve as an informal institution-specific advantage not only to arrange mergers and acquisitions (e.g., Aoki, Patrick and Sheard, 1994) but also to maneuver ministerial staff to interpret the rules in favor of their business activities and opportunities (van Rixtel and Hassink, 2002). In a

similar vein, van Rixtel (2002) also argues that an amakudari bank can maximize its own economic rents by manipulating established relationships with monetary regulators to its competitive advantage.

The key research focus of this paper is to reassess (1) how assigning high-ranking retiring bureaucrats to boards of directors affects bank profitability and (2) whether banks with more government officials as directors are more involved in risky lending activities than those with fewer directors in Japanese banking industry in the post-bubble period, particularly between 1997 and 2004. This period has been judged as essential to understand the institutional context of amakudari and the decline of the organizational power of monetary bureaucrats (Hoshi and Ito, 2004). Despite the importance of this period, none of the previous studies have investigated how the practice of amakudari affects the performance of banks. This study attempts to provide a deeper understanding of the utility of amakudari for firm performance in an extension of resource dependency theory (Pfeffer and Salancik, 1978). We use the Japanese financial sector as an empirical test because the amakudari phenomenon takes place between the financial authorities (i.e., the MOF and the BOJ) and business in particular (Colignon and Usui, 2003; Schaede, 1995), and these monetary regulators have much stronger policy coordination responsibilities, as compared to other government ministries (Colignon and Usui, 2001, p. 875). As van Rixtel and Hassink (2002) showed, performance measures include the development of profitability and the level of risk-lending behavior in our study.

This paper is organized as follows: The next section of this paper presents the theoretical tenets of the resource dependence tradition and the institutionalized nature of amakudari networks in Japan. Section III develops hypotheses based on the resource dependence tradition and the existing literature. Section IV presents data collection, measures, and estimation method. Section V demonstrates the empirical results regarding the impact of the value of the amakudari practice and informal regulation on bank strategy and performance in the case of the Japanese financial sector in the post-bubble crisis period. The final section presents a discussion of empirical results and offers suggestions for future research.

II. THEORETICAL FOUNDATIONS

A. Resource Dependence Theory

The resource dependence perspective pioneered by Pfeffer and Salancik (1978) attaches importance to the creation of external organizational networks and the assignment of board members. According to resource dependence theory, the board of directors has been regarded as 'provision of resource function', which indicates that the skills, social connections and past experience possessed by board members have various effects on an organization's strategic decisions and its performance (Wernerfelt, 1984). In particular, management scholars argue that governments play a decisive role in influencing the behavior and strategy of firms (Hillman, 2003; Hillman et al., 1999; Lester et al., 2008) because of high transaction costs arising from uncertainty in government-industry relationships (Hillman et al., 1999). For example, Lester et al. (2008, p. 1000) emphasize that "nearly every aspect of business is shaped by government regulation, which can significantly modify firms' opportunity sets".

Similarly, Hillman (2005, p. 464) regards government as "a critical source of external interdependency and uncertainty for business".

According to Hillman and her colleagues (1999, p. 70), firms having former politicians on their boards could reinforce their competitiveness to overcome emerging competition through (1) useful access to or influence with policy-makers that is unavailable to rivals, (2) information not available to rivals, (3) special tax benefits, and (4) the awarding of government contracts. Similarly, Hillman (2005) and Lester et al. (2008) argue that firms having former government officials as directors can benefit from four factors: (1) technical advice, (2) special access to information regarding current policy issues, (3) political control and power over competitive environments facing the firm, and (4) legitimacy and reputation. Therefore, it is not surprising that organizations strive to create interdependencies with the government in an attempt to accommodate unexpected changes in institutional conditions through having former government officials on the board. Advocates of resource dependence theory have emphasized that board interlocks are thought of as a strategic political instrument for the firm in co-evolving with the government.

Theoretically, the resource dependence tradition has a variety of aspects in common with transaction cost economics (Williamson 1985), institutional theory (North, 1990) and social network theory (Granovetter, 1985; Uzzi, 1996). As explained by transaction cost logic, the resource dependence view of the firm also considers that a firm will continue to regularly control its transactional efficiency and adapt its business structure to changing environmental pressures through creating external linkages (Hillman et al., 1999). Network relations between a firm and the government thus lead to a reduction in uncertainties, low transaction costs and an increase in legitimacy and goodwill since the close business-government interplay will aid the firm in gathering more information on public policymaking. Both advocates of an institution-based view of business strategy (Peng, 2002; Peng and Heath, 1996) as well as social network theorists (Granovetter, 1985; Uzzi, 1996) lend credence to the value of social connections with other organizations based on personal trust and reciprocity since various types of regulations made by governmental entities could have direct effects on the competitive positions of firms.

B. Former Bureaucrats as Board Directors (Amakudari) in Japan's Banking Sector

In the Japanese context, amakudari (translated as 'descent from heaven') is a specific term referring to the phenomenon of appointing high-ranking retiring bureaucrats to the boards of directors of private corporations. The role of the amakudari practice in shaping public policy and the competitive positions of firms has been a central issue of the Japanese corporate governance system (e.g., Aoki, 1988; Colignon and Usui, 2003; Usui and Colignon, 1995; van Rixtel, 2002). Amakudari has been recognized as being at the heart of Japan's state-led policy coordination system and as a system of informal regulation (Colignon and Usui, 2001). Scholars of the Japanese economy highlight that board interlocks in the state-industry interplay contribute to merging policy interests between government and industry together so as to achieve successful economic performance (e.g., Schaede, 1995). As is well known, amakudari, from the government perspective, has been widely understood as a monitoring and advisory mechanism to

ensure firms' cooperative behavior in accordance with administrative guidance (gyōsei shidō) formulated and implemented by the Japanese bureaucracy (Colignon and Usui, 2003; van Rixtel, 2002; van Rixtel and Hassink, 2002). Amakudari is also believed to be an incentive mechanism for the government since this informal institutional arrangement helps high-ranking bureaucrats secure their positions in the private industry after they leave government service (Rhyu, 2008).

