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OF THE MISGOVERNED FIRM

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Financial Malaise and the Myth of the Misgoverned Firm

By Yoshiro Miwa & J. Mark Ramseyer*

Abstract: For nearly a decade now, the specter of financial malaise has haunted East Asia. It overwhelms the weaker economies. It imperils North America. Persistently, it refuses to retreat.

Yet even as the specter teases entrepreneurs with insolvency, some observers suggest that responsibility might lie with the entrepreneurs themselves. Might not the source of the malaise lie in the very governance structures they created and maintain, particularly in the shareholding and board composition patterns they support? Might not its solution lie in legal reforms that would force them to remake those structures?

To examine these questions, we consider the governance arrangements at the heart of the malaise: in corporate Japan. Theoretically, we find nothing to suggest that the source of the recession lies in issues of corporate governance, and nothing to suggest that the solution lies in corporate law reform. We then assemble data from the banking industry -- one of the sectors most badly struck by the financial crisis. Empirically, we find nothing to suggest that the contested governance structures explain the poor performance of the banks involved.

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As the century opens, we blame the international financial malaise on lax banking regulation. The nearly global ideology of democracy what it is, we blame the government when we have half a chance. Banks handle nothing if not finance, and they do seem in trouble. In the U.S., bad regulatory design arguably drove the S&L fiasco. Within Japan, maybe the same thing ruined the banks.

We blame it on rich managers. The global rhetoric of populism what it is, we blame the rich even without half a chance. The rich are different from us, and at various turns in the last century Americans blamed John D. Rockefeller, Michael Milken, and William Gates. Japanese blamed the Mitsui, Sumitomo, Yasuda, and Iwasaki families. The rich do seem to be wreaking havoc in Russia. Maybe they did the same in Japan.

We blame it on bad “corporate governance,” and in imagining this nightmare we implicate both the spineless regulators and the avaricious rich. Absent well-performing firms, economies will not rebound. Absent good governance, firms will not perform well. And maybe absent stringent regulatory frameworks, greedy managers will install the lackadaisical governance structures that generate the lackluster performance we see today.

Or so the self-styled public intellectuals declare. But is it so? Public intellectuals have been wrong before. Did managers indeed cause the malaise by wheeling and dealing beyond the law? Or did the intellectuals yet again round up their usual suspects?

To explore these issues, we focus on Japan. Arguably, the crisis and recession began there. Arguably, they remain as intractable there as anywhere. Arguably -- at least the blond institutional investors peddling the CalPIRG gospel in Tokyo so claim -- they demand the same solution there that they demand everywhere else.¹

Whatever did cause the international malaise (and we offer no hypothesis), it was not bad corporate governance. Indeed, by standard economic theory it could not have been bad governance, for competitive capital and product markets drive firms to adopt efficient governance mechanisms or die. Without a governance structure that promotes investor returns, a firm faces higher capital costs. Unable to expand as cheaply as its rivals, it faces higher product or service market costs. Eventually, its competitors drive it out of business. In such a world, proposals to improve corporate governance are \$20 bills on sidewalks: either ideas firms have already adopted, or ideas that would fail.

To apply this logic to the current malaise, we first summarize the literature tying the crisis to corporate governance (Section I). We then trace the implications of basic governance theory (bad governance cannot account for the depression; Section II). We ask whether the malaise is systemic or sector-specific (sector-specific, we conclude), and which sectors have suffered most severely. We take data from a major, badly depressed sector (banking) and examine the tie between performance and governance. The results, we find, closely track the basic governance

¹ See Takafusa Kamiya, Shagai torishimariyaku no juyo to kyokyu [The Supply of and Demand for Outside Directors], 1155 *Jurisuto* 129, 130 (1999) (discussing CalPIRG’s Japan program).

theory we introduced earlier (Section III, Appendix). Finally, we ask whether the depression resulted from the deregulation in the financial services industry. No, we answer, and explain why not (Section IV).

I. Governance and the Recession

“The 1990s,” several prominent economists recently observed, “turned out to be a traumatic decade for Japan.” As the “unemployment rate soared,” it became “Japan’s ‘lost decade.’” The trauma had begun in 1990 with the fall in stock and land prices. Prices had been high before, but not -- these economists argued -- because of “economic fundamentals.” Instead, they had been high because of a “classic speculative bubble.”²

When the “bubble” burst, banks that had lent money on the now-depressed real estate found their loans uncollectable. As they lost their funds, firms that relied on them found themselves without access to cash. By 1997, the financial crisis had spread across Asia. Appearing first in Thailand, it soon engulfed South Korea and Indonesia. By the end of the century, it had reached even Russia and Brazil.

Still, a fall in asset prices -- whether a burst bubble or no -- should not cause a ten-year recession. Several observers (we discuss the literature in more detail below) blame the economy’s failure to rebound on bad corporate governance. Typically, they cite the decline of the “main bank system.” Japanese firms, they explain, for years borrowed from many banks but maintained one as their “main bank.”³ That bank lent the most to the firm, and monitored it on behalf of other lenders. As Japan deregulated its capital markets in the 1980s, firms increasingly switched from bank finance to the newly available sources. By so doing they cut their dependence on their main bank. In the process, they reduced both the bank’s access to the information it needed to monitor the firm, and its incentive to do so.

By cutting main bank monitoring, these observers continue, Japan eliminated the one mechanism that might seriously have checked managerial folly and greed. Although managers in U.S. firms answered to shareholders, Japanese managers had long ignored the stock market. Although U.S. managers answered to a corporate control market, Japanese managers faced none. As the “reliance on debt capital [by Japanese firms] has fallen,” predicted management scholar Michael E. Porter in the early 1990s, “main banks will take a diminished role ... as effective monitors of companies The lack of effective monitoring will accentuate existing weaknesses of

² Thomas F. Cargill, Michael M. Hutchison & Takatoshi Ito, *Financial Policy and Central Banking in Japan* 1, 11, 14 (Cambridge: MIT Press, 2000). For skepticism toward bubble-analysis generally, see Peter M. Garber, *Famous First Bubbles: The Fundamentals of Early Manias* (Cambridge: MIT Press, 2000).

³ See generally Masahiko Aoki, Hugh Patrick & Paul Sheard, *The Japanese Main Bank System: An Introductory Overview*, in *The Japanese Main Bank System* 1 (Masahiko Aoki & Hugh Patrick, eds., Oxford: Oxford University Press, 1994); Paul Sheard, *Reciprocal Delegated Monitoring in the Japanese Main Bank System*, 8 *Journal of Japanese & International Economies* 1 (1994); Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 *Journal of Economic Behavior & Organization* 399 (1989). For a critique of this literature, see Yoshiro Miwa & J. Mark Ramseyer, *Nihon keizairon no gokai: “keiretsu” no jubaku kanara no kaiho* [Misunderstandings in the Theory of the Japanese Firm: Liberation from the Spell of the “Keiretsu”] chs. 1, 5 (Tokyo: Toyo keizai shimpo sha, 2001); Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, Harvard Law School John M. Olin Center for Law, Economics & Business, Discussion Paper 333 (2001); Yoshiro Miwa & J. Mark Ramseyer, *Directed Credit? Capital Market Competition in High-Growth Japan*, Harvard Law School John M. Olin Center for Law, Economics & Business, Working Paper 334 (2001).

the Japanese system.”⁴ By the close of the decade, concluded sociologist Bai Gao, “the weak control and monitoring of corporations” in Japan had contributed decisively to the disaster.⁵

II. Governance and Performance

A. Demsetz-Lehn in Theory:

And yet, for reasons economists Harold Demsetz and Kenneth Lehn explained in 1986, this corporate governance talk should leave one troubled. Elsewhere, we discuss why the “main bank system” never existed anywhere but in the academic imagination.⁶ Yet even with a main bank system, firms that maintain underperforming governance arrangements should face higher costs in the capital market. That penalty should in turn raise their product or service market costs. Over time, such firms should not survive.⁷

Demsetz and Lehn made the point in the context of the Berle-Means debate -- were public American firms at a competitive disadvantage because their dispersed ownership patterns allowed managers to shirk undetected?⁸ They argued no, but their logic applies more broadly: given competitive capital markets, firms with ownership or governance structures that do not minimize investor costs will tend to go out of business. In that context, any reforms academics might propose were either reforms firms had already incorporated, or ideas that would not work.

The point is not that firms consciously chose their ownership structure to maximize shareholder returns. Rather, firms that do maximize those returns will raise new capital more cheaply. Over time, such firms will disproportionately tend to survive. In equilibrium, the firms that persist will tend to be those that choose ownership and management structures that increase investor returns.

What is more, because the efficient government structure is specific to a firm, scholars who tie observed firm profitability to governance structures will find no relationship. Recall the logic. Firms with inefficient structures will fail and drop out of the sample. If so, then a firm for which a given structure promotes shareholder returns will tend to persist, while a firm for which the same structure generates losses will tend to disappear. Although a particular structure may well lower shareholder returns at most firms, that point will not appear in the data since only the firms at which it increases returns will tend to survive.

