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CEO Power and Risk-taking: Intermediate Role of Personality Traits

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Abstract

The authors examine the ways in which different personal characteristics of a CEO under the influence of CEO power may in turn affect personal risk-taking. Agency theory states that managers have non-changing risk preferences and are either risk-averse or risk-neutral. However, there may be cases when managers are risk-seekers, and the power of executives is positively related to excessive risk-taking. Additionally, agency theory assumes that CEOs are homogenous in power use and ignores the difference between CEOs in terms of personality traits, as well as their impact on corporate decisions. Therefore, our aim is to focus specifically on the factors that connect CEO power to CEO risk-taking and to analyze the possible effects of this relationship on a firm. Based on both psychological and managerial studies, we conclude that, on the one hand, a CEO's power can affect their personal traits by producing [in the case of overconfidence or hubris] or enhancing them [in case of narcissism]. On the other hand, CEOs' personal traits affect their risk-taking. It can occur either through changing risk perception or due to behavior patterns inherent in those traits. Finally, we hypothesize that CEO power can affect CEO personal risk-taking through personality traits. By examining the relationship between CEO power and CEO risk-taking based on individual-level determinants, our paper adds to the behavioral corporate finance and corporate governance literature.

Keywords: CEO power, CEO personality traits, CEO risk-taking, corporate governance, behavioral finance

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Introduction

Agency theory, driven by the idea of divergent interests of the parties who own and control the firm, stipulates that company managers are more risk-averse than shareholders want them to be [1–3]. That is why the issue of corporate governance is to establish proper mechanisms that would amend managers' orientation in terms of their risk-taking preferences [4]. Despite a substantial amount of research devoted to the association between managerial risk-taking and corporate governance mechanisms, the results are still imprecise [5]. The problem may lie in the acceptance of the agency theory, which states that managers have non-changing risk preferences and are either risk-averse or risk-neutral [4; 6; 7]. Conversely, there may be cases when managers are risk-seekers, and the power of executives is positively related to excessive risk-taking. This additional assumption was proposed by social psychology scholars apart from the classical agency perspective [8]. The most important point here is that if managerial interests are in line with the shareholders' interests, corporate risk-taking will yield benefits. However, if there is a misalignment of managerial beliefs with shareholders' attitudes, additional risk may be harmful for the firm [9].

Unfortunately, agency theory largely ignores the possibility that agency problems may vary at the personal level. However, academic literature is currently shifting its focus from exploration of company-level determinants of corporate risk-taking to individual-level determinants. The vast body of contemporary research attempts to investigate how psychological and demographic characteristics of top managers influence corporate risk-taking attitudes [10]. For example, innate attributes of executives, such as overconfidence [11], narcissism [12], hubris [13], sensation seeking [14], education [15], military background [16], early life experiences [17], religious belief [18], and political affiliations are of interest [19]. Moreover, the fraction of variance in firm performance explained by CEOs' individual characteristics has grown substantially over the last decades [20].

Agency theory also ignores the impact of CEO power on individual-level processes. Alternatively, a bulk of recent research in the field of social psychology has substantiated that on the individual level power has the ability to alter basic psychological processes [21]. It was reasonable to look at power through the lens of two neurobiological systems, namely, inhibition and approach systems, to explain the differences in individuals' behavior [22]. Research demonstrated that the activation of each system leads to differences in individuals' attitude to risk preferences [8; 23]. Accordingly, in our paper we hypothesize that a CEO's personal characteristics may be affected by a CEO's power, which in turn affects their personal risk-taking attitude.

In our study we explore the link between CEO power, personal traits and risk-taking on the individual level. There is abundant evidence in both theory and practice that CEO has the most influential role within the company and is the driver of company decisions and outcomes [24–26]. Moreover, we postulate that different authority levels of CEOs' positions may lead to different attitudes to risks. Therefore, the aim of this paper is to focus specifically on the factors that connect CEO power with CEO risk-taking and to analyze the possible effects of this relationship on firm performance.

