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CEO overconfidence and financial crisis: Evidence from bank lending and leverage[☆]

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ABSTRACT

Over a period that includes the 1998 Russian crisis and 2007–2009 financial crisis, banks with overconfident chief executive officers (CEOs) were more likely to weaken lending standards and increase leverage than other banks in advance of a crisis, making them more vulnerable to the shock of the crisis. During crisis years, they generally experienced more increases in loan defaults, greater drops in operating and stock return performance, greater increases in expected default probability, and higher likelihood of CEO turnover or failure than other banks. CEO overconfidence thus can explain the cross-sectional heterogeneity in risk-taking behavior among banks.

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1. Introduction

The near-decade before the US credit market freeze in the fall of 2007 was a period of unprecedented prosperity and credit expansion. In a speech delivered on March 7, 2001, Federal Reserve System chairman Alan Greenspan pointed out that “there is doubtless an unfortunate tendency among some, I hesitate to say most, bankers to lend aggressively at the peak of a cycle and that is when the vast majority of bad loans are made.”[1]

Greenspan cautioned against an overly optimistic assessment of borrower prospects during a credit boom. Unrealistic assumptions make banks more vulnerable when a credit boom is followed by a crisis. We examine whether banks with an overconfident attitude acted differently from other banks in terms of lending standards and bank leverage prior to a crisis and then how such banks performed during crisis years. We focus on the top decision maker in the bank, the chief executive officer (CEO).

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[1] The full text of Greenspan’s speech is on the Federal Reserve Board website (http://www.federalreserve.gov/boarddocs/speeches/2001/20010307/default.htm).

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Because CEOs are the primary influence on bank financing and investment decisions, CEO attitudes toward borrower prospects could affect their banks' lending standards and leverage levels, which then can affect a bank's sensitivity to a crisis. We specify that banks with an overconfident attitude are banks with overconfident CEOs, who generally think they are better than they are in terms of skill and judgment or in gauging the prospects of a successful outcome. We thus examine whether CEO overconfidence can help explain a bank's risk taking before a crisis and the poor performance of a bank during a crisis.[2]

Managerial overconfidence can influence bank risk-taking behaviors in several ways. Hirshleifer and Luo (2001), Malmendier and Tate (2008), and Gervais, Heaton, and Odean (2011) show that overconfident CEOs overestimate the probability of a positive state and the likelihood of returns to be generated from an investment project. They underestimate the downside risk of a project and tend to choose a project with higher true risks than optimal.[3] During an economic upswing, an overconfident CEO who is more bullish than others on prospects for the economy could relax lending standards and increase bank leverage more than other banks while they take exposures believed to be the most profitable for current shareholders. Yet, by taking greater risk, overconfident CEOs make their banks more vulnerable to an external shock such as a financial crisis.

We collect CEO overconfidence data from publicly listed US banks over 1994–2009, a period that includes the 1998 Russian financial crisis and the most recent worldwide financial crisis of 2007–2009. Both crises followed a period of lending growth (Ivashina and Scharfstein, 2010; Becker and Ivashina, 2014), and both are among the worst financial crises in the last 50 years (Fahlenbrach, Prilmeier, and Stulz, 2012). Fahlenbrach, Prilmeier, and Stulz (2012) find that some bank characteristics connoting risk-taking behaviors are significantly associated with poor performance in both crises. Hence, if overconfidence as a managerial trait can explain heterogeneity in risk-taking behavior among banks, an overconfident bank should have suffered more than other banks in the two crises. Following Fahlenbrach, Prilmeier, and Stulz (2012), we take 1998 as the start of the Russian crisis and 2007 as the start of the most recent financial crisis. We then define 1998 and 2007–2009 as crisis years and other years as noncrisis years.

We use a stock options-based proxy for CEO overconfidence and construct our measure using Standard & Poor's ExecuComp database. Following Campbell, Gallmeyer, Johnson, Rutherford, and Stanley (2011), we classify CEOs who postpone exercising stock options that are more than 100% in the money at least twice during their tenure as overconfident (from the first time a CEO is seen to postpone exercise). The rationale is that a manager who chooses to keep holding deep-in-the-money stock options after the vesting period is likely to be overconfident about the firm's future prospects.[4]

Our empirical results show that, over 1994–2009, overconfident banks were more aggressive in lending than non-overconfident banks in the noncrisis years, particularly in lending to real estate borrowers. Overconfident banks on average increased their loans (real estate loans) by about 14.98% annually (18.06%), which is 4.60 (11.42) percentage points higher than the increase for non-overconfident banks. We also find that overconfident banks showed greater growth in leverage in the noncrisis years. For example, the annual rate of change in market leverage for overconfident banks was on average about 5.37 percentage points higher than for non-overconfident banks during the noncrisis years, again indicating greater risk-taking behavior.

After a crisis developed, our results show that many loans extended by overconfident banks in noncrisis years were in default or near default, creating large capital losses. Such unanticipated losses for overconfident banks, accompanied with high leverage, diminished their net worth considerably, prompting some depositor withdrawals and fire sales and thereby reducing these banks' net worth still further.[5]

We find that overconfident banks generally experienced more severe worsening of operating and stock return performance, along with greater increases in expected default probability. Many of these banks replaced their CEOs and even failed during the crisis years.[6] Our results thus indicate that overconfidence can lead risk-averse CEOs to take exposures that they perceive are the most profitable for current shareholders ex ante but that could harm their banks and themselves ex post.

We further explore whether a bank CEO's attitude toward risk before the 1998 crisis could help predict the bank CEO's attitude before the most recent crisis. We find that, instead of learning from their experience in the 1998 crisis, banks with overconfident CEOs in 1997 significantly tended to have overconfident CEOs in 2006. This is consistent with the finding of Fahlenbrach, Prilmeier, and Stulz (2012) that the same firms that suffered significant losses

[2] For simplicity, we call banks with overconfident CEOs "overconfident banks" and those whose CEOs are not overconfident "non-overconfident banks."

[3] Several researchers have investigated the effects of managerial overconfidence on firm performance. Many of them show that overconfident CEOs reduce the value of the firm as a result of overinvestment (see, e.g., Goel and Thakor, 2008; Malmendier and Tate, 2008; Campbell, Gallmeyer, Johnson, Rutherford, and Stanley, 2011). On the other side of the coin, Hirshleifer, Low, and Teoh (2012) show that overconfident CEOs can increase firm value through effective innovation.

[4] The options-based CEO overconfidence measure has become widely used in recent empirical research (see, e.g., Malmendier and Tate, 2005, 2008; Campbell, Gallmeyer, Johnson, Rutherford, and Stanley, 2011; Malmendier, Tate, and Yan, 2011; Hirshleifer, Low, and Teoh, 2012). Malmendier and Tate (2008) and Hirshleifer, Low, and Teoh (2012) note several alternative reasons for such behavior, including positive inside information, signaling, board pressure, risk tolerance, and taxes, that fail to sufficiently explain the delay in exercise behavior among overconfident CEOs.

[5] Laeven (2011) shows that, after the global financial crisis started in the summer of 2007, a large number of US banks experienced depositor runs, forced fire sales, reductions in the value of their assets, or increases in the possibility of failure to meet their obligations.

[6] In our sample during crisis years, 25.93% of overconfident banks experienced CEO turnover, compared with only 15.83% of non-overconfident banks, and 10.37% of overconfident banks failed, compared with 4.17% of non-overconfident banks during the period.

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