Despite occasional debates about its empirical implications, the logic behind the Demsetz-Lehn hypothesis remains unchallenged.⁹ Recently, empiricists have confirmed its application to

⁴ [Comments], in Mitsuhiro Fukao, *Financial Integration, Corporate Governance, and the Performance of Multinational Companies* 92, 94 (Washington, D.C.: Brookings Institution, 1995).

⁵ Bai Gao, *Japan’s Economic Dilemma: The Institutional Origins of Prosperity and Stagnation* 19 (Cambridge: Cambridge University Press, 2001).

⁶ Miwa & Ramseyer, *supra* note (Myth).

⁷ Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership*, 93 *Journal of Political Economy* 1155 (1985); see generally Yoshiro Miwa, *Corporate Social Responsibility: Dangerous and Harmful, Though Maybe Not Irrelevant*, 84 *Cornell L. Rev.* 1227, 1229 (1999).

⁸ Adolph Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1932).

⁹ Among the articles contesting the empirics are: Randall Morck, Andrei Shleifer & Robert W. Vishny, *Management Ownership and Market Valuation: An Empirical Analysis*, xx *J. Fin. Econ.* 293 (1988); Randall Morck, Masao Nakamura & Anil Shivdasani, *Banks, Ownership Structure, and Firm Value in Japan*, 73 *J. Bus.* 539 (2000); John J. McConnell & Henri Servaes, *Additional Evidence on Equity Ownership and Corporate Value*, 27 *J. Fin. Econ.*

the U.S.¹⁰ In a related article, we do the same with Japan. Toward that end, we ask how firms responded to the late 1940s zaibatsu dissolution program -- an exogenous shock to the pre-war ownership equilibrium. Almost immediately, the firms subject to the dissolution began reconcentrating their ownership. A year after the close of the occupation (1953), they had not yet completed the process, and firms with dispersed shareholdings still earned lower profits than their peers. By 1958, the equilibrating process was largely complete. The formerly zaibatsu firms had reconcentrated their ownership (though at different levels than twenty years earlier), and the observable correlation between ownership concentration and profitability had vanished.¹¹

B. Demsetz-Lehn Applied:

1. Cross-shareholdings.-- (a) Generally. For most proposals to “improve” Japanese governance, the Demsetz-Lehn hypothesis poses devastating implications. According to a variety of writers, the desultory Japanese economic performance reflects the nefarious effect of widespread cross-shareholding arrangements. Suppose, however, that these arrangements cut shareholder returns at a given class of firms. Those firms should incur a penalty on the capital market when they try to raise funds. Suffering when they need to expand, over time they should “wither away.” If the cross-shareholdings impose a net cost on the constituent firm shareholders, firms with the arrangements should tend to disappear.

In fact, the cross-shareholding arrangements are not disappearing, for there were no arrangements to vanish. Take the principal roster of Japanese corporate groupings from their putative heyday in 1965.¹² Among the Sumitomo keiretsu of 48 non-financial firms, only eleven pairs of firms had at least a one percent stake in each other; among the Mitsui keiretsu of 48 firms, only six pairs did; among the Sanwa keiretsu of 36 firms, only six pairs; among the Mitsubishi keiretsu of 46 firms, only four; among the Fuji keiretsu of 45 firms, only three; and among the Daiichi keiretsu of 29 firms, only 2 pairs. Cross-shareholding in Japan was a myth from the start.¹³

Between the financial and non-financial firms, more cross-holdings exist -- but not because anyone tried to exchange the shares. Given that Japanese banks can legally hold stock (unlike banks in the U.S.),¹⁴ prudent banks will diversify their assets into a broad equity portfolio. Given that the standard keiretsu roster selects group members from among (*inter alia*) a bank’s principal borrowers,¹⁵ banks will have the best information about those firms that the roster lists as group

595 (1990); Holderness, Randall Kroszner & Sheehan, Changes in Managerial Stock Ownership since the Great Depression, 54 J. Fin. 435 (1999).

¹⁰ Myeong-Hyeon Cho, Ownership Structure, Investment, and the Corporate Value: An Empirical Analysis, 43 J. Fin. Econ. 103 (1998); Benjamin E. Hermalin & Michael S. Weisbach, The Effects of Board Composition and Direct Incentives on Firm Performance, 20 Fin. Mgt. 101 (1991); Charles P. Himmelberg, R. Glenn Hubbard & Darius Palia, Understanding the Determinants of Managerial Ownership and the Link Between Ownership and Performance, 53 J. Fin. Econ. 353 (1999).

¹¹ Yoshiro Miwa & J. Mark Ramseyer, Does Ownership Matter: Evidence from the Zaibatsu Dissolution Program, University of Tokyo Faculty of Economics, Discussion Paper CIRJE-F-105 (Feb. 2001).

¹² Keizai chosa kai, ed. Keiretsu no kenkyu [Research on the Keiretsu] (Tokyo: Keizai chosa kai, various years).

¹³ See generally Yoshiro Miwa & J. Mark Ramseyer, The Fable of the Keiretsu, J. Econ. & Mgmt Strat. (forthcoming 2001); Miwa & Ramseyer, supra note (Nihon keizai ron), at ch. 3.

¹⁴ The Glass-Steagall Act, Act of June 16, 1933, ch. 89, 48 Stat. 162, codified in scattered sections of 12 U.S.C.

¹⁵ See Miwa & Ramseyer, supra note (JEMS).

members. If they invest in ways that economize on information costs, they will tend to buy stock in those members. And if the borrowers in turn occasionally invest in their banks, cross-holdings will ensue. Crucially, they will not ensue because anyone tried to insulate his firm from stock market pressure. They will ensue because firms prudently and efficiently diversified investments.¹⁶

2. Outside directors. -- (a) Generally. Stock-exchange-listed Japanese firms seldom have outside directors. Instead, they choose their directors from their senior managerial ranks, from their customers or suppliers (like banks), or from the government. Might the absence of genuine outsiders generate bad governance? So, again, do argue journalists, academics, politicians, and institutional investors. As of this writing, by spring 2002 reformers planned to require by statute all large firms to install outside directors.¹⁷

The ostensible logic behind the proposal resembles the logic behind its U.S. equivalents. Insiders will not scrutinize the actions their golfing buddies take, the story goes. Instead, they will help them shunt firm perquisites to themselves.¹⁸

Alas, the reformist agenda again miss the logic of competitive capital markets.¹⁹ Firms that insiders manipulate for private gain will earn investors less money. Systematically delivering a lower return, they will suffer on the capital market and find that the funds to operate or expand come at a higher price. Facing higher capital costs, over time they will tend to disappear. In equilibrium, only firms that deliver competitive returns will endure.

Remember, outside directors do not just bring benefits. They come at a cost, for generally they know little about firm dynamics. They may be independent of everyone at the firm, but only because they know nothing about them. For exactly that reason, U.S. firms long retained few outsiders.

(b) Outside directors and derivative suits. Although U.S. firms have more outside directors now, they did not hire them to improve their governance. If it were only to improve governance, capital market pressure would have induced them to hire the outsiders decades ago. Instead, in their eagerness only recently to hire outsiders they reflect the receptivity U.S. judges now show toward derivative litigation. As corporate law scholar Roberta Romano explained, virtually all these suits involve extortionate claims that generate attorney fees but no shareholder returns.²⁰ For firms facing such claims, outside directors offer substantial benefits: by routing potential conflicts of interest through a committee of nominally independent outsiders, the firms can insulate themselves from virtually all duty of loyalty claims. For such firms (which is to say, for almost all listed firms), outside directors offer cheap insurance against the plaintiffs' securities bar.

¹⁶ Many observers cite cross-holdings in the mid-70% range. These are not the figures for cross-shareholdings, but rather for corporate shareholdings more generally.

¹⁷ Takayasu Kamiya, *Kokai kaisha no kikan* [The Mechanisms of the Public Corporation], 251 *Hogaku kyoshitsu* 69, 69 (2001).

¹⁸ In fact, the reformers profer a more mottley set of reasons: e.g., that outside directors will increase managerial efficiency and corporate social responsibility as well. See Kamiya, *supra* note, at 69 (discussing draft bill).

¹⁹ I.e., the logic behind Demsetz-Lehn. It also misses the more general logic against mandatory corporate law terms, articulated most forcefully in Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press, .

²⁰ Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 *J. Law, Econ. & Org.* 55 (1991).

Until recently, Japanese law imposed on derivative claimants a formidable set of costs, and virtually no shareholders filed suit.²¹ Over the past few years, courts and legislators have begun to dismantle those burdens.²² Even if the scheduled 2002 bill to require outside directors does not pass, firms may well start hiring outsiders anyway. They would not be hiring them because outsiders improved management. They would be hiring them because outsiders helped insulate them from fraudulent derivative litigation.

