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The relationship between Global Financial Crisis and the overconfidence of the higher-level management

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Abstract: *Decision-making is vital for financial industry. Previous research has indicated potential associations that the overconfidence on banking behavior and performance could make bad effects. The paper seeks to understand and explain the causes of overconfidence and their effects on highest-level managers, and how to led to absurd decision making in Global Financial Crisis (GFC). This paper used literature review to identify the reasons that overconfidence affects the decision-making in banking, and further explore how this relates to GFC. This review found evidence that the managerial hubris of the CEOs and other higher authorities making the banking policies, what makes the banks were the most impacted institutes from this havoc. The overconfident attitude of the CEOs lead to the worst performance of the banks and the risk-taking abilities of the bank were completely modified after the financial crisis was over. As a result of these investigations, suggestions were identified for further research.*

Keywords: *Global Financial Crisis (GFC), Overconfidence, Higher-level management, Managerial Hubris*

1. Introduction

Global Financial Crisis (GFC) was a severe financial crisis that impacted the major economies around the globe. The major causes of this crisis are related to the US state housing bubble along with the absurd and false assumptions by the banking department that lead to havoc (Adrian and Shin., 2009). The crisis of 2007 saw the bankruptcy of many major organizations including that of the 'Lehman Brothers'. This bankruptcy till the date remains the biggest bankruptcy of the history but the detrimental impacts didn't stop over here. This crisis is considered as the major catalyst of severe global depression. This global depression is regarded as the second-largest global depression after the 'Great Depression of 1930'. The impacts of the financial crisis of 2007 were long term and started the 'European Debt Deficit' that was started in Greece in 2009. The 'Icelandic Crisis' of 2008 is also related to the GFC in which Iceland suffered the greatest economic crisis of the history as its all three banks suffered from bank failure (Becker and Ivashina, 2014).

As discussed above that there were many major reasons for this economic crisis and much anecdotal evidence suggests that it was the overconfidence of the higher-level management including the CEOs and highest-level managers that led to absurd decision making. This decision making was also observed in the banking sector and the housing sector of the US leading to this havoc that shook the world economically. This led to a long term investor insecurity and lack of belief in the bank solvencies disturbing the global economies. Thus, this report will analyze the anecdotal claims blaming the managerial hubris as an important factor leading to this economic havoc. A sound conclusion will be made based on facts studied in the literature review.

2. Literature Review

The financial crisis of 2007-2009 is generally connected with the absurd and illogical decision making of the banking and financial departments. Before the crisis, the banking standards seemed to be leveraged and lending standards were weakened. This made the financial institutions more vulnerable to a crisis and bankruptcy. There were many cautions issued by the 'Federal Reserve System' over the optimistic assessment of the banks and other financial institutions. This assessment was majorly related to the borrowers' prospects in case any credit boom occurs (Bruin et al., 2012). A credit boom increases the vulnerability to the stability of the banking and financial system if a false assumption is taken.

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3. Managerial Hubris

The term hubris is a human characteristic of overconfidence and arrogance. This leads to a personal belief that the individual can never take any wrong step or all of his assumptions are correct. This overconfidence and pride can be detrimental to the personality of an individual. Managerial hubris is a term that is associated with wrong managerial decisions (Adrian and Shin, 2009). The manager of any financial institution or bank can assume that he can manage the current assets better than anyone else and can take unrealistic approaches to manage the firm. An example of the managerial hubris is the mergers creating minimal profits or no profits at all. The financial crisis of 2007 is also related to the similar traits of the managers and CEOs.

4. Managerial Hubris and the GFC

The managerial decisions are taken about a decade before the financial crisis was alarming and many financial experts tried to aware of the CEOs and managers regarding absurd and baseless decision making. The unprecedented economic prosperity and credit expansion was a clear sign of the upcoming havoc (Adrian and Shin, 2009).

Hirshleifer et al., (2016) also conducted the same research on analyzing the role of managerial decisions and hubris in the mega financial crisis. The author connected the beginning of the financial crisis with the banking policies that were implemented a decade ago. The Federal State Reserve officials also expressed their concern for the rising loan rate and the aggressive lending policies of the banks in the USA. Alan Green Span, the chairman of the Federal State Reserve in 2002 alarmed the bankers and the CEOs to maintain a steady lending policy and not to apply an optimistic approach towards the borrowers (Becker and Ivashina., 2014). And the results of bank performance with an overconfident and optimistic approach during the crisis time illustrate that the concern of the state was right. The banks with a moderate lending approach somehow survived the financial crisis and regained the confidence of the investors as soon as the crisis began to diminish.

Gervais and Heaton, (2011) also illustrated in their research that the overconfident top-level management wrongly estimated the likelihood of the returns from the borrowers and other investment projects that were more likely to be failed. The CEOs tend to be inclined towards the projects offering greater risks and ignored the projects with minimal or moderate risk. Similarly, during the economic upswing, the overconfident CEOs tend to relax the lending policies and increased the bank leverage to gain a competitive advantage over other banks with a moderate risk policy. And the result of such overconfident banks was great suffering from the financial crisis of 2007-09.

