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Behavioral consistency in corporate finance: CEO personal and corporate leverage[☆]

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ABSTRACT

We find that firms behave consistently with how their CEOs behave personally in the context of leverage choices. Analyzing data on CEOs' leverage in their most recent primary home purchases, we find a positive, economically relevant, robust relation between corporate and personal leverage in the cross-section and when examining CEO turnovers. The results are consistent with an endogenous matching of CEOs to firms based on preferences, as well as with CEOs imprinting their personal preferences on the firms they manage, particularly when governance is weaker. Besides enhancing our understanding of the determinants of corporate capital structures, the broader contribution of the paper is to show that CEOs' personal behavior can, in part, explain corporate financial behavior of the firms they manage.

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"I just don't like to owe money."

William F. Laporte, CEO of American Home Products that carried no debt until after his 17-year leadership (*Forbes*, September 1, 1968, p. 87)

1. Introduction

Since the start of modern capital structure research with the seminal work of Modigliani and Miller (1958),

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financial economists have devoted significant effort to studying the determinants of corporate leverage. The focus of most empirical work has been on market, industry, and firm characteristics. Yet, firms that are similar in terms of these fundamentals often choose very different corporate leverage. This has led researchers to recently study the impact of personal characteristics of the firm's top executive, the Chief Executive Officer, CEO (Bertrand and Schoar, 2003; Frank and Goyal, 2009b; Graham, Harvey, and Puri, 2009; Malmendier, Tate, and Yan, 2010). Our paper extends this work, but we focus on personal decisions made by CEOs that are in the same domain as the analyzed corporate decision. Specifically, we attempt to explain corporate capital structures based on what CEOs have revealed about themselves and their debt tolerance through past *personal* leverage choices. The scientific basis for this hypothesis is an extensive set of well-cited studies on "behavioral consistency theory," i.e., the notion that individuals behave consistently across situations. We find that this is a promising empirical approach in corporate finance because firms are found to behave consistently with how their CEOs behave personally in the context of leverage decisions. Besides enhancing our understanding of the determinants of corporate capital structures, the broader novel contribution of the paper is to show that CEOs personal behavior can, in part, predict corporate financial behavior of the firms they manage.[1]

Until recently, most prior empirical studies assume, at least implicitly, that a firm's CEO does not impact corporate leverage decisions. If it takes a certain type of individual to rise to the top of a firm, then CEOs are homogeneous or close substitutes for one another. Alternatively, there may be significant differences across CEOs, but they do not affect firms if governance constrains CEOs from imprinting their personal preferences on the firms they manage. In either case, firms in the same industry with similar fundamentals choose similar capital structures despite being managed by different CEOs. In contrast, several researchers have recently taken the position that differences in terms of personal preferences/tastes across CEOs may indeed impact corporate leverage decisions. For example, in a recent and extensive review of empirical capital structure papers, Parsons and Titman (2008, p. 24) state that CEOs' personal characteristics, such as "managerial preferences," may also affect capital structures. A similar prediction is provided by Opler and Titman (1994, p. 1021) who state that "[d]ifferences in management tastes…could also explain differences in leverage ratios within an industry."

Indeed, financial economists have recently examined some observable CEO characteristics as potential determinants of corporate leverage.[2] Overall, the empirical evidence is ambiguous. For example, Bertrand and Schoar (2003) show that older CEOs choose lower leverage, and having a MBA does not significantly affect corporate capital structures. But, Malmendier, Tate, and Yan (2010) report that older CEOs take on more debt, and Frank and Goyal (2009b) show that MBAs are associated with more leverage. Frank and Goyal (2009b,p. 5) conclude that, "leverage choices are not all that closely connected to readily observable managerial traits," suggesting that we are still missing identification of important CEO characteristics. By focusing on CEOs' personal leverage, our approach offers to capture the mix and interplay of the underlying CEO beliefs and preferences that are relevant to a debt decision.

In contrast to existing studies of CEO characteristics, our approach is based on behavioral consistency theory.[3] An individual, in our case a firm's CEO, is predicted to behave consistently across situations. Although we have not previously noted the term behavioral consistency in research in financial economics, we are aware of several recent studies in economics, finance, and accounting which are supportive of this notion. Perhaps the most important example is Barsky, Juster, Kimball, and Shapiro (1997), who show a positive relation across individuals between all the risky behaviors they study: holding stocks rather than Treasury bills, risky entrepreneurial activity, and smoking and alcohol consumption. In a corporate finance context, Malmendier and Tate (2005) find that CEOs who show signs of overconfidence in their personal portfolios are overconfident also in corporate investment decisions. Hong and Kostovetsky (forthcoming) find that portfolio managers who make personal campaign contributions to Democrats invest relatively less of the portfolios they manage in firms deemed socially irresponsible. Hutton, Jiang, and Kumar (2010) find that Republican CEOs pursue more conservative corporate policies than do Democrats. Chyz (2010) finds that CEOs who are personally more tax aggressive manage firms with more tax avoidance activities. In sum, the personal preferences and choices of decision-makers such as CEOs and portfolio managers seem to partly explain their professional decisions.

In this paper, we apply behavioral consistency theory to corporate finance by studying CEOs' personal leverage (as in their choice of mortgage for their primary residences) and the corporate leverage of the firms they manage. We choose the financing of the CEOs' primary homes because it involves the domain of debt decisions, the home purchase is an important decision, and mortgage debt tends to be the most important source of debt, even if not a measure of total personal indebtedness. Notably, behavioral consistency theory only requires us to identify and use a relevant comparable situation and not

[1] Borghans, Duckworth, Heckman, and Weel (2008) is a very informative overview of the economics of personal characteristics, and they conclude: "There is a lot of room for cooperation and exchange of findings and methods between personality psychology and economics." (p. 84). We view our paper as an attempt to engage in such exchange of methods and findings.

[2] Later in this paper, we review related empirical studies. But, it is worth pointing out that there also exists theoretical research which (*footnote continued*) incorporates heterogeneity in CEOs' personal characteristics into models of corporate capital structure decisions. For example, Cadenillas, Cvitanić, and Zapatero (2004) model the relation between managerial risk aversion and leverage, while Hackbarth (2008) models the relation with optimism or overconfidence.

[3] Seminal references include Allport (1937, 1966), Epstein (1979, 1980), and Funder and Colvin (1991).

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