(c) Retired bureaucrats. Scholars offer cross-cutting theories about bureaucrats-turned-directors. On the one hand, several argue that the retired bureaucrats retain their loyalty to the government and help it monitor the banks (or other firms) to which they retired.²³ Because the bureaucrats earn no (present or future) compensation from the government, this reverses their incentives.

On the other hand, economists Akiyoshi Horiuchi and Katsutoshi Shimizu suggest that banks hire retired bureaucrats to buy regulatory largess.²⁴ Perhaps, they write, the firms hire them to keep someone on staff who can negotiate regulatory favors.²⁵ To test this hypothesis, they collect data on over 120 regional banks from 1985 to 1989.²⁶ They then regress the log of the firms' bad loan ratio in 1996 on the presence of a retired Ministry of Finance (MoF) or Bank of Japan (BoJ) bureaucrat. The presence of an ex-MoF bureaucrat during the 1980s was indeed associated with a higher fraction of bad loans in 1996, they find. The practice of taking retired bureaucrats constituted, they conclude, "implicit collusion to enable banks to expand risk-taking activities."²⁷

"Corrupt" as public intellectuals may consider all this, for shareholders it potentially represents corporate governance as it should be. If retired bureaucrats perform as Horiuchi and Shimizu suggest, then their presence on a board may indeed reduce regulatory compliance. It will also, however, boost shareholder returns.

²¹ Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 *Nw. U. L. Rev.* 1436 (1994).

²² Mark D. West, *Why Shareholders Sue: The Evidence from Japan*, 30 *J. Legal Stud.* 351 (2001).

²³ *E.g.*, Masahiko Aoki, Hugh Patrick & Paul Sheard, *The Japanese Main Bank System: An Introductory Overview*, in Masahiko Aoki & Hugh Patrick, eds., *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies* 3, 31 (Oxford: Oxford University Press, 1994): "When a bank is judged to be poorly managed and to need drastic organizational and asset restructuring, typically the MOF arranges for a retired high-ranking MOF bureaucrat to enter as a director" However, continue Aoki-Patrick-Sheard, the "flow of personnel is not limited to the trouble-shooting cases." Instead, "[h]ealthy banks are willing to accept ex-bureaucrats for various reasons, including as a means of gaining access to valuable information from, and to exert influence on, the regulatory authorities." *Id.*, at 32.

²⁴ *Did Amakudari Undermine the Effectiveness of Regulator Monitoring in Japan?*, 25 *J. Banking & Finance* 573 (2001).

²⁵ This also explains why the private firms would hire these ex-bureaucrats, a point made more informally in J. Mark Ramseyer & Frances M. Rosenbluth, *Japan's Political Marketplace* 111-19 (Cambridge: Harvard University Press, 1993).

²⁶ Apparently, to the regular regional banks, they add the so-called "type-two regional banks" -- successors to the pre-war mutual credit lotteries known as mujiin. Because of the sample heterogeneity that this causes, we focus only on regular regional banks.

²⁷ Horiuchi & Shimizu, *supra* note, at 590.

3. Financial disclosure. -- Many observers argue that the lackluster Japanese performance follows from the lenient financial disclosure rules. Since the post-war occupation, Japanese law has imposed costly disclosure requirements analogous to the 1933 Securities Act.²⁸ According to the reformists, though, on several counts the Japanese rules are less onerous than their U.S. analogues. Perhaps that is true, perhaps not. We have not tried to gauge the relative stringency of the securities disclosure rules in the two countries.

Yet the reformers assert that because of the lax Japanese disclosure rules, investors cannot monitor the firms, and the firms find it harder to raise funds.²⁹ Disclosure is the currency of governance, and governance the means to investment. Absent disclosure governance will not function, and absent governance investors will not part with their funds.

Unfortunately, the reformers again miss the logic of competitive securities markets (in this case, a logic classically explained by George J. Stigler).³⁰ To investors, disclosure brings benefits: information they want to know. They can either acquire the information individually, or invest in a firm that produces the information for everyone. If a firm collects, assembles, and disseminates it, shareholders incur costs. As a result, whether a firm produces the information itself or its investors do so privately, investors foot the bill. If either the production of the information entails scale economies or the information is a firm-specific public good, they gain by having the firm produce the information collectively. If not, then public disclosure yields no net benefits.

With information, more is not necessarily better than less.³¹ Even if the production of information involves scale economies or public goods, investors will not want all information. They will want only cost-justified information. Beyond that point, they suffer a net loss from any additional information.

Given these principles, the optimal level of disclosure is that level generated in competitive securities markets.³² In such markets, firms that disclose information up to but only up to the cost-justified level incur the lowest capital market costs. They produce and expand most cheaply. By contrast, firms that produce either too much information or too little suffer a capital market hit. They eventually change their strategy or go out of business. By this logic, when the law mandates disclosure beyond the level firms produce voluntarily, it necessarily mandates information that investors value less than the the cost to the firm of disclosing it. Otherwise, after all, the firm would have disclosed the information voluntarily to attract them.

What then do we make of reformist claims that disclosure in Japan is too low? Nothing. Maybe the optimal level of disclosure in the U.S. is higher than in Japan. Maybe the disclosure levels do not differ in fact. More likely, maybe the U.S. accounting and legal cartels controlling

²⁸ 15 U.S.C. §§ 77a, *et seq.*

²⁹ Mark D. West even uses the lack of disclosure to explain how and why gangsters commandeer shareholder meetings in Japan. Information, Institutions, and Extortion in Japan and the United States: Making Sense of *Sokaiya* Racketeers, 93 Nw. U. L. Rev. 767 (1999).

³⁰ Public Regulation of the Securities Markets, 37 J. Bus. 117 (1964).

³¹ For expositional simplicity, we focus exclusively on the costs associated with simple disclosure. We ignore here the many costs associated with regulating and mandating disclosure -- costs such as shifts in the type of information disclosed, the disclosure of information benefiting competitors but not shareholders, or the reduced informativeness of the information in a heavily regulated environment caused by fears of liability.

³² All this holds even when the information is unfavorable. If a firm refuses to produce information that investors would ordinarily value, investors will presume the worst -- and their competitors will encourage them to adopt that presumption. To avoid their adopting that presumption, firms will produce even information that is negative.

the securities registration process enjoy more political clout than their Japanese counterparts. The bar generally is less powerful in the U.S. than in Japan,³³ but the securities sub-bars could well be otherwise. To generate rents for themselves, maybe U.S. lawyers and accountants demanded disclosure requirements beyond the levels that benefit their clients.

Then again, maybe any differences reflect relative political clout within the securities industry. Lower-tier securities analysts everywhere probably prefer more disclosure to less. Because investors bear the cost of the disclosure, mandatory disclosure lowers the informational advantage sophisticated analysts can offer. If lower-tier analysts have less political power in Japan than in the U.S., that too could generate more lax disclosure rules in Japan.

4. Objections. -- (a) Mutual insurers. Surely, many readers will claim, such a corrosively stock-market-based theory cannot apply to mutuals. Yet mutual life-insurance firms are prominent among bank shareholders, they observe. If mutuals control the banks but do not maximize profits, then neither should the banks.³⁴

Unfortunately, this observation misses the product market incentives that mutuals face. At any given level of contractual benefit, consumers choose from among life insurance contracts by price. A mutual insurance firm can offer a given level of benefits at a competitive price only if it effectively invests the premiums it receives. If it systematically buys under-performing stock, it will earn a lower return than a firm that invests in market-performing stock. Over time, the former will offer less attractive prices than the latter. Over time, competition in the insurance product market will tend to drive the former out of business.

(b) Government guarantees. That the government guaranteed deposits and allegedly promised to rescue troubled banks affects none of this. In the late 1980s, it insured deposits of up to 10 million yen per depositor.³⁵ Simultaneously, claim many observers, it informally promised not to let banks fail. One might wonder about the latter, as it did let them fail once it faced hard times in the 1990s. Nonetheless, law professors Curtis J. Milhaupt and Geoffrey P. Miller accurately capture the received wisdom when they characterize Japanese banking regulation “as a ‘convoy’ system of regulation” in which “the group is allowed to move no faster than its slowest members,” and the government focuses on “the avoidance of failure by financial institutions.”³⁶ As game theorist Masahiko Aoki put it, “the expectation that the government is responsible for the control of financially distressed banks, either through bailing-out or an arrangement of acquisition by healthier banks, was generally shared and taken for granted.”³⁷

According to economists Masaharu Hanazaki and Akiyoshi Horiuchi, these government guarantees eviscerated corporate governance. The deposit insurance and promised rescues

³³ J. Mark Ramseyer, *Lawyers, Foreign Lawyers, and Lawyer-Substitutes: The Market for Regulation in Japan*, 27 *Harv. Int'l L.J.* 499 (1986).

³⁴ See generally, *e.g.*, Masaharu Hanazaki & Akiyoshi Horiuchi, *A Vacuum of Governance in the Japanese Bank Management*. University of Tokyo Faculty of Economics Discussion Paper CIRJE-F-29 (Dec. 1998), at 8-10.