In Japan, bureaucrats traditionally play a prominent role in controlling and policing business (e.g., Aoki, 1988; Hanazaki and Horiuchi, 2006; van Rixtel, 2002; van Rixtel and Hassink, 2002). The state bureaucracy was typically assumed to have played a key role in realizing Japan's economic miracle in the 70s and 80s (Johnson, 1982). Usui and Colignon (1995, pp. 684-685) identified several grounds for the powerful role of the Japanese monetary bureaucracy in particular. First, legislation is written and enforced by bureaucrats. Second, vice ministers are influential in shaping public policy due to their superior knowledge and rich administrative experience. Third, private enterprises' interests are aligned to ministries' interests because ministries are endowed with the power to enforce administrative guidance. Fourth, ministries have strong policy decision-making power over government finance agencies such as the Bank of Japan and the Japan Development Bank. Schaede (1995, pp. 297-298) also argues that firms gain benefits from expanding interorganizational ties with bureaucrats in Japan because of bureaucrats' extensive, influential and resourceful business, political and social relations.

Given a convoy-style regulation system (Aoki et al., 1994), Japanese banks were often confronted with informal regulation and supervision by the MOF because of the so-called carrot-and-stick principle, which stipulates that political leverage tends to be more concentrated in the regulators (e.g., the MOF; van Rixtel, 2002). For example, the MOF exercises "the power to reward benevolence and punish non-cooperative behavior" (Moerke, 2005, p. 64) through administrative guidance. Banks are often subject to the MOF's and the BOJ's discrete interpretation of regulations (Schaede, 1995). In response to this informal nature of regulation, private financial institutions have more incentives to recruit ex-bureaucrats into top-ranking positions and as a result are more capable of gathering informal information in a web of social exchange networks. Calder (1989, p. 395) emphasizes the importance of obtaining strategic information on state intervention and regulatory change through cultivating and capitalizing on informal ties with the regulators because "economically strategic information is much more frequently unavailable from public sources in Japan than in Europe and the U.S.". According to Amyx (2001), constant communication with the MOF enables banks to create more predictable financial regulatory environments. In sum, amakudari serves as a substitute for a rule-based system of governance. In the next section, we will develop hypotheses based on previous literature and theories.

III.   CONCEPTUAL FRAMEWORK AND HYPOTHESES

A.   Former Bureaucrats on Boards of Directors and Profitability

Scholars of management argue that the appointment of former government officials to boards of directors in a private enterprise facilitates its access to complementary assets (e.g., information on informal market knowledge and regulatory changes) (Hillman,

2005; Lester et al., 2008). Blumenthal (1985) supports the view that connections with the state bureaucracy are valuable because firms would gain benefits from amakudari bureaucrats with high technical and administrative abilities and experience. Personal ties also support an informal policy network allowing information to be shared between the state and business while facilitating conflict resolution and consensus building on issues of industrial policy (Usui and Colignon, 1995, p. 683). Such information policy networks engender a situation whereby firms that listen and respond to the ministries' signals are thus favored by the ministries, receiving "easy access to capital, tax breaks, and approval of plans to import foreign technology or establish joint ventures" (Usui and Colignon, 1995, pp. 688-689).

Empirically, in a study of Japanese banks in two different periods, (77 banks in 1977-1993 and 74 banks in 1981-1993), van Rixtel and Hassink (2002) identified that the widespread movement of former bureaucrats onto the boards of banks plays a crucial role in improving bank performance and consolidating banking operations. These results show that amakudari is characterized as "an instrument of prudential policy (ex-post monitoring)" (van Rixtel and Hassink, 2002, p. 25). In Moerke's (2005) study, the Cobb-Douglas function was adopted in investigating the relevance of strengthening the amakudari network for sales, measured as firm performance, over two time spans (bubble period: 1985-1991; crisis period: 1992-1998). Moerke noted that inter-organizational linkages with former bureaucrats are positively associated with sales in both periods. These results justify the resource dependence perspective that the appointment of retired bureaucrats to the board of directors promotes access to complementary resources and thus provides the firm with more bargaining power with the MOF and the BOJ bureaucrats. We can, thus, hypothesize as follows:

Hypothesis 1a: *The appointment of former monetary bureaucrats on the board of directors has a positive impact on bank profitability, all other things being equal.*

In contrast, there have also been some discussions that discredit the positive effect of former bureaucrats being on a firm's board of directors. For example, previous literature emphasizes that regulatory bodies take advantage of the amakudari network as an incentive for enhancing their economic rents (Hanazaki and Horiuchi, 2006). In an analysis of amakudari in the case of the Ministry of Post and Telecommunications (MPT) and Nippon Telephone and Telegraph (NTT), Nakano (1998, pp. 113-115) concluded that firm performance may be disturbed by the practice of amakudari because of (1) limited competition in the telecommunication industry and (2) discouragement to sustaining the work ethic, motivations and corporate loyalty of employees. In addition, the incompetence of former bureaucrats on the board of directors in the private sector is emphasized (Suzuki, 2001).