Based on existing studies, we propose that CEO power may be one of the factors affecting CEO risk-taking. On the one hand, CEO power can affect their personal traits, producing or enhancing them. Based on psychological studies, we can conclude that power can act both as the underlying condition for traits to emerge or develop [in the case of overconfidence or hubris] and as an enhancement factor [in case of narcissism]. On the other hand, CEOs' personal traits affect their risk-taking either by changing their perception of risk, or because of behavior patterns inherent in those traits. This relationship expands the existing theories that connect CEOs' power and risk-taking, including corporate risk-taking. By examining the relationship between CEO power and CEO risk-taking based on individual-level determinants, our paper adds to the literature on behavioral corporate finance and corporate governance. As far as we are aware, our study is the first attempt to link CEO power and personal risk-taking based on personality traits.

The paper is structured in following way: we begin with an analysis of the relationship between CEO power and personality traits, then we proceed to examining the risk-taking patterns with respect to personality traits, finally, we combine the two parts in order to connect CEO power and risk-taking behavior.

CEO power and personality traits

CEO power has one of the key roles in the relationship between CEO and shareholders. Agency theory postulates that since shareholders are widely dispersed, it is hard for them to effectively monitor and control CEO behavior. Lack of control leads powerful CEO to use this power to engage in self-serving actions at the expense of company owners. Thus, we can expect that the presence of a powerful CEO may impact corporate performance. Indeed, a significant amount of research provide interesting insights into this relationship. For instance, empirical findings suggest that CEO power is associated with the firm's financial performance, performance volatility and productivity [27–33], IPO, M&A and divestitures [34–36]; innovativeness [37; 38]; dividend policy [39; 40], firm performance under turbulent conditions [41; 42] and most importantly for our study of the company's risk attitude [43–49].

Despite extensive literature coverage, the topic of CEO power remains open for discussion. Indeed, existing studies do provide an understanding of how CEO power can affect corporate performance. However, they still fail to provide conventional wisdom on this relationship, as results often lead to contradictory conclusions. One of the likely shortcomings of agency theory is that CEOs are viewed to be homogeneous in their use of power. Seeing CEOs as agents who are expected to behave in a certain way based

on agency conflict, agency theory ignores CEOs' personal attitude to power and their personality traits, which may be affected by that power. In fact, there is a corpus of psychological research studies that show that one's personality traits indeed may be influenced by the experience of power, which changes a person's behavior pattern.

In their studies of CEO power and bank risk-taking, K.B. Lewellyn and M.I. Muller-Kahle [47] draw the attention to the fact that agency theory ignores the possible impact of power on CEOs' psychological processes. The authors rely on results of D. Keltner et al. [8] and C. Anderson and A.D. Galinsky [50], who point out that those in power tend to pay more attention to positive outcomes, discounting possible threats. These results are also supported by the findings of M.E. Inesi [51], which indicate that power reduces loss aversion; moreover, results suggest that power holders are less risk averse as well. N.J. Fast et al. [52] complemented these results by showing that the experience of power can lead to overconfidence in decision-making or, more specifically, to overestimation of the accuracy of one's own knowledge. Additionally, power can affect people's behavior, leading to an overestimation of their own initial judgment, and making the most powerful people the least accurate in their assessments [53]. It is reasonable to assume now that above-described relationship between power and overconfidence found in psychological research holds in the corporate context as well.

The problem of overconfidence as a CEO personality trait is proposed and first documented in the study by U. Malmendier and G. Tate [54]. The authors argue that overconfident managers overestimate the returns on their investment projects and found that investment-cash flow sensitivity is affected by CEO overconfidence. Of particular interest for our study is the work of H. Hwanga et al. [55]. Based on the psychological observation that power can induce overconfidence, the authors argue and empirically test the hypothesis that CEO power may be the source of CEO overconfidence. Their results support the general findings of N.J. Fast et al. [52], who revealed a causal relationship between overconfidence and power, specifically pointing out that the latter increases the former. Moreover, H. Hwanga et al. [55] identify two types of overconfidence: power-led overconfidence and personality-led overconfidence. Connecting their own findings and conclusions in existing literature on overconfident CEO behavior in M&A, the author argues that previous studies typically depict power-led overconfident CEOs. As a result, H. Hwang et al. [55] show that power-led overconfident CEOs tend to complete more deals regardless of economic circumstances, conduct stock acquisitions, and acquire diversified assets. From another point of view, I. Vitanova [56] documented that power-induced overconfidence has a positive impact on overall corporate performance.