³⁵ Nihon ginko kin'yu kenkyu jo, ed., *Shimpan: waga kuni no kin'yu seido* [New Edition: Our Country's Financial System] 124 (Tokyo: Nihon ginko, 1995).

³⁶ *Cooperation, Conflict and Convergence in Japanese Finance: Evidence from the “Jusen” Problem*, 29 *Law & Pol'y Int'l Bus.* 1, 8 (1997).

³⁷ *Information, Corporate Governance, and Institutional Diversity: Competitiveness in Japan, the USA, and the Transitional Economies* 150 (Oxford: Oxford University Press, 2000).

“deprived investors,” they write, “of incentives to monitor the performance of individual banks.” In the process, they “hindered the development of market mechanisms to discipline bank management.”³⁸

In truth, the policies did nothing of the sort. To be sure, they raised the possibility -- indeed probability -- of moral hazard. If times were good the shareholders made money, but if times were bad the government paid the bill. Under such conditions, shareholders obviously had an incentive to increase risk. Crucially, they did not have any lesser incentives to monitor the firm. Although the government changed the risk level that maximized firm profits, it did not reduce their incentive to ensure that managers selected that (now higher) optimal risk level. Neither did it reduce their incentive to ensure that managers took other profit-maximizing steps.

(c) Competitive restraints. Nor is any of this changed by the restrictions on competition. Again, Hanazaki and Horiuchi speak for many scholars when they cite the “interest rate controls and restrictions on new entry into banking,”³⁹ and suggest these restraints weakened bank governance. However faithfully they capture the standard wisdom, they again mischaracterize the industry itself.

First, the loan interest rate controls did not bind. In recent research, we investigate the effect that these rate ceilings had. Even in the 1970s, they did not constrain.⁴⁰ From time to time, observers have suggested that banks circumvented the controls by requiring debtors to maintain low-interest deposits at the bank. If true, the ploy could have ratcheted up the effective interest rates. In fact, the loan interest rate caps were so porous that banks rarely demanded them. Even without the “compensating balances,” they charged market-clearing rates.

Second, the entry restrictions did not shape competition. As of the early 1990s, Japanese firms chose from among 140-plus banks.⁴¹ With that many rivals, the industry was competitive, new entrants or no. To be sure, only the three long-term credit banks (and a few other financial institutions) could issue debentures and only the seven trust banks could serve as trustees on any trusts their clients wanted. Otherwise, the market was largely open to all -- hardly what law professors Curtis J. Milhaupt and Geoffrey P. Miller characterize as “extreme compartmentalization.”⁴² In any case, money is nothing if not arbitrable. Given the possibility of arbitrage, even harsher regulations than this would have had little effect.

(d) The corporate control market. And none of this hinges on any “corporate control market.” Nearly four decades ago, Henry G. Manne tied the market for corporate control to

³⁸ Hanazaki & Horiuchi, *supra* note, at 15-16.

³⁹ Hanazaki & Horiuchi, *supra* note, at 19.

⁴⁰ Directed Credit?: Capital Market Competition in High Growth Japan, Harvard Law School John M. Olin Center for Law, Business & Economics, Working Paper (2001).

⁴¹ As of March 1993, there were 11 “city” (money-center) banks, 64 regional banks, 66 “type-2” regional banks, 3 long-term credit banks, and 7 trust banks. There were no legal distinctions among the first three of these categories. In addition, there were a wide variety of other financial institutions. See generally Hiroshi Kusumoto, ed., *Nihon no kin'yu gyosei, kancho, kin'yu kikan*, [Japanese Financial Administration, Bureaucracy, and institutions] (Tokyo: Toyo keizai shimpo sha, 1994).

⁴² Cooperation, Conflict, and Convergence in Japanese Finance: Evidence from the “Jusen” Problem, 29 *Law & Pol'y Int'l Bus.* 1, 6 (1997). Regional banks may have “specialize[d] in local lending to small business,” *id.* at 7, but (other than the effects of the ministry’s approval process for branches), this specialization was not regulatorily driven.

efficient managerial incentives.⁴³ Ever since, many legal (and occasionally economic) academics have suggested that without a thriving takeover market managers will indulge their greed and indolence. Eyeing few hostile acquisitions in Japan, they posit inefficient governance. Only with the help of their “main bank,” they explain, do shareholders keep their managers in check. Only in the “main bank,” as Paul Sheard famously put it, does Japan have a “substitute mechanism for [the] ‘missing’ takeover market.”⁴⁴

Help as the prospect of a takeover may to constrain managers, firm efficiency does not hinge on it. The takeover is not a prerequisite to efficient management. Instead, it is one mechanism among several by which market competition moves assets to their most productive use. In an academic environment that castigated takeovers as wasteful and irresponsible, Manne explained how they could facilitate productive efficiency. He did not posit rampant agency slack without them.

Takeovers or no, a firm sells good products cheap or -- eventually -- dies. To make those products it needs capital, and to raise the capital it needs to convince investors to part with their money. Whether as debt or as equity, however, investors will invest only if it promises them a market return. Absent efficient governance, it will find that promise hard to keep.

In any case, the Japanese government never imposed high costs on tender offers anyway. Until 1971, it regulated them not at all. Since then, it has merely imposed on acquirers a framework modeled on the Williams Act. Although the framework does raise the cost of an acquisition, it raises it little -- if any -- more than the Williams Act itself.⁴⁵ The point is crucial, because the incentive effect of the corporate control market does not hinge on the number of takeovers (if most firms are well-managed, after all, there will be few takeovers even in an unregulated market -- simply because there will be few plausible targets). It hinges only on the potential for takeovers. Sans regulatory interference, that potential will remain high.

In crucial ways, moreover, hostile takeovers and friendly mergers are substitutes, and there have always been plenty of mergers in Japan.⁴⁶ In the former, a would-be acquirer obtains the target shares by paying target shareholders a premium. In the latter, it does so by bribing target managers to deliver the firm. The bribe is a fiduciary duty breach, to be sure. Disguised as a consulting agreement or other high-salary low-work contract, it is also unpoliceable. Suppose an acquirer could more efficiently run a firm than its incumbent managers. Whether it offers the target shareholders a premium or those senior managers a consulting contract, it will obtain the firm. Either way, the target’s assets will move to the entrepreneurs who can most efficiently exploit them.⁴⁷

⁴³ Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965).

⁴⁴ Paul Sheard, The Main Bank System and Corporate Monitoring and Control in Japan, 11 J. Econ. Beh. & Org. 399, 407 (1989); see M. Aoki, *supra* note, at 64: “the neoclassical market for corporate control was eliminated as a prevailing system in Japan. What took its place was stable shockholding by corporate stockholders centered around a main bank.”

⁴⁵ J. Mark Ramseyer, Takeovers in Japan: Opportunism, Ideology and Corporate Control, 35 UCLA L. Rev. 1 (1987).

⁴⁶ Ramseyer, *supra* note (-1).

⁴⁷ Modelled on the 1933 Illinois Business Corporations Act, the Japanese corporations code imposes no particularly onerous costs on mergers. See Minoru Nakazato & J. Mark Ramseyer, Japanese Law: An Economic Approach ch. 5 (Chicago: University of Chicago Press, 1999).

III. The Recession

A. Pervasive or Sectoral?

Speculative bubble or new information -- we will not guess what caused real estate prices to climb so precipitously in Japan in the late 1980s and fall disastrously a few years later.⁴⁸ Perhaps investors tried to play a bubble. Perhaps they updated their information about future rental streams. Perhaps some investors did one, some the other, and some a bit of both. What matters for our purposes is that prices rose, and then fell. At the six largest cities (with prices indexed at 100 for March 1990), they rose from 24.5 in March 1980 to 33.6 in March 1995. After hitting 100 in March 1990, they fell to 54.7 by March 1995. The fluctuation was particularly pronounced for commercial real estate: from 16.7 in 1980 to 25.6 by 1985, 100 in 1990, and then to 41.7 by 1995.⁴⁹

Within the real-estate industry, this fluctuation caused massive losses. Obviously, those who bought high and sold low lost money, but the loss was a simple transfer: assets moved to those who had sold high. More inefficient were the projects driven by future projections. On the basis of high expected rentals, contractors and developers (they at least seem not to have thought the prices a bubble) began golf courses, houses, office towers. When expected future demand fell, many of them found their finished projects unmarketable and their unfinished ones not worth completing. For the economy, they generated a dead-weight loss.

Not only did developers and construction firms lose when the demand for real estate fell, so did those who lent them the money they lost. Particularly when they borrowed nonrecourse by pledging the real estate, the firms could walk away from the loan. Effectively, they forced a sale to their creditors. Those creditors then lost additional funds when -- after the price collapse -- they lent extra money to try to help the debtors recover.