Ivashina and Scharfstein, (2010) also researched the overconfident behavior of the CEOs and top-level management. The authors collected the banking data from 1994 to 2009 to compare the performance of different banks before and during the financial crisis. The results were no different as they illustrated that the banks with an overconfident and risk-taking approach suffered badly from the financial upswing. The results also revealed that the presumptuous banks were more aggressive in their lending policies and they were lending aggressively to the real-estate borrowers expecting a hefty return from their side. These banks seemed to increase their loan by an overwhelming 14% annually which was about 12% more than the non-confident banks. And 11% of this increase was observed while lending to the real estate borrowers. The increase of leverage of the overconfident banks was also found to be 6% more than the non-confident banks in the non-crisis years. This indicates a greater risk-taking behavior that was identified by the Federal State Revenue as well as the other financial experts. But the managerial hubris lead these banks to suffer the most.

Fahlenbrach et al., (2011) observed that the over-confident banks suffered due to their loan policies. Most of the issued loans were in default or near to default which caused a large capital loss to them. These capital losses along with high leverage decreased the worth of the banks. In addition to this, the GFC era also saw many depositors withdraw all their savings and fire sales leading to a further decreased worth of these banks. These financial institutes recorded the worst stock return performance due to faulty assumptions by the CEOs and top-level management. And about 90% of these banks replaced their over-confident CEOs with a moderate policymaker who decreased the leverage to bring these financial institutes back on the track (Fahlenbrach and Stulz., 2012).

Beltratti and Stulz, (2012) compared the performance of the overconfident CEOs before the 1998 Russian financial crisis and 2007 GFC. The researchers found a similarity in the attitudes of the CEOs of both eras. The banks and financial institutes seemed to fail to understand the need for moderate policies

rather than the illogical and higher-return policies that impacted them detrimentally. In addition to this, both the financial crisis were found to be occurring due to the real-estate and the monetary policies favoring the real-estate sector (Beltratti and Stulz, 2012).

Berger and Bouwman., (2013) conducted research over the managerial competency and relating it with the modern era financial crisis of 2007. The researchers found out the managerial competency plays a key role in the management of the firm and gaining a competitive advantage over the other firms. However, a slightly better performance saw the overconfident side of many CEOs. The same happened before the GFC of 2007 when the banks slightly benefited by their easy lending options implemented an easy-loan policy for the real-estate sector. The sector failed to return resulting in the capital losses of the banks. Thus, the managerial incompetency not cost them their post but also resulted in a decreased worth of these banks.

Prilmeier and Stulz., (2012) researched to investigate the stock performance of different banks before and during the financial crisis. The authors analyzed the data of about 347 banks operating in the US during this period and related the stock performance with the risk-taking ability of the banks. The weaker risk-management abilities of the managers are related to their traits. The CEOs taking rash and over-confident decisions were found to have weak risk-management abilities. Similarly, the stock performance of the banks with a non-confident manager implementing moderate lending decisions was better in the crisis as compared to the managers implementing aggressive lending policies.

Malmendier et al., (2011) illustrated that the managers issuing a large number of loans to the real estate sectors were unable to finance the investments due to the overestimated returns on their investment. This faulty approach led them to lend funds from different external sources and they preferred debt over equity. These managers tend to increase the leverage when their overconfident nature perceived a business opportunity much stronger than it was. Due to their large business returns on high leverage during the non-crisis period, these CEOs never took the financial crisis much seriously and continued with the same approach during the credit boom. That resulted in the lost worth of the banks and the managers who overinvested in the real-estate sector were deeply trapped in additional debts. Thus these banks were more vulnerable to the external crisis than the non-confident banks.

Santos (2011) also illustrated the role of managerial hubris in this leading financial crisis. The CEO and corporate decision making lead to the issue of shaky loans that made these financial institutions more vulnerable to economic upturns. The overconfident CEOs eased down the loan returns to attract a large number of customers expecting a huge return on these investments. The results were otherwise as the financial crisis resulted in a decrease in the quality of these loans and the managers were unable to recover their overconfident investments. Thus, the GFC was detrimental for the CEOs who implemented an overconfident policy (Santos, 2011).

5. Conclusion

So, the GFC of 2007 not only shook the financial institutes of the US but also created a void in the performance of the banks around the globe. Many countries suffered from worse financial sufferings during this era and recovered with great difficulty. However, the banks were the most impacted institutes from this havoc. Especially the banks with increased leverage and easy loan conditions suffered badly and their stocks performed the worst during this period. The managerial hubris of the CEOs and other higher authorities making the banking policies were the most blamed individuals for the worst performance of the banks. Many of them were replaced after the havoc and moderate policies were implemented afterward. The above-conducted literature review also illustrates the same results. The overconfident attitude of the CEOs lead to the worst performance of the banks and the risk-taking abilities of the bank were completely modified after the financial crisis was over.

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