Overconfidence is not the only power-related trait, in fact, hubris is probably the most power-affected personality trait. It is one of the human cognitive biases, which is characterized by exaggerated self-confidence and pride [57]. It should be noted that even though overconfidence is usually observed among persons with hubristic behavior, the two traits still differ. While overconfidence depicts an excessive degree of confidence, hubris reflects a person's presumptions and arrogance [i.e., towards gods in Greek myths]. Describing the "hubris syndrome," D. Owen [58] declares that hubris is inextricably linked to power, that power is an important prerequisite and when it wanes, the syndrome weakens as well. Under certain circumstances, in particular the experience of power, hubristic leaders become "intoxicated" by it and grow overconfident, overestimating the probability of successful outcome and discounting possible threats [59]. Powerful CEOs are probably the most likely candidates for the hubris syndrome to emerge. It is therefore not surprising that the combination of CEO power and CEO hubris found its representation in empirical research. Specifically, J.H. Park et al. [57] demonstrate that CEO power exacerbates the negative impact of CEO hubris on Korean firms. While hubris by itself makes CEO overestimate possible positive outcomes and underestimate negative ones, as well as discount advice from others, power and its entrenchment provides decision-making authority and resources to undertake value-destroying projects. However, results suggest that board vigilance can mitigate this negative effect. D. Cormier at al. [60] also document the negative effect of hubristic and powerful CEOs in connection with financial misreporting. In contrast, their results point out that governance mechanisms, in particular board independence, are ineffective in mediating this relationship.

Another personality trait that psychologists link to power is narcissism. Unlike hubris, which is more of a state-like phenomena, narcissism is more similar to a personality trait, meaning that power is not a mandatory condition for the emergence of narcissism [59]. Narcissism in psychology is described as a "multifaceted personality trait encompassing individual differences in feelings of grandiosity and entitlement and in strivings for attention and superiority" [61]. In this case, power is a fantasy, a source of constant supply of attention, admiration, and recognition for a narcissistic person [62]. Accordingly, narcissists strive for power and can subsequently abuse power to achieve personal needs. The key driver for power abuse is self-intoxication, unlike the power intoxication in case of hubris [59]. This fact may have implications for agency theory that connects CEO power and extraction of resources for personal needs (in case the CEO is narcissistic). Therefore, while narcissism is not dependent on power, power is an important and desired tool in the hand of a narcissistic person. In a corporate context, for example, D.H. Zhu and G. Chen [63] showed that narcissistic CEOs with power are likely to appoint new directors to the board who have similar narcissistic tendencies. The authors argue that such CEOs may expect that similarity in narcissistic inclinations among new directors can decrease the level of uncertainty in the directors' support of CEOs' leadership and decisions.

Overall, based on psychological studies we can conclude that power can have an impact on a person's behavior. Power can act as both the underlying condition for traits

to emerge or develop (in the case of overconfidence or hubris), as well as the enhancement factor (in case of narcissism). In a corporate context, such patterns are also observed and documented, meaning that CEOs' personal traits may be also dependent on their level of power.

CEO personality traits and risk-taking

It is important for any company to understand the factors that affect corporate decisions, especially those related to risk-taking. Corporate risk preferences and risk-taking are crucial for the decision-making process and affect firm growth, survival, and performance [64; 65]. According to agency theory, in comparison with managers, company shareholders prefer to take higher risks when those risks are associated with positive project returns, because shareholders may diversify risks [9]. If managerial interests are in line with the interests of shareholders, corporate risk-taking will yield benefits. However, if there is a misalignment of managerial beliefs with shareholders' ones, additional risk may be harmful for the firm.