GNP did grow during the 1990s, even if at a slow pace,⁵⁰ and other than the firms that either bought real estate or lent to those that did, many firms remain healthy at the core. To see this, first take indexed stock prices for Tokyo-Stock-Exchange-listed firms (we follow the Tokyo Stock Exchange's classification of firms by industry; note that anomalies occasionally arise through changes in the classification scheme). The effect of the real estate collapse appears directly. Among the ten sectors with the lowest share prices relative to 1986, four were involved directly in real estate (agriculture, mining, real estate, and construction), and two more invested heavily in firms did (securities and banking).

By contrast, the firms whose stock prices rose fastest since 1986 included firms in several of the sectors most central to the Japanese economy. Stock prices in the automobile (transportation equipment) industry, for example, rose 86 percent between 1986 and 1998 (tire manufacturers catalogued under "rubber" grew even more rapidly). Machinery, pharmaceuticals, and electrical products posted less dramatic results (9 percent, 16 percent, and 18 percent), but still showed growth. Economists Fumio Hayashi and Edward Prescott find no evidence that firms were unable

⁴⁸ On this question, see, *e.g.*, Robert S. Chirinko & Huntley Schaller, *Business Fixed Investment and "Bubbles": The Japanese Case*, 91 *Am. Econ. Rev.* 663 (2001); Kazuo Ueda, *Are Japanese Stock Prices Too High?*, 4 *J. Japanese & Int'l Eco.* 351 (1990).

⁴⁹ *Nihon fudosan kenkyu jo*, ed., *Shigai chikakaku shisu* [Price Indexes for Metropolitan Real Estate] (Tokyo: Nihon fudosan kenkyu jo, 1998).

⁵⁰ Fumio Hayashi & Edward C. Prescott, *The 1990s in Japan: A Lost Decade* (Unpublished, 2001) (0.5% annual GNP growth, 1991-2000).

to exploit profitable investment opportunities because of a credit crunch.⁵¹ All this hardly shows a boom, but neither does it suggest an economy facing a governance crisis.

⁵¹ Id.

**Table 1: Stock Prices and Market Capitalization,
1998 relative to 1986**

Industries	Stock Price	Market Capitalization	
	98/86 (%)	98/86 (%)	1998 .
Securities	37	*	3616
Communication	50	*	16229
Air transp	52	42	1149
Agriculture	53	62	244
Mining	53	51	279
Real Estate	54	47	2835
Petroleum ref'g	56	54	1647
Construction	58	61	7185
Textiles & app	66	73	3691
Banks	70	*	32979
Glass & cement	71	72	3300
Gas & elec. util.	71	53	14152
Marine transport.	75	74	863
Nonferrous metals	77	68	2984
Wholesale	77	*	7814
Warehousing	80	82	660
Foods	85	107	9376
Metal Products	85	110	1830
Pulp & paper	86	97	1666
Chemicals	89	*	13810
Iron & steel	90	84	4056
Insurance	91	*	4804
Land transport.	98	128	12066
Misc. services	104	271	7879
Misc. finance	105	*	6519
Machinery	109	148	9491
Retail	112	*	15002
Pharmaceuticals	116	*	12804
Electrical prod	118	122	40275
Misc. manuf.	121	146	6792
Precision instr.	130	80	2457
Transp. equip.	186	176	24039
Rubber	265	262	2688

Note: Weighted average of 1998 stock price relative to 1986 stock price (in %), followed by 1998 market capitalization relative to 1986 market capitalization (in %), followed by 1998 market capitalization (in billion yen).

* Entry omitted either because the data are not available, or because they are potentially misleading due, for example, to changes in TSE classifications (e.g., by 1998 the TSE had split Chemicals into Chemicals and Pharmaceuticals) or to major changes in the firms included (e.g., the listing of the former national telephone monopoly NTT in Communication).

Sources: Tokyo shoken torihiki jo, Shoken tokei nempo [Securities Statistics Annual] (Tokyo: Tokyo shoken torihiki jo, various years).

B. Corporate Governance in Banking:

1. Introduction. -- If basic economic theory suggests that the roots of the crisis lie not in issues of governance, consider data from the banking industry, one of the most severely troubled sectors and the largest among the 10 sectors doing the worst by Table 1. Coupling data on corporate performance with those on corporate governance, ask whether the proposed governance changes would likely improve economic outcomes.

We describe our data, variables, and econometric estimates in more detail in the Appendix. As explained there, we take financial data on 56 regional banks from 1977 to 1995 and explore the effect of a wide variety of governance variables on bank performance.

2. Geography. -- The tests confirm the decisive effect of the real estate market. According to our regressions, metropolitan banks did well in the 1980s and poorly in the 1990s: in the early 1980s, banks headquartered in the greater Tokyo and Nagoya areas earned higher returns; in the early 1990s, those headquartered in Osaka earned lower returns, and those in Tokyo suffered a greater fraction of bad loans. Crucially, the price of metropolitan real estate rose more dramatically than rural real estate in the 1980s, and fell more dramatically in the 1990s. Because the metropolitan banks loaned to borrowers who invested in urban real estate, they did better than rural banks in the 1980s and worse in the 1990s.

3. Cross-shareholdings. -- Suppose, as reformers routinely argue, that Japanese managers exchange blocks of stock with business partners to evade the pressure of the capital market. If so, then firms with large portions of stock held by lead shareholders should earn lower returns than their rivals.

In fact, firms with large block shareholders do not underperform. Consistently, the percentage of stock held by the top ten shareholders has no significant effect on shareholder returns. Although theorists continue to debate whether block shareholdings improve firm performance, we note here that the effect probably varies by industry, by market, by personalities. Demsetz and Lehn suggest that firms will choose the shareholding structure that maximizes their expected performance. If so, then the observed relation between shareholding patterns and firm performance will be insignificant. Such is what we observe.

4. Financial shareholders. -- Reformers also argue that financial institutions hurt bank performance when they buy bank stock. Fundamentally, they claim that these institutions do not themselves maximize profits. If they hold bank stock, neither will they pressure those banks to maximize. Following the Demsetz-Lehn hypothesis, we suggest instead that the effect will vary by firm, and that the firms that tend to survive will be those that approach their firm-specific optimal level of financial shareholding. If so, then the level of financial-institution shareholding should have no observable effect on shareholder returns. Again, such is what we observe.

5. Outside directors. -- Reformers write that Japanese firms could substantially improve their performance by adding outsiders to their boards. Yet if many firms are selecting sub-optimal numbers of outside directors, then those with more outsider directors should outperform those with fewer. By contrast, we reason that firms that could profit from outside directors will already have hired them. Since firms earn a competitive return or eventually die, those with more outsiders on their boards should do no better than those with fewer.

Once more, so the data suggest. Whether in the 1980s or 1990s, banks with more outside directors do no better than those with fewer. If outsiders promoted the “social responsibility” that reformists so cherish, one might have thought they would prevent moral hazard. Not so. As of 1996, banks with more outside directors had no smaller a fraction of bad loans than the others.

6. Retired bureaucrats. -- Horiuchi and Shimizu claim that by hiring retired MoF bureaucrats (they find no effect with BoJ bureaucrats) Japanese banks bought regulatory forbearance. In effect, through these officials they could negotiate their way out of unpleasant regulatory predicaments. Accordingly, firms with retired bureaucrats were more likely to raise the risk level of their portfolios, and exploit the government’s deposit insurance and rescue commitment.

Horiuchi and Shimizu do not suggest that banks without retired bureaucrats could have improved their performance by hiring them, and rightly so. Like other facets of corporate governance, this too is endogenous. Firms should hire retired bureaucrats when retired bureaucrats improve expected performance, and do without them when they would not. In equilibrium, those with retired bureaucrats will then earn shareholders returns no higher than those without. Our results again confirm this logic: like Horiuchi and Shimizu, we find that banks with retired bureaucrats earn no more than those without.

Yet where Horiuchi and Shimizu argue that banks with retired MoF officials had a larger fraction of bad loans in their 1996 portfolios, we find no such results. Instead, we find that the presence of retired bureaucrats at a bank had no significant effect on its loan portfolio. If ex-bureaucrats facilitated moral hazard, it does not appear in our data.

IV. The Significance of Deregulation

A. Introduction:

This debate poses implications not just for corporate law reform, but for regulation and deregulation more generally. For if some scholars see the source of the current financial malaise in corporate governance, some also see its genesis in the 1980s deregulation of financial services. According to these scholars, it was through that deregulation that Japanese firms came to raise funds through avenues outside banks.⁵² As they did, either managers escaped the disciplining effect of “main bank monitoring” and then failed (a theory we summarize in Subsection B, below), or banks turned to riskier borrowers who then failed (Subsection C, below). By either hypothesis, the political implications are obvious: increased competition need not create a healthy economy; deregulate without the appropriate governance-related infrastructure and disaster can strike even the healthiest economy.

B. Aoki:

Game theorist Masahiko Aoki ties the current malaise to a deregulation-induced decline in “main-bank monitoring.”⁵³ As Japan loosened bond-market restrictions, he argues, firms became “less reliant on bank loans and [were] freed from the bank’s implicit and explicit intervention.”⁵⁴

⁵² In Miwa & Ramseyer, supra note (Directed Credit), we explain how this exaggerates the unavailability of non-bank funds during the period before deregulation. See also Miwa & Ramseyer, supra note (Nihon keizai ron), at chs. 1, 5, 6.