Based on a review of performance by four different types of presidents (founder, second generation, insider and amakudari) for the period 1973-1980, Blumenthal (1985) found that the worst performance was shown by the amakudari president. According to his study, this was rooted in three major factors: (1) the President's poor acquaintance with staff, (2) his lack of success in obtaining employees' cooperation and (3) his lack of flexibility in implementing innovative measures in difficult times. Using GMM estimation, Horiuchi and Shimizu (2001) found that amakudari, a form of collusion between regulators, taxpayers and banks, is likely to destroy the validity of

the safety net and thus has a distorting effect on the bank's performance. In a survey of 82 regional and second-tier regional banks for the period 1992-1999, Suzuki (2001) also verified that former bureaucrats on the board of directors seriously hamper bank performance. According to Suzuki (2001), the main reason for this result is that amakudari banks are less flexible in responding to social censure and changes in rules and laws as compared with non-amakudari banks. Similarly, Yamori (1998), who emphasizes expense-preference behaviors in 443 Japanese mutual banks at the end of 1993, demonstrates that amakudari does not act as a guard over corporate governance of Japanese financial institutions. Rather, the amakudari practice could bear significant costs. Yamori (1998, p. 386) argues that board interlocks in the state-business relationship turn out to be an incentive to "indulge in excessive expenditures". We can, thus, hypothesize as follows:

Hypothesis 1b: *The appointment of former monetary bureaucrats to boards of directors has a negative impact on bank profitability, all other things being equal.*

B.   Former Bureaucrats on the Board of Directors and Risky Lending Behavior

As compared to research on the effect of former government officials on firm performance, there exists a limited body of literature on the link between the appointment of former bureaucrats to the boards of directors and banks' risk-taking behavior. Management scholars argue that government-to-business relationships could facilitate private corporations' risk-taking behavior (Konishi and Yasuda, 2004; van Rixtel, 2002). One possible reason for this negative linkage is that banks with ex-bureaucrats on their boards of directors may have less strict monitoring control by the MOF and the BOJ than those without (Konishi and Yasuda, 2004). Van Rixtel and Hassink (2002, p. 3) support this view that amakudari bureaucrats are capable of influencing the regulators to "bend the rules" and induce amakudari banks to seek more risks to increase profits. In other words, it is possible to assume that banks with a high representation of former monetary regulators on the board could take advantage of their corporate political resources to evade regulation that is detrimental to their business activities. In particular, troubled banks purchase regulatory forbearance from the MOF or the BOJ at the expense of the acceptance of retiring high-ranking bureaucrats into the top executive positions, thus investing in business activities with high returns and high risks (van Rixtel, 2002; van Rixtel and Hassink, 2002).

Empirically, evidence presented by van Rixtel and Hassink lends support for the argument that amakudari urges banks to lend money to risky industries such as the real estate sector and the non-bank financial sector. Based on a dataset of 184 amakudari bureaucrats at 125 regional banks for the period 1977-1992, Horiuchi and Shimizu (2001), who emphasize principal-agency logic, estimated that a higher number of amakudari bureaucrats from the MOF was linked to higher non-performing loan ratio, suggesting that amakudari tends to expand risky lending practices. We can, thus, hypothesize as follows:

Hypothesis 2: *Former monetary bureaucrats on boards of directors are linked to an increase in risky lending activities, all other things being equal.*

IV.   METHODOLOGY

A.   Data Collection

The data used for this study were collected from the annual reports of "*Ginkō eno Amakudari Jittai Chōsa*" (An investigation of the movement of amakudari officials into the boards at Japanese private banks) by Teikoku Data Bank. Our sample consists of 92 regional banks for the period 1997-2004. This time span should be considered important because various key institutional changes took place in the Japanese financial industry.

First, this period witnessed the creation of new formal institutions, which may have weakened the informal state-business relationship and the power of financial bureaucrats. For example, the National Public Service Ethics Act of 1999 was introduced to restrain the practice of amakudari after many scandals involving amakudari during the 1990s (Hoshi and Ito, 2004). The government set up the Financial Supervisory Agency (FSA) as a new regulator independent from the MOF and the BOJ and instituted Prompt Corrective Action (PCA) rules to ensure the transparency and accountability of financial regulators in terms of banking supervision and inspection. Shimizu (2006) argues that the creation of the FSA was effective in preventing banks from concealing their real amount of non-performing loans and in enhancing economic efficiency by forcing troubled banks to leave the financial market.

Second, strict state intervention in the rehabilitation of the Japanese financial industry was observed during the post-bubble crisis period. One example is that the Financial Reconstruction Commission (FRC) was successful in nationalizing the Long-Term Credit Bank of Japan (LTCB) and closing five insolvent regional banks in 1999 (Hoshi and Ito, 2004). Due to public pressure on improving bank management, the government also continued to inject public funds to recapitalize banks with a large amount of non-performing loans under the Financial Revitalization Act and increased the total size of the Financial Revitalization Plan to 60 trillion yen (Montgomery and Shimizutani, 2009).

Third, the Japanese government implemented a series of policy measures in order to deregulate the Japanese financial market effectively. These are Hashimoto's 'Big Bang' financial reform plan, the passing of the Financial System Reform Law, and the abolition of controls on foreign exchange transactions and fixed share-trading commissions, and government stipulated uniform insurance premiums (Paprzyncki and Fukao, 2008, p. 151). The financial deregulation measures in response to global market pressures may have led to the end of the convoy-style regulation system and thus encourage foreign institutional investors to play a key role in reshaping the structure of the Japanese financial industry (Yafeh, 2000). As a matter of fact, the proportion of FDI accounted for in the financial sector jumped from no more than 5 per cent in the mid-1990s to 41 per cent between 1997 and 2004 (Paprzyncki and Fukao, 2008, p. 152).

