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Financial expert CEOs: CEO's work experience and firm's financial policies ☆

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A B S T R A C T

We study CEOs with a career background in finance. Firms with *financial expert CEOs* hold less cash, more debt, and engage in more share repurchases. Financial expert CEOs are more financially sophisticated: they are less likely to use one companywide discount rate instead of a project-specific one, they manage financial policies more actively, and their firm investments are less sensitive to cash flows. Financial expert CEOs are able to raise external funds even when credit conditions are tight, and they were more responsive to the dividend and capital gains tax cuts in 2003. Analyzing CEO-firm matching based on financial experience, we find that financial expert CEOs tend to be hired by more mature firms. Our results are consistent with employment histories of CEOs being relevant for corporate policies. However, we cannot formally rule out that our findings are partly explained by endogenous CEO-firm matching.

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1. Introduction

There is evidence that chief executive officers (CEOs) have particular management styles and that they matter for corporate performance (see Adams, Almeida, and Ferreira, 2005; Bennedsen, Perez-Gonzalez, and Wolfenzon, 2008). Most evidence on CEO-specific heterogeneity examines education, personal characteristics, or personality traits. Malmendier and Tate (2005) study education, Kaplan, Klebanov, and Sorensen (2012) personal characteristics, and Malmendier and Tate (2005, 2008), Graham, Harvey, and Puri (2013), Hirshleifer, Low, and Teoh (2012), Malmendier, Tate, and Yan (2011), and Lin, Ma, Officer, and Zou (2011) analyze personal traits. Less is known about the work experience of CEOs. An exception is Custódio and Metzger (2013) who study CEOs' industry expertise in the context of diversifying mergers and acquisitions (M&A) activity.

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We contribute to the literature on CEO style in three ways. First, we show that previous financial expertise of CEOs is correlated with firms' financial policies. Second, we provide micro-level evidence on how financial experience operates. Third, we explicitly discuss the possibility that endogenous matching between CEOs and firms based on *time-varying characteristics* biases our results. Even though it is very difficult in general to establish a clean causal link between financial expertise and firm policies because exogenous variation in the financial expertise of the CEO is simply not observed, we provide a coherent and vast set of results that support the view that financial expertise matters. We also make use of both exogenous variations in the business conditions in which the CEO operates and CEO turnovers that are likely to be exogenous.

We first show that an important fraction of CEOs are *financial expert CEOs*. That is, 41% of the CEOs have previous experience in the financial industry or in a financial role. When we look at their firm's financial policies, we find that nonfinancial firms headed by financial expert CEOs hold less cash on average. Furthermore, they are more leveraged and they have a higher propensity than other firms to pay out money to shareholders. These differences are economically meaningful. Regression results indicate that cash holdings are about 12% lower and average leverage ratios are 6% higher (evaluated at the mean). These firms are also 7% more likely to repurchase shares.

Evaluating financial expert CEOs' actions and decisions at a micro-level, we provide evidence that they are more financially sophisticated. Typical firms use companywide discount rates to evaluate investment projects rather than a project-specific one. This has been called the weighted average cost of capital (WACC) fallacy (Graham and Harvey, 2001; Krüger, Landier, and Thesmar, 2011). Following Krüger, Landier, and Thesmar (2011), we use segment-level investment policy in diversified firms to find that only firms without a financial expert CEO fall into the WACC fallacy trap. We then exploit exogenous changes to business conditions to test whether financial experts react in a way that is consistent with higher levels of financial sophistication. We use the 2003 cuts to dividend and capital gains taxes, known as the "*Bush tax cuts*," and find that financial experts were more responsive as measured by increases in total payout to shareholders. The tax cuts increased the dollar value of dividends and capital gains after 2003, therefore, increasing payout would be more beneficial to shareholders. We also show that financial expert CEOs are better able to raise external financing, even under tighter credit market conditions, suggesting that they have better access to capital markets. These results are consistent with the idea that financial experts can follow more aggressive financial policies (holding less cash and more debt) because they can access financial markets more easily.

Guner, Malmendier, and Tate (2008) show in their research on board of directors' composition that financial experts have better access to capital markets. They show that firms with bankers on their boards use more external financing and have lower investment-cash flow sensitivity. However, the presence of bankers on a board is associated with policies that tend to benefit those financial institutions, but not necessarily the lending firms' shareholders. In fact, banks seem to provide funding to firms with good credit but poor investment opportunities.[1] We also show lower investment-cash flow sensitivity for financial expert CEOs, but interestingly, the benefits of CEO financial expertise do not come at the cost of benefiting financial institutions. We find no evidence suggesting that financial experts overinvest just because they have better access to financing. This result seems plausible, as CEOs with financial expertise do not have a conflict of interest as bankers on the board do.

Additional evidence that financial expertise matters is that newly hired financial expert CEOs are more likely to replace an incumbent chief financial officer (CFO) within the first year of their hire. We interpret this result as indication that financial expert CEOs are more involved with firm financial policies. It is likely to be easier to implement changes in a firm by changing a management team, in this case the CFO. Of course, we cannot rule out the alternative hypothesis that CFOs resign voluntarily more often if a financial expert CEO is hired.

Financial expert CEOs might also directly benefit from their personal links to the financial sector. We test this hypothesis by examining whether former employers of the CEO are providing loans to his or her firm. There is no evidence that these direct links are driving our results. We use data on syndicated bank loans from Dealscan to show that only a very small fraction (2.1%) of loan facilities is provided by former employers of the CEOs. We also do not find evidence that financial expert CEOs are more likely to use indirect links beyond their previous employers, as they are no more likely to borrow from a new lending institution (a bank that was not providing loans to the company before the CEO was appointed).

Overall, our findings also contribute to the literature that tries to understand cross-sectional variation in cash holdings, leverage, and payout policy. Early survey evidence by Graham and Harvey (2001) and more recently by Lins, Servaes, and Tufano (2010) suggest that the managerial impact on financial policies is likely to be big. They show that managers largely differ in their criterions and application of financial theories when it comes to capital structure.

A common limitation in the literature on CEO characteristics is interpretation of the results. There are at least two ways that selection can bias the estimation of any potential effect of a CEO characteristic such as financial expertise on firm decision making. First, there might be omitted variables on the CEO level. For instance, financial expertise might be correlated with other CEO characteristics such as talent or education that drive our results. We address this concern in several ways. We control for education, general expertise, and talent using detailed biographical data. We also show direct evidence of financial sophistication by financial experts. This increases our

[1] Dittmann, Maug, and Schneider (2010) show similar findings in Germany.

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