⁵³ Directly, albeit more tentatively than we present in the abbreviated summary here.

⁵⁴ Aoki, supra note, at 91.

Increasingly, they raised their funds directly on the capital market and diversified their remaining bank debt among multiple banks. In the process, they “diminished the flow of information from firms to main banks, and consequently diminished the bank’s ability to perform interim monitoring.” Ultimately, “a vacuum in the external discipline over Japanese firms” resulted. Banks could no longer keep managers in line, and newly freed managers made risky bets that went bad.⁵⁵

Others echo the hypothesis. Economic historian Hideaki Miyajima, for example, claims in a recent study:⁵⁶

[D]uring the bubble economy period corporate governance ... was characterized by a conspicuous decline in main bank monitoring In the absence of a market-based system of control such as that found in the United States, Japan was left without an effective system for monitoring and disciplining the top managements of large Japanese firms.

Similarly, Gao asserts that the 1980s liberalization, coupled with the lingering effects of the 1970s recession, led to a changed relation between banks and firms such that “the banks’ monitoring of big corporations deteriorated further. Having lost their leverage over big corporations, banks could not monitor them closely even had they wanted to do so.”⁵⁷

Unfortunately for this hypothesis, the firms that failed in the 1990s were rarely firms that had turned to the bond market. Indeed, if bond-market firms had been the ones to fail rather than bank-loan firms, Japan would not have the banking-sector crisis it does. The firms that could sell bonds in the 1980s were the blue-chip firms, and what were blue-chip firms then largely remain solvent today. The firms that defaulted in the early 1990s were instead those tied to real estate: developers, contractors, and construction firms. Generally smaller and often unlisted, most of them would have been unable to tap the bond market if they had tried.⁵⁸

C. Hoshi-Kashyap:

Economists Takeo Hoshi and Anil Kashyap similarly argue that the malaise traces its roots to deregulation, but not to a failure in main-bank monitoring. Rather, they reason that the deregulation caused a shift in bank-loan strategy. According to them, deregulation enabled blue-chip firms to raise disintermediated funds; these firms increasingly abandoned banks; and banks responded by turning to riskier firms that then failed. “[B]etween 1983 and 1989,” they explain, “the Japanese bond market blossomed, permitting many internationally known companies to tap the public debt markets for the first time.” As a result, the banks “lost many of their borrowers in a very short period of time.”⁵⁹ “[T]he bank mortgage lending business became more attractive,” explain Milhaupt and Miller, “when banks began to lose corporate finance business to the capital

⁵⁵ Aoki, supra note, at 91, 98.

⁵⁶ Hideaki Miyajima, “The Impact of Deregulation on Corporate Governance and Finance,” in Lonny E. Carlile & Mark C. Tilton, eds., *Is Japan Really Changing its Ways? Regulatory Reform and the Japanese Economy* 33, 57 (Washington, D.C.: Brookings Institution, 1998).

⁵⁷ Gao, supra note, at 38.

⁵⁸ Miwa & Ramseyer, supra note (Nihon keizai ron), at 382-84.

⁵⁹ Takeo Hoshi & Anil Kashyap, “The Japanese Banking Crisis: Where Did It Come from and How Will It End?,” 1999 NBER Macroeconomics Ann. 129, 143-44 (1999). Miyajima, supra note, at 53, similarly writes: “with the amount of loans to large Japanese firms decreasing drastically from the mid-1970s onward, city banks attempted to diversify their clientele by shifting their focus from manufacturing to service industries (real estate and construction), pursuing the business of small and medium-sized firms, and expanding their international operations.”

markets in the mid-1970s and 1980s.”⁶⁰ To make up the lost business, banks turned to real estate developers. Those developers failed when the market crashed, and banks then found themselves saddled with losses.

To show how blue-chip firms left banks, Hoshi and Kashyap examine the ratio of bank debt to assets among the biggest listed manufacturing firms. That ratio, they note, fell from 36 percent in 1970 to 32 percent in 1980. From 32, it fell to 13 percent by 1990, and there it has roughly remained since.⁶¹ “As the banks started to lose their customers to capital markets, they went after small firms.” The result was a “portfolio shift: increasing loans to the real estate industry.”⁶²

Ratios mislead here, for the banks did not lose their customers, and bond issues do not explain the shift into real estate loans.⁶³ At root, any decline in loans to these listed manufacturing firms was simply too small to have driven any substantial shift in bank loans. From 1983 to 1989, bank loans to all listed manufacturing firms fell 6.6 trillion yen (see Table 2). During the same period, the total loans made by Japanese banks increased monotonically by 174 trillion yen. Even loans to listed firms increased year by year. At the “city banks” alone, total loans increased by 71 trillion. Banks did not shift into real estate because their loans to their traditional clientele fell, for traditional clients as a whole apparently did not cut their loans. They shifted because they captured huge increases in loanable funds.

⁶⁰ Milhaupt & Miller, *supra* note, at 29.

⁶¹ Hoshi & Kashyap, *supra* note, at 148 Tab. 5.

⁶² Hoshi & Kashyap, *supra* note, at 163.

⁶³ Miwa & Ramseyer, *supra* note (Nihon keizai ron), at ch. 6. The listed manufacturing firms that cut their bank loans in the 1980s-90s were not the firms in the strongest sectors. From 1983 to 1995, the largest percentage declines were in oil (20.3 percent, or 488 billion yen), non-ferrous metals (23.5 percent, or 498 billion), glass (24.3 percent, or 283 billion yen), and steel (40.6 percent, or 2.6 trillion yen). Significantly, these were declining sectors that are currently losing equity as well. Consider the Table 1 stock market capitalization test: the percentage change from 1986 to 1998. By this measure, the oil industry lost 44 percent of its equity value over the period, non-ferrous metals lost 23 percent, glass lost 29 percent, and steel lost 10 percent.

Table 2: Bank Loans, by Borrower Category

	All Firms							Listed Firms						
	Total	Const	Manuf	Total	Const	Retail	Real Est	Total Manuf	Chem	Oil & Coal	Steel	Mach.	Elec Goods	Tran Equi
1980	1346	73	430	564	33	116	13	267	40	27	55	15	21	36
1981	1484	80	468	604	33	120	14	285	42	32	56	16	22	39
1982	1640	88	501	641	33	131	16	295	43	29	61	16	22	42
1983	1810	100	523	657	34	139	16	293	43	24	64	15	22	43
1984	2021	114	553	665	36	150	16	280	42	21	63	15	20	40
1985	2228	127	582	675	39	154	18	280	43	17	65	16	22	37
1986	2444	135	576	690	40	158	20	282	41	17	66	16	25	37
1987	2686	140	550	717	41	184	25	268	38	17	60	16	28	34
1988	2882	148	539	770	45	242	30	252	35	17	46	16	27	36
1989	3551	192	591	813	44	298	35	227	30	18	35	16	26	32
1990	3760	200	592	857	52	288	45	255	32	27	33	18	34	35
1991	3857	216	600	899	71	279	50	275	37	25	33	20	38	39
1992	3930	234	592	932	81	275	52	293	40	23	37	21	40	42
1993	4776	298	766	937	92	242	54	296	43	21	41	20	36	44
1994	4784	307	748	937	93	240	54	290	42	20	42	19	38	39
1995	4845	311	726	928	90	232	54	279	41	19	38	20	36	36

Notes: Figures are in 100 billion yen. Figures for "all firms" give the loans and discounts through the banking accounts of all banks. They thus exclude loans through trust accounts, and loans from such sources as life insurance companies and government institutions. Note that in 1990 when manufacturing firms borrowed 59.2 trillion yen through their banking accounts, they borrowed only 2.2 trillion yen through trust accounts. Figures for "listed firms" include (non-securitized) loans from all sources.

Sources: Toyo keizai shimpo sha, ed., Kigyo keiretsu soran [Firm Keiretsu Overview] (Tokyo: Toyo keizai shimpo sha, various years); Nihon ginko, ed., Keizai tokei nempo [Economic Statistics Annual] (Tokyo: Nihon Ginko, various years).

V. Conclusion

Since the start of the 1990s, vast tracks of the capitalist expanse have flirted with financial disaster. Few wealthy economies flirted so dangerously as Japan. Idolized and feared for much of the 1980s, Japanese firms have been ridiculed and shunned for much of the ensuing 1990s.

Did the source of the malaise lie in the governance structures these very firms adopted? Contrary to several corporate observers, we suggest not. Like firms in the U.S., firms in Japan face competitive capital, service, product, and labor markets. Govern themselves inefficiently, and they find themselves punished when they ask for capital. Given that capital market constraint, the firms that survive will tend disproportionately to be those with governance structures adapted to their markets, their industries, their personnel. Given that constraint, blaming the firms for the malaise is blaming the victim all over again.