Lastly, one cannot afford to ignore that this period also witnessed how increasing liberalization and deregulation of financial markets intensified competition not merely from abroad but also from non-financial rivalries in Japan. For example, Akiyoshi (2002) emphasizes that technological innovation and the slow recovery of private financial institutions from the accumulation of non-performing loans have made

it possible for non-financial firms to enter into the banking sector (e.g., Itō-Yōkadō's entry into settlement services for the retailing sector and Sony in Internet banking to the public). Accordingly, these institutional changes indicate that the policy of regulatory forbearance arguably came to an end.

The primary reason for choosing regional banks is that amakudari in the financial sector has been especially concentrated in these banks. According to Teikoku Databank, as of the fiscal year 2002, the total number of amakudari board members amounted to 111. Of 111, 54 sought out post-retirement positions in first-tier regional banks, while 57 were in second-tier regional banks. According to Teikoku Data Bank (2003), none of the major banks (e.g., the Bank of Tokyo-Mitsubishi UFJ, Mitsui Sumitomo Banking Corporation, and Mizuho Corporate Bank) recruited amakudari officials for top executive positions. Mega banks might have no need for heavy reliance on retiring bureaucrats because they have already accumulated human capital with technical expertise and experience and have strengthened the scope of their internationalization. A growing trend is that the organizational behavior of Japanese mega banks is more structured and influenced by international financial regulation that aims to strengthen corporate governance (e.g., the Basel II Framework). Following Calder's (1989, pp. 395-396) 'equalization' argument, two possible grounds can be cited for little or no reliance by major banks on the internal dynamics of the regulators: (1) major banks care about maintaining autonomy from state regulatory control and (2) major banks have an independent capacity for collecting economically strategic information.

B.   Measures

I.   Dependent variables

Building on past work (e.g., van Rixtel, 2002; van Rixtel and Hassink, 2002), we use return on equity (ROE) and a BIS or MOF capital-adequacy ratio (CAPITAL) as performance indicators. A ratio of loans provable in bankruptcy in total asset (RISK) as a risk-taking index is calculated. Data are collected from Tōyō Keizai Shinpōsha's *Kaisha Zaimu Karute* (2007).

2.   Explanatory variables

Amakudari practice: We use a ratio of *amakudari* executives in total board members (AMARAT) in a given bank. The data is compiled from Teikoku Data Bank's "*Ginkō eno Amakudari Jittai Chōsa*" in various issues. As has been hypothesized, the expected sign of AMARAT is positive in the development of bank performance.

3.   Control variables

Our analysis used various controls. *Bank size*: In an extension of the resource-based view of the firm, the smaller a bank is the less responsive the bank is to external shocks that arise from market imperfections. Bank size is considered as the scale of bargaining power. There are various ways of measuring firm size, but in our study, total asset (SIZE) is utilized as a proxy for bank size. The data for this variable are collected from

Tōyō Keizai Shinpōsha's *Kaisha Zaimu Karute* (2007). *Bank age*: This study predicts that bank age (AGE) has a positive effect on the development of bank performance since older banks can more effectively exploit intangible assets such as experience-based knowledge and have greater learning capabilities in comparison with newly established companies. The bank age variable is measured by the length of years from the establishment to a given year. The expected sign of bank age is not clearly determined. The data for this variable are gathered from Tōyō Keizai Shinpōsha's *Kaisha Zaimu Karute* (2007). *Asset growth*: Asset growth is included in the regression models. Following Horiuchi and Shimizu (2001), asset growth (GAS) is measured by percent change in assets. Data are collected from Tōyō Keizai Shinpōsha's *Kaisha Zaimu Karute* (2007). *Foreign ownership*: As in previous studies (Miyajima and Kuroki, 2008), foreign ownership (FOREIGN) is measured by the percentage of shares held by foreign institutional investors. The data for this variable are compiled from annual editions of Tōyō Keizai Shinpōsha's *Kaisha Shikihō* (1996-2003). *Recapitalization value*: Recapitalization (RECAP) is measured by the amount of capital injection. The data for this variable are collected from the Deposit Insurance Corporation of Japan's *Sōki Kaizenkahō ni motozuku Shihon Zōkyo Jisseki Ichiran* (www.dic.go.jp). *Recapitalization dummy*: The value of one is taken if a bank received the capital injection; otherwise, it is zero. The recapitalization dummy variable is coded as RECAPDUM. Previous studies address that public recapitalization policies in the late 1990s in Japan play a key role in boosting bank performance (Montgomery and Shimizutani, 2009). Montgomery and Shimizutani (2009), who analyze the impact of bank recapitalization policies in Japan based on a panel dataset of 109 banks, find that the capital injection increases the adjusted BIS-MOF capital ratio and promotes loan growth. *Economic growth*: Economic growth (GRW) is measured by the percent change in real Gross Domestic Product (GDP). Data are obtained from the Organization for Economic Co-operation and Development (OECD) (www.oecd.org).

C.   Estimation Method

We constructed model specifications and examined them by using a time-series and cross-section (TSCS) technique, which empowers us simultaneously to observe the effects of independent variables on the dependent variables across time and space. Ordinary Least Square (OLS) with panel-corrected standard errors (PCSE) is employed for our TSCS analysis. The use of OLS with PCSE is supported by two main sources: One is that OLS parameter estimates with PCSE are more accurate than the Generalized Least Squares (GLS) (Beck and Katz, 1995).

Second, OLS with PCSE is suitable in solving the issue of panel heteroskedasticity, autocorrelation and contemporaneous correlation more adequately, even in the presence of complicated panel error structures (Beck and Katz, 1995, pp. 634-641). To make the results more precise and reliable, we employ a first-order auto regression to deal with a nuisance in the residuals. We report Paris-Winston coefficients with panel-corrected standard errors. The generic TSCS model is as follows:

$$Y_{i,t} + \alpha + \beta X_{i,t} + \varepsilon_{i,t} \ (i = 1, \dots, N; \ t = 1, \dots, T)$$

As the generic model (1) exhibits, Y is a dependent variable. α is an interval term. β is a parameter of coefficients to be estimated and therefore examines the marginal effect of the explanatory variables. X represents the set of explanatory variables. i and t indicate bank and year, respectively. ε refers to an error term that represents immeasurable factors or idiosyncratic shocks. The following models will be tested in this study:

$$\begin{aligned} \text{ROE}_{i,t} = {}& \alpha + \beta_1(\text{AMARAT})_{i,t-1} + \beta_2(\text{SIZE})_{i,t-1} + \beta_3(\text{AGE})_{i,t-1} + \beta_4(\text{GAS})_{i,t-1} \\ & + \beta_5(\text{FOREIGN})_{i,t-1} + \beta_6(\text{RECAP})_{i,t-1} + \beta_7(\text{RECAPDUM})_{i,t-1} \\ & + \beta_8(\text{GRW})_{i,t-1} + \varepsilon_{i,t} \end{aligned}$$

$$\begin{aligned} \text{CAPITAL}_{i,t} = {}& \alpha + \beta_1(\text{AMARAT})_{i,t-1} + \beta_2(\text{SIZE})_{i,t-1} + \beta_3(\text{AGE})_{i,t-1} + \beta_4(\text{GAS})_{i,t-1} \\ & + \beta_5(\text{FOREIGN})_{i,t-1} + \beta_6(\text{RECAP})_{i,t-1} + \beta_7(\text{RECAPDUM})_{i,t-1} \\ & + \beta_8(\text{GRW})_{i,t-1} + \varepsilon_{i,t} \end{aligned}$$

$$\begin{aligned} \text{RISK}_{i,t} = {}& \alpha + \beta_1(\text{AMARAT})_{i,t-1} + \beta_2(\text{SIZE})_{i,t-1} + \beta_3(\text{AGE})_{i,t-1} + \beta_4(\text{GAS})_{i,t-1} \\ & + \beta_5(\text{FOREIGN})_{i,t-1} + \beta_6(\text{RECAP})_{i,t-1} + \beta_7(\text{RECAPDUM})_{i,t-1} \\ & + \beta_8(\text{GRW})_{i,t-1} + \varepsilon_{i,t} \end{aligned}$$

OLS with PCSE is employed to evaluate the parameters of the explanatory variables, which determine bank performance for 92 first-tier and second-tier regional banks for the period 1997-2004.

V.   EMPIRICAL RESULTS

Table 1 reports the descriptive statistics and correlation matrix for all variables tested in this research. To enhance the credibility of the estimation, a multicollinearity analysis was performed using Pearson correlation tests. It was confirmed that none of the variable sets exceeds more than 0.60 except for the highest correlation coefficient (0.73) between RECAP and RECAPDUM. Therefore, to avoid encountering potential biased empirical results due to the multicollinearity problem, these aforementioned variables are alternately tested in the estimating equations.

Table 1 supports Hypothesis 1b and 2, with strong correlation coefficients between AMARAT and ROE (-0.28), AMARAT and CAPITAL (-0.31), and AMARAT and RISK (0.26) at the five percent level in all the cases. The ratio of amakudari to total board members is 7.8%. Table 2 demonstrates the empirical results using OLS with panel corrected standard errors. The first and second rows correspond to the estimated coefficients and z-values, respectively. The chi-square statistic proves that all the models are highly significant, with $p<0.0001$. The R^2 values for the models were moderate and ranges from a low of 0.116 to a high of 0.478.

Controlling for firm-specific and policy variables, we found that the estimated coefficient for AMARAT is negative and statistically significant at the 1% level. Our empirical analysis confirms that the amakudari practice exerts an adverse effect on return on equity and capital-adequacy ratio, indicating that Hypothesis 1b was supported, while Hypothesis 1a was rejected. Our results reveal that the coefficient of AMARAT is positive and highly statistically significant ($p<0.01$), as predicted in Hypothesis 2. Namely, greater board participation by ex-bureaucrats either from the MOF or from the BOJ tends to encourage banks to get involved with more risky lending activities.

Table 1
Correlation matrix

	Variable	N	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11
1	ROE	716	4.3	1.2	1										
2	CAPITAL	717	8.8	2.0	**0.70**	1									
3	RISK	718	0.7	0.4	**-0.40**	**-0.44**	1								
4	AMARAT	712	7.8	6.9	**-0.28**	**-0.31**	**0.26**	1							
5	SIZE	723	6.3	0.3	**0.18**	**0.50**	**-0.27**	**-0.18**	1						
6	AGE	736	1.8	0.2	0.06	**0.09**	**-0.11**	**-0.21**	**0.15**	1					
7	GAS	713	1.1	9.4	-0.02	0.01	**-0.08**	0.01	-0.04	-0.01	1				
8	FOREIGN	721	1.6	2.1	**0.25**	**0.36**	**-0.17**	-0.06	**0.51**	0.05	-0.01	1			
9	RECAP	736	0.0	0.1	-0.02	-0.02	0.05	0.04	0.03	0.04	-0.05	-0.01	1		
10	RECAPDUM	736	0.8	9.5	-0.01	0.02	-0.03	0.03	**0.10**	0.04	-0.05	0.06	**0.73**	1	
11	GRW	736	0.9	1.5	0.04	0.03	**-0.11**	0.01	0.00	-0.01	0.06	0.05	-0.02	-0.03	1

Note: Bold values indicate statistical significance at the 0.05 level.