Consider the reforms academics propose: unwind cross-shareholdings, hire outside directors, disclose more financial data -- and if firms refuse, legislate them offers they cannot refuse. A draconian litany that embodies nothing so much as the the government-can-do-no-wrong conceit in the academic tradition, it leaves unanswered -- indeed, unasked -- the classic Chicago workshop question: if the reforms are so great, why did firms that ignore them so thoroughly earn so much for so long?⁶⁴ If cross-shareholdings, inside boards, and non-disclosure harmed investors, why did Japanese firms that indulged those characteristics succeed so spectacularly for decades? Should they not have found themselves penalized in the capital market? Unable to raise funds competitively, should they not have disappeared?

In Japan, the recession hit banks among the hardest. To ask whether bad governance caused the malaise, we explore the relation between governance and performance among 50-odd banks. We find: that banks with outside directors did no better than those without; that banks with concentrated shareholding networks did no worse than the others; that banks owned disproportionately by financial institutions did no worse than the others; that retired bureaucrats did not add value or raise risk levels; and that the financial crisis did not trace its roots to the deregulatory steps in the 1980s. At least according to this banking industry data, bad governance did not cause the malaise. Statutes to change that governance would do nothing to end it.

⁶⁴ Miwa, supra note, at 1228-29.

Appendix: Econometric Estimates

A. Data:

To explore the association between corporate governance and firm performance, we assemble a data set containing selected board and financial data for 56 regional banks, from 1977 to 1996. We limit ourselves to regional banks to maintain a relatively homogenous sample.

Note that the retired bureaucrats were concentrated in these regional banks. In 1986, only 2 of the city banks had Ministry of Finance officials in positions of representative director or higher. Only 3 had Bank of Japan officials.

We obtain our shareholder return data from the Kabushiki toshi shueki ritsu, our bad loan data from Kin'yu bijinesu, and all other data from the Kigyo keiretsu soran.⁶⁵

B. Variables:

1. Dependent variables. --

Return on Investment (ROI): Total annual shareholder returns on investment (annual rate of appreciation in stock price plus dividends received) for 1980-85, 1985-90, and 1990-95.

Loan Growth: Growth in loans (in percent, calculated from book value) at the bank, for 1977-81, 1981-86, and 1986-89.

Bad Loans: The percent of a bank's total loans catalogued as bad loans by the staff of Kin'yu bijinesu in 1996. Following Horiuchi and Shimizu, we also run our regressions using the log of bad loans. The results (available upon request) remained qualitatively similar.

2. Explanatory variables. --

Outside Dir: The number of outside directors on a firm's board. We also used a dummy variable equal to 1 if the firm had any such directors, and obtained qualitatively similar results (available upon request). We include variables for 1981 (Regs. 3(a)-3(c), 4(a)-4(f)) and 1989 (Regs. 3(d)-3(i), 4(g)-4(i), 5(a)-5(e)).

MoF Alum: 1 if the bank included as a representative director (jomu torishimariyaku or higher) one or more retirees from the central management (kanbu) of the Ministry of Finance (MOF); 0 otherwise. We include variables for 1981 (Regs. 3(a)-3(c), 4(d)-4(f)) and 1986 (Regs. 3(d)-3(i), 4(g)-4(i), 5(a)-5(e)). We use the comparable figures for 1977 in Regs. 4(a)-4(c), but for reasons of data availability use all (not just representative) directors in defining the variable. Following Horiuchi and Shimizu, we use a dummy for this variable. We reason that regulatory clearance (the Horiuchi-Shimizu hypothesis) is something one director could handle as well as several.

BoJ Alum: Analogously defined for the Bank of Japan.

Top 10 S/h: The percentage of a bank's shares held by the ten shareholders holding the most bank stock. We include variables for 1977 (Regs. 4(a)-4(c)), 1981 (Regs. 3(a)-3(c), 4(d)-4(f)) and 1986 (Regs. 3(d)-3(i), 4(g)-4(i), 5(a)-5(e)).

Fin S/h: The percentage of a bank's shares held by the financial institutions listed among the bank's top 10 shareholders. We include variables for 1977 (Regs. 4(a)-4(c)), 1981 (Regs. 3(a)-3(c), 4(d)-4(f)) and 1986 (Regs. 3(d)-3(i), 4(g)-4(i), 5(a)-5(e)).

⁶⁵ Toyo keizai shimpo sha, ed., Kigyo keiretsu soran [Firm Keiretsu Overview] (Tokyo: Toyo keizai shimpo sha, various years); Nihon shoken keizai kenkyu jo, ed., Kabushiki toshi shueki ritsu [Rates of Return on Common Stocks] (Tokyo: Nihon shoken keizai kenkyu jo, various years); 96 nen 3 gatsu kessan, ginko sogo rankingu [Consolidated Bank Rankings, March 1996], Kin'yu bijinesu, Sept. 1996, at 48.

Geographical dummies: 1 if a bank was headquartered in Tokyo, Osaka, or Nagoya; 0 otherwise. Note that these are the locations where the price of real estate most radically escalated in the late 1980s.

Sm Firm Fin: The percentage of a bank's loans to firms classified as small- or medium-sized by the Ministry of International Trade & Industry in 1989.

We include selected summary statistics in Table App-1.

C. Results:

In general, stock market returns on investment will most accurately capture any effect governance has on shareholder welfare. For that reason, we urge readers to focus on our regressions using Returns on Investment as the dependent variable (Table App.-3). Because of the collinearity among some of the independent variables (see Tab. App.-2), we report the results of several different combinations of these variables.

At least hypothetically, however, to the extent that shareholders can observe any bad governance structures, stock market returns may not reflect the effect those structures have on firm performance. For example, suppose both that a group of firms maintains a systematically inferior set of governance structures, and that the structures are ones which an acquiror could not remove. In such a world, investors will anticipate the negative effect of the structures, and discount the price they pay for the stock ex ante. In equilibrium, they will then earn a competitive market return on the stock ex post.

Other than with regulatorily imposed governance structures, we do not believe this occurs. As we explain in the body of this article, entrepreneurs can indeed launch takeovers in Japan, and if bad governance structures were in place they would have strong incentives to do so. Nevertheless, to deal with the possibility that shareholders might anticipate the effect of non-removeable, observably bad governance structures, we add regressions using a bank's loan portfolio as the dependent variable. We then ask which banks grew most rapidly before the 1990 real-estate price peak (Tab. App.-4), and which banks found themselves with the largest portfolios of bad loans after that peak (Tab. App.-5)? To the extent strategies that maximize profits correlate with those that generate growth (obviously a less-than-perfect correlation), the results are consistent with the theory we outline above: variations in governance among firms do not explain variations in performance.

Our regressions together yield several significant results, but most are a function of geography rather than governance. More specifically, the results reflect the greater volatility of urban (we focus on the Tokyo, Osaka and Nagoya metropolitan centers) over rural real estate. Because banks disproportionately lent to local borrowers and took local real estate as collateral, urban bank performance reflected that volatility. During the early 1980s, Tokyo and Nagoya banks earned noticeably higher shareholder returns than banks generally (Regs. 3(a)-3(c)); in the early 1990s, Osaka banks earned lower (Regs. 3(g)-3(i)). Similarly, Osaka banks grew rapidly in the late 1970s (Regs. 4(a)-4(c)), Tokyo banks in the early 1980s (Regs. 4(d)-4(f)), and Tokyo, Osaka and Nagoya banks in the late 1980s (Regs. 4(g)-4(i)). By 1996, however, the Tokyo banks had amassed a larger fraction of bad loans than banks generally (Regs. 5(a)-5(e)).

Smaller firms also showed higher variance performance during this period. Accordingly, banks that financed smaller firms grew faster than other banks in the late 1970s (Regs. 4(a)-4(c)), but by 1996 those loans had disproportionately gone bad (Regs. 5(c)-5(d)).

By contrast, the coefficients on the governance variables are seldom significant, and even when significant show no coherent pattern. Most basically, the data exhibit no sign that outside

directors improve performance. Indeed, in our stockmarket returns regressions, the signs are not even in the right direction (Tab. App.-3). The coefficient on the presence of Bank of Japan alumni on a bank's board is similarly insignificant. The coefficient on the presence of Ministry of Finance alumni is correlated only with loan portfolio growth in the late 1970s (and then only at the 10 percent confidence level; Regs. 4(a)-4(c)), and is otherwise insignificant. Holdings by top 10 shareholders are associated with high growth rates in the late 1980s (Reg. 4(h)) but not otherwise. Holdings by financial shareholders are associated with high growth in the early 1980s (Reg. 4(d); 10 percent confidence level), but not otherwise.

Table App-1: Selected Summary Statistics

	n	Min	Mean	Max
<i>A. Dependent Variables:</i>				
ROI				
1980-85	42	6.1	17.8	36.9
1985-90	46	13.5	20.3	34.0
1990-95	55	-20.2	-7.4	5.3
Loan Growth				
1977-81	48	158.1	193.8	257.8
1981-86	48	119.2	150.4	180.1
1986-89	54	115.5	142.5	175.1
Bad Loans (1996)	56	.74	2.77	7.86
<i>B. Independent Variables:</i>				
Outside Dir				
1981	49	0	2.5	5
1989	56	0	2.9	7
MoF Alum				
1977	56	0	.357	1
1981	56	0	.286	1
1986	54	0	.357	1
BoJ Alum				
1977	56	0	.500	1
1981	56	0	.446	1
1986	56	0	.393	1
Top 10 S/h				
1977	48	11.3	22.7	41.6
1981	48	13.3	24.4	43.3
1986	54	15.5	25.2	40.7
Fin S/h				
1977	48	2.3	15.7	38.3
1981	48	4.3	17.4	36.7
1986	54	6.1	19.1	34.5
Tokyo	56	0	.179	1
Osaka	56	0	.107	1
Nagoya	56	0	.089	1
Sm Firm Fin	56	58.1	77.7	90.2

Sources: Toyo keizai shimpo sha, ed., Kigyo keiretsu soran [Firm Keiretsu Overview] (Tokyo: Toyo keizai shimpo sha, various years); Nihon shoken keizai kenkyu jo, ed., Kabushiki toshi shueki ritsu [Rates of Return on Common Stocks] (Tokyo: Nihon shoken keizai kenkyu jo, various years); 96 nen 3 gatsu kessan, ginko sogo rankingu [Consolidated Bank Rankings, March 1996], Kin'yu bijinesu, Sept. 1996, at 48.

Table App-2: Selected Correlation Coefficients*A. For 1980-85 ROI Regressions:*

	<u>BoJ Alum</u>	<u>MoF Alum</u>	<u>Outsid Dr</u>	<u>Top10 S/h</u>	<u>Fin S/h</u>
BoJ Alum	1.00				
MoF Alum	.06	1.00			
Outsid Dr	.23	.36	1.00		
Top10 S/h	.22	.11	.31	1.00	
Fin S/h	.10	.20	-.01	.32	1.00

B. For 1985-90 and 1990-95 ROI Regressions:

	<u>BoJ Alum</u>	<u>MoF Alum</u>	<u>Outsid Dr</u>	<u>Top10 S/h</u>	<u>Fin S/h</u>
BoJ Alum	1.00				
MoF Alum	-.09	1.00			
Outsid Dr	.21	.23	1.00		
Top10 S/h	.22	.09	.37	1.00	
Fin S/h	.10	.20	.12	.27	1.00

Sources: See Table App-1.

Table App-3: Return on Investment

	3(a)	3(b)	3(c)	3(d)	3(e)	3(f)	3(g)	3(h)	3(i)
	1980-85			1985-90			1990-95		
Outsid Dr	-.265 (0.35)	-.369 (0.50)	-.532 (0.77)	-.404 (0.68)	-.333 (0.58)	-.287 (0.52)	-.254 (0.46)	-.182 (0.32)	-.279 (0.56)
MoF Alum	-1.807 (0.89)	-1.841 (0.91)		-.637 (0.40)	-.738 (0.47)		.154 (0.10)	.137 (0.09)	
BoJ Alum	-1.035 (0.56)	-.696 (0.38)		.884 (0.62)	.759 (0.53)		.536 (0.37)	.625 (0.44)	
Top10 S/h		-.115 (0.76)			-.025 (0.18)			-.099 (0.73)	
Fin S/h	.091 (0.63)			-.060 (0.49)			-.027 (0.23)		
Tokyo	7.788** (2.65)	9.773** (3.58)	8.216** (3.64)	.665 (0.30)	.253 (0.13)	.084 (0.05)	-1.064 (0.47)	-.807 (0.37)	-1.181 (0.61)
Osaka	-4.911 (1.27)	-3.164 (0.81)	-4.403 (1.26)	4.755 (1.57)	4.696 (1.49)	3.993 (1.53)	-6.459** (2.72)	-6.300** (2.66)	-6.300** (2.94)
Nagoya	5.068* (1.80)	5.043* (1.80)	5.216* (1.96)	-2.589 (1.17)	-2.489 (1.12)	-2.390 (1.12)	-.448 (0.19)	-.423 (0.18)	-.425 (0.19)
S Firm Fin	-.127 (0.35)	-.120 (0.92)	-.107 (0.87)	.158 (1.44)	.149 (1.38)	.158 (1.63)	-.136 (1.22)	-.134 (1.22)	-.156 (1.60)
Adj R2	0.27	0.27	0.31	0.02	0.01	0.08	0.10	0.11	0.16
n	41	41	42	44	44	44	53	53	55

Notes: The dependent variable is Return on Investment. The regressions are ordinary least squares. The table gives the coefficient, followed by the absolute value of the t-statistic in parentheses. * -- statistically significant at the 10 percent level, two-tailed test; ** -- statistically significant at the 5 percent level, two-tailed test. All equations include a constant term, not reported.

Sources: See Table App-1.

**Table App.-4: Loan Regressions --
Portfolio Growth during 1977-89**

	(4a)	(4b)	(4c)	(4d)	(4e)	(4f)	4(g)	4(h)	4(i)
	1977-81			1981-86			1986-89		
Outside Dr	1.327 (0.68)	.966 (0.49)	2.828 (1.51)	-.357 (0.25)	-.753 (0.51)	-.628 (0.46)	1.822 (1.47)	1.348 (1.09)	1.720 (1.43)
MoF Alum	9.933* (1.94)	10.245* (1.96)		.787 (0.20)	1.689 (0.42)		-2.645 (0.74)	-1.742 (0.51)	
BoJ Alum	6.460 (1.26)	6.261 (1.20)		-2.580 (0.72)	-2.221 (0.59)		-4.215 (1.27)	-4.332 (1.35)	
Top10 S/h		.385 (0.97)			.166 (0.55)			.683** (2.24)	
Fin S/h	.462 (1.26)			.500* (1.79)			.401 (1.47)		
Tokyo	-4.621 (0.61)	-2.614 (0.36)	2.958 (0.44)	17.526** (3.06)	21.555** (3.89)	22.767** (4.67)	15.357** (3.12)	15.537** (3.44)	18.229** (4.07)
Osaka	17.554** (2.28)	16.715** (2.14)	19.658** (2.50)	5.471 (0.96)	5.537 (0.93)	5.529 (0.97)	10.205* (1.84)	9.026 (1.67)	8.992* (1.69)
Nagoya	-2.010 (0.26)	-1.988 (0.25)	-5.135 (0.64)	8.924 (1.52)	8.885 (1.46)	9.306 (1.58)	11.678** (2.13)	11.489** (2.16)	11.512** (2.10)
S Firm Fin	.748** (2.13)	.742** (2.10)	.740** (2.03)	.227 (0.86)	.248 (0.91)	.258 (0.97)	.037 (0.14)	.054 (0.22)	.136 (0.55)
Adj R2	0.32	0.32	0.27	0.33	0.28	0.32	0.33	0.37	0.33
n	48	48	48	48	48	48	54	54	54

Notes: The dependent variable is Loan Growth. The regressions are ordinary least squares. The table gives the coefficient, followed by the absolute value of the t-statistic in parentheses. * -- statistically significant at the 10 percent level, two-tailed test; ** -- statistically significant at the 5 percent level, two-tailed test. All equations include a constant term, not reported.

Sources: See Table App-1.

**Table App-5: Loan Regressions --
Portfolio Quality (Bad Loan Ratio) in 1996**

	5(a)	5(b)	5(c)	5(d)	5(e)
Outside Dir	.030 (0.17)	.002 (0.01)	.098 (0.59)		
MoF Alum	.481 (0.97)	.583 (1.20)		.707 (1.49)	
BoJ Alum	-.712 (1.55)	-.687 (1.51)			-.705 (1.61)
Top 10 S/h	.047 (1.09)				
Fin S/h	.041 (1.08)				
Tokyo	1.416 (2.08)**	1.525 (2.37)**	1.539 (2.47)**	1.621 (2.89)**	1.790 (3.16)
Osaka	.906 (1.18)	.817 (1.07)	.869 (1.17)	.601 (.80)	1.077 (1.49)
Nagoya	-.837 (1.10)	-.853 (1.13)	-1.027 (1.33)	-.999 (1.32)	-.979 (1.29)
Sm Firm Fin	.043 (1.21)	.047 (1.32)	.059 (1.77)*	.068 (2.07)**	.048 (1.51)
Adj R2	0.20	0.20	0.17	0.20	0.21
n	54	54	56	56	56

Notes: The dependent variable is Bad Loans. The regressions are ordinary least squares. The table gives the coefficient, followed by the absolute value of the t-statistic in parentheses. * -- statistically significant at the 10 percent level, two-tailed test; ** -- statistically significant at the 5 percent level, two-tailed test. All equations include a constant term, not reported.

Sources: See Table App-1.