Table 2
The effect of the appointment of former monetary bureaucrats to boards of directors on
performance of regional banks for the period 1997-2004 (OLS with PCSE)

Explanatory variable	Model 1 (ROE)	Model 2 (CAPITAL)	Model 3 (RISK)	Model 4 (ROE)	Model 5 (CAPITAL)	Model 6 (RISK)
Amakudari variable						
AMARAT	-0.031^{***}	-0.064^{***}	0.011^{***}	-0.030^{***}	-0.059^{***}	0.011^{***}
	(–4.11)	(–4.87)	(3.93)	(–3.80)	(–4.24)	(3.87)
Control variables						
SIZE	0.418	2.763^{***}	-0.265^{***}	0.423	2.769^{***}	-0.271^{***}
	(1.42)	(5.35)	(–2.86)	(1.50)	(5.41)	(–2.85)
AGE	0.193	–0.094	–0.121	0.184	–0.109	–0.122
	(0.40)	(–0.19)	(–1.26)	(0.37)	(–0.22)	(–1.19)
GAS	–0.001	–0.008	–0.002	–0.001	–0.008	–0.002
	(–0.45)	(–0.79)	(–1.20)	(–0.46)	(–0.79)	(–1.17)
FOREIGN	0.032	0.049	–0.003	0.031	0.050	–0.002
	(0.84)	(1.02)	(–0.22)	(0.82)	(1.03)	(–0.19)
RECAP	0.005	0.010^{**}	–0.003			
	(1.35)	(2.30)	(–1.54)			
RECAPDUM				0.432	0.985^{**}	–0.096
				(1.45)	(2.16)	(–0.59)
GRW	0.058	0.107	–0.020	0.058	0.107	–0.021
	(0.96)	(1.57)	(–0.92)	(0.96)	(1.57)	(–0.91)
Constant	1.453	-8.164^{**}	2.469^{***}	1.442	-8.170^{**}	2.510^{***}
	(0.78)	(–2.14)	(4.27)	(0.79)	(–2.15)	(4.12)
Observation	696	697	697	696	697	697
Number of groups	92	92	92	92	92	92
R-squared	0.360	0.476	0.124	0.360	0.478	0.116
Prob > chi2	0.000	0.000	0.000	0.000	0.000	0.000

Note: z-values are reported in parentheses.
** Significant at 0.05 level; *** significant at 0.01 level.

Table 3

The effect of the appointment of former monetary bureaucrats to boards of directors on performance of regional banks for the period 1997-2004 (OLS with PCSE)

Explanatory variable	Model 7 (ROE)	Model 8 (CAPITAL)	Model 9 (RISK)	Model 10 (ROE)	Model 11 (CAPITAL)	Model 12 (RISK)
Amakudari variable						
AMADUM	-0.509^{***}	-0.790^{***}	0.139^{***}	-0.500^{***}	-0.770^{***}	0.138^{***}
	(−4.10)	(−4.61)	(3.95)	(−4.09)	(−4.29)	(3.61)
Control variables						
SIZE	0.489^{**}	2.941^{***}	-0.291^{***}	0.498^{**}	2.955^{***}	-0.298^{***}
	(2.38)	(6.81)	(−3.20)	(2.41)	(7.50)	(−2.92)
AGE	0.265	0.181	−0.167	0.264	0.182	−0.169
	(0.65)	(0.40)	(−3.51)	(0.66)	(0.39)	(−2.75)
GAS	−0.001	−0.007	−0.002	−0.001	−0.007	−0.002
	(−1.04)	(−0.78)	(−1.34)	(−1.08)	(−0.79)	(−1.28)
FOREIGN	0.036	0.051	−0.004	0.035	0.051	−0.003
	(0.61)	(0.85)	(−0.24)	(0.60)	(0.87)	(−0.21)
RECAP	0.005^{***}	0.011^{**}	−0.003			
	(3.02)	(2.00)	(−1.47)			
RECAPDUM				0.371^{**}	0.880	−0.076
				(2.02)	(1.60)	(−0.44)
GRW	0.057	0.107	−0.020	0.057	0.107	−0.020
	(0.61)	(1.57)	(−1.39)	(0.62)	(1.25)	(−1.28)
Constant	0.985	-9.728^{***}	2.704^{***}	0.922	-9.838^{***}	2.754^{***}
	(0.62)	(−3.93)	(4.60)	(0.58)	(−4.44)	(4.01)
Observation	696	697	697	696	697	697
Number of groups	92	92	92	92	92	92
R-squared	0.357	0.467	0.118	0.355	0.467	0.109
Prob > chi2	0.000	0.000	0.000	0.000	0.000	0.000

Note: z-values are reported in parentheses.   ** Significant at 0.05 level; *** significant at 0.01 level.

The negative association between the amakudari practice and bank performance validates the belief that the acceptance of retired ministerial officials into the top executive positions in a private financial institution would damage its reputation and quality of corporate governance. For taxpayers, the amakudari system would not be economically rational in terms of resource allocation and mobilization. Rather, it tends to be a source of public criticism. It may also disturb employees' motivation to work harder and to remain dedicated to the company. As pointed out in Okimoto's (1989) study, there is also the possibility that amakudari may exacerbate employees' resentment against amakudari bureaucrats within the bank. Accordingly, this internal conflict may be detrimental to bank profitability.

In this section, we perform additional model specifications to check the statistical validity of the earlier-presented empirical outcomes. Table 3 demonstrates the results of the OLS with PCSE using the amakudari dummy variable (AMADUM). Most estimated results presented in Table 3 show a high degree of similarity to those in Table 2. The relation between AMADUM and ROE is negative and statistically significant at the 1% level. We also found a negative and significant relation between AMADUM and CAPITAL. These results mean that the amakudari practice seems to discourage bank performance.

We found that AMADUM is significantly and positively correlated with RISK at the 1% significance level. Firm size exerts a positive effect on bank profitability. The impact of recapitalization is found to exert a positive and statistically significant effect on ROE and CAPITAL. These findings confirm the pattern after controlling for additional variables.

This study also needs to carry out an additional robustness check by utilizing an alternative method that solves potential endogeneity bias since OLS yields inconsistent estimates due to the presence of a correlation problem between a lagged dependent variable and the error term. It is thus important to consider that amakudari will not only affect bank performance but bank performance may also affect the inflow of amakudari. The generalized method of moments (GMM) technique developed by Arellano and Bond (1991) is believed to be appropriate in estimating a dynamic panel data model because this estimation technique controls unobserved fixed effects and solves potential endogeneity problems. These properties thus help to yield reliable estimates (Arellano and Bond 1991).

Table 4 reports the GMM-system estimation results for the Japanese banking industry. As seen in the above table, the robustness check validates that the results are highly consistent with those presented in Tables 2 and 3. Signs of coefficients of the lagged dependent variable are positive and statistically significant in GMM at the one percent level in all the models. The amakudari practice is associated with decreased bank performance ($p<0.1<0.1$~0.01) on the one hand and induces individual banks to engage in risky lending practices ($p<0.01$) on the other. Consisitant with Montgomery and Shimizutani (2009), the empirical analysis based on Arellano-Bond GMM estimator reveals that the recapitalization variables are statistically significant in all the estimation models. The major difference between empirical findings in OLS with PCSE and GMM is observed in the three control variables, namely SIZE, GAS and GRW.

As a follow-up, a t-test was carried out to investigate whether there was any group difference in ROE, CAPITAL and RISK for firms above and below the 7.84 threshold level. Table 5 reports the mean difference in the dependent variables between high- and low-amakudari (AMARAT) groups of regional banks. The mean difference is highly significant at the 0.001 level. The high (AMARAT>7.84) and low (AMARAT<7.84) amakudari groups of regional banks have a mean ROE of 3.945 and 4.652, a mean CAPITAL of 8.179 and 9.360, and a mean RISK of 0.784 and 0.560, respectively.

These results indicate that the resource dependence tradition that was based upon US-based studies might not be exactly applicable to organizations from non-Western countries such as Japan. The evidence also reveals that rigid and exclusive personal networks may no longer be a solution to market failures.

VI.   CONCLUDING REMARKS

To date, the appointment of policy decision makers (i.e., politicians and bureaucrats) to the boards of directors of private corporations has been intensely debated among scholars and practitioners of management and governance. The main objective of this study is to explore and examine whether the inflow of former monetary bureaucrats (i.e., the MOF and the BOJ) into the boards of directors of regional banks has aided these banks in improving their profitability or, in fact has undermined their financial situation

Table 4
The effect of the appointment of former monetary bureaucrats to boards of directors on
performance of regional banks (GMM)

Explanatory variable	Model 13 (ROE)	Model 14 (CAPITAL)	Model 15 (RISK)	Model 16 (ROE)	Model 17 (CAPITAL)	Model 18 (RISK)
Lagged dependent variable						
	0.262***	0.293***	0.479***	0.262***	0.291***	0.448***
	(3.85)	(5.53)	(6.37)	(3.87)	(5.58)	(6.04)
Amakudari variable						
AMARAT	–0.034***	–0.028*	0.016***	–0.036***	–0.033**	0.016***
	(–3.60)	(–1.79)	(3.11)	(–3.84)	(–2.09)	(3.17)
Control variables						
SIZE	–0.765	–0.506***	0.013	–0.542	–4.597***	–0.015
	(–0.72)	(–2.87)	(0.02)	(–0.51)	(–2.63)	(–0.03)
AGE	6.139*	2.522	–0.700	6.295*	2.853	–0.725
	(1.77)	(0.43)	(–0.37)	(1.82)	(0.50)	(–0.38)
GAS	–0.002	–0.028***	–0.002	–0.002	–0.027***	–0.002
	(–0.78)	(–5.27)	(–1.29)	(–0.71)	(–5.22)	(–1.25)
FOREIGN	–0.029	–0.083	0.003	–0.030	–0.084*	0.007
	(–0.95)	(–1.63)	(0.17)	(–0.99)	(–1.67)	(0.41)
RECAP	0.009***	0.017***	–0.005***			
	(3.60)	(4.08)	(–3.65)			
RECAPDUM				0.829***	1.705***	–0.211*
				(4.08)	(4.99)	(–1.91)
GRW	0.040***	0.156***	0.017*	0.040**	0.155***	0.015
	(2.56)	(6.20)	(1.80)	(2.56)	(6.24)	(1.63)
Constant	0.051*	0.017	–0.046***	0.047*	0.010	–0.045***
	(1.79)	(0.38)	(–3.05)	(1.67)	(0.21)	(–2.98)
Observation	515	516	517	515	516	517
Number of groups	92	92	92	92	92	92
AR1	–5.24***	–7.13***	–7.93***	–5.07***	–7.08***	–7.78***
AR2	–2.10**	–0.84	–0.41	–2.20**	–0.69	–0.63

Note: z-values are reported in parentheses.
* Significant at 0.1 level; ** Significant at 0.05 level; *** significant at 0.01 level.

Table 5
The mean difference in return on equity, capital-adequacy ratio and risky lending ratio
between high- and low-amakudari groups of regional banks

Dependent variables	Group	N	Mean	S.D.	t-Value
ROE	AMARAT<7.84	393	4.652	0.055	8.416†
	AMARAT>7.84	308	3.945	0.064	
CAPITAL	AMARAT<7.84	393	9.360	0.091	8.108†
	AMARAT>7.84	309	8.179	0.117	
RISK	AMARAT<7.84	394	0.560	0.017	–7.513†
	AMARAT>7.84	309	0.784	0.025	

Note: † Significant at 0.001 level.

in the post-bubble crisis period in Japan. A cross-sectional dataset of 92 regional banks for the period 1997-2004 in the Japanese banking sector was used to scrutinize the amakudari-performance relationship in the post-bubble crisis period.

In contrast to the resource dependence logic, one of the key empirical findings presented in this study calls for greater recognition that board interlocks in the state-industry relationship exert a negative impact on bank profitability. This negative link between the amakudari practice and profitability would in part be accounted for by various dimensions. First, a bank relying heavily on a regulator-regulated nexus may suffer from an internal conflict between amakudari bureaucrats and employees, harsh criticism in the public, and a low level of corporate loyalty of employees. Second, a bank having former monetary regulators on the board may be less flexible and responsive in taking innovative measures in times of difficulties. In other words, one can argue that banks de-traditionalizing the accepted corporate political strategy tend to be more competitive than banks following rigid and personal networks. Lastly, the value of the amakudari practice would be costly since banks with amakudari bureaucrats often have to meet politically oriented goals rather than shareholders' interests.

This study also finds that a bank's risky lending behavior is positively influenced by the amakudari practice, as pointed out in previous scholarship (Horiuchi and Shimizu, 2001; Konishi and Yasuda, 2004). Accordingly, it can be argued that institutionalized ties between the state authority and financial services institutions may cause a moral hazard problem rooted in soft budget constraints, thus undermining the soundness of bank management in the Japanese financial industry. Following Konishi and Yasuda (2004), another possible reason might be that sending the former MOF and the BOJ bureaucrats to private corporations would weaken regulators' role in monitoring the effectiveness and soundness of banks and thus expand risky lending activities in an attempt to achieve better performance.

The empirical results of this study present several interesting implications for scholars and practitioners. In the first place, we found the negative impact of the acceptance of amakudari bureaucrats on the development of organizational performance of financial institutions in Japan. This finding supports the claim that amakudari banks underperform compared to non-amakudari banks since the costs of institionalized bureaucracy-business ties may outweigh their gains. For managers, it is important to consider that the future success of Japanese financial institutions may rest on the de-institutionalization of traditional informal networks between bureaucrats and firms in Japan. Additionally, the negative relation between the intensity of informal networks and bank profitability suggests that managers should pay more attention to the importance of improving the strategic value of internal capabilities.

Second, this study indicates that the legitimacy of relationship-based economic incentives tends to lose importance in face of increasing diffusion of the Anglo-Saxon model characteristic of formal rule-based financial governance. However, it may be too early to conclude the demise of the amakudari practice since the real dynamics of the Japanese model of network capitalism has been in transition to become congruent with rising pressure for institutional changes in corporate governance and industrial relations (Yoshikawa and McGuire, 2008). Following Rhyu (2008), it is plausible that future research could also benefit from investigating different types of amakudari (e.g., those who are hired from major banks such as Tokyo-Mitsubishi UFJ Bank, Mizuho

Financial Group, Sumitomo-Mitsui Banking Corporation or those who are hired from quasi-governmental bodies) in the broad context of the Japanese model of network capitalism.

The final point is that it is worth scrutinizing whether special access to state regulators in other East Asian countries which share socio-cultural similarities with Japan will contribute to or hinder organizational and market performance.

In sum, although the evidence presented herein has identified that bank performance and strategy are significantly affected by the intensity of amakudari networks, future research should take many steps to increase the reliability of our results. First, future studies need a more extensive dataset. Second, a more refined approach is called for concerning the measurement of the value of amakudari so as to allow more precise estimates of the impact of board interlocks in the state-business relationship on the behavior of firms. Furthermore, future research should answer the question of the effect of amakudari board members' experiences, knowledge and skills on firm performance. Third, a further direction of this study will need to integrate additional variables that affect bank performance. Following prior research in the banking literature, market structure (Goldberg and Rai, 1996), ownership concentration (Iannotta et al., 2007), taxation (Albertazzi and Gambacorta, 2010), and marketing investments (Mullineaux and Pyles, 2010) can be tested in future research. Fourth, it is important to investigate why banks still rely on their informal connections with amakudari bureaucrats despite their negative effects on bank performance as indicated by this study. It might be related to weak corporate governance in Japan. In other words, a market-based corporate governance environment has not been fully transferred in the Japanese business system yet since some traditional institutions may disrupt the process of change. Therefore, future research is needed to further clarify the origins and conditions of amakudari utilization by applying institutional theory. Last but not least, it should be valuable to explore how the representation of former politicians on the board is linked to firm performance. In parallel, it is fruitful to explore what characteristics of a former government official would determine his or her attractiveness as a board director. Fourth, more appropriate data for the risk-taking measures such as Konishi and Yasuda's (2004) risk indicator, measured by the standard deviation of a bank's daily stock returns for each fiscal year, is also required. These aspects are of significant importance to further augment our understanding of the dynamic institutional transformation of Japanese governance system.

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