According to T.B. Palmer and R.M. Wiseman [66], it is important to separate managerial [personal] risk-taking from corporate risk-taking, although the latter may be affected by the former. Personal risk-taking is rooted in personal traits, perceptions of and beliefs about future outcomes, whereas corporate risk-taking mostly refers to the overall implementation of a company's long-term strategies [67; 68]. A huge corpus of literature in applied psychology demonstrates the need to examine the effect of different personality dimensions on managerial decision-making through perceived threat, optimism, reaction to gains and losses and high uncertainty [69–73]. Attributes such as gender, age and personality were found to affect an individual's risk propensity [74; 75], resulting in different personal risk-taking patterns [67]. An understanding of differences in individual risk perception, which depends on variability of personalities, may explain the differences in companies' risk profiles and risk-taking decisions [76].

The relationship between personality traits and risk-taking has been already partially discussed earlier. Risk-taking characterizes a choice pattern of a person who decides whether to receive a guaranteed outcome or to play lottery with equal expected values [77]. Figner and Weber [77] point out that risk-taking is dependent on the characteristics of the decision maker, as well as on the decision domain. The authors argue that person-centered characteristics such as age, gender, personality, and culture have an impact on risk-perception – an important factor for risk-taking.

W.K. Campbell et al. [78] specifically analyze how narcissism relates to risk-taking. The authors draw the attention to the fact that narcissists fail in two areas: accurate assessment of their own abilities and appropriate strivings to success. Thus, self-overconfidence and focus on success make narcissists rely on bold decisions and bet on successful outcomes with little fear of failure. It is reasonable to assume that narcissists may take additional risks, driven by the overwhelming expectation of possible narcissistic supply flow in case of a successful outcome. This assumption is supported by the study of J.D. Foster et al. [79], who showed that narcissistic risk-taking is fueled by increased expectations of benefits stemming from risky behaviors.

In a corporate context, narcissism provides CEOs with situational incentives, which are then transformed into their decisions and have an overall effect on a company's strategic and investment plans [80]. Previous research on narcissism established that narcissistic executives, compared with their non-narcissistic colleagues, manifest themselves as more talented people with greater levels of creativity and leadership attributes [81–83]. Consequently, narcissistic CEOs base their decisions on a biased expectation that their performance will be better than that of others, and assume that they will reach guaranteed success in each of the tasks [78]. However, such cognitive bias may result in the overestimation of problem-solving capabilities and the underestimation of risky ventures and the firm's levels of uncertainty [84]. To satisfy their need for admiration, narcissistic executives get involved in risky activities, which highlight their superiority and place them in the center of attention [85; 86]. Moreover, when corporate strategies include innovative projects, narcissistic CEOs with higher influence on corporate decisions prefer to be engaged in high-risk projects [87]. Thus, power is an important attribute for this leader type, and they use their power in order to fulfil their strong desires [88]. That is why, from the above-described perspective, we expect to discover a positive relationship between CEO narcissism and personal risk-taking, as well as a positive relationship between CEO power and CEO risk-taking. On the other hand, the persistent need for a confirmation of their self-view may lead narcissistic CEOs to less risk-taking, because they may fear criticism of useless and unsuccessful initiatives [89]. In line with these thoughts, A. Agnihotri and S. Bhattacharya [90] show that risky decisions, such as firm internationalization, are related to CEO narcissism. The authors point that while other CEOs may see risk and uncertainty in risky decisions, i.e., internationalization, narcissistic CEOs may rely on bold and aggressive decisions by virtue of their personality and supreme self-confidence.

As discussed earlier, in addition to narcissism, overconfidence can have an impact on risk-taking. The prefix "over" already reveals an expectation of a certain assessment bias. Based on existing psychological literature, D.A. Moore and P.J. Healy [91] highlighted the three key ways of defining overconfidence, namely overprecision, overplacement, and overestimation. All these three elements imply that a person overestimates their accuracy or abilities compared to themselves or others. Thus, in case of risk-taking, overconfidence may have an impact on risk-perception, leading to greater risk-taking. While a narcissistic person may take additional risks because of their striving for success, an overconfident person may rely on their inflated expectation of successful outcome probability [or low risk-percep-

tion]. M.H. Broihanne et al. [92] show that among finance professionals, overconfidence and underestimation of risk play a crucial role in explaining risk-taking decisions, more specifically, that overconfidence has a positive impact on risk-taking behavior.

In addition to psychological characteristics, existing studies provide empirical evidence of the relationship between CEO risk-taking and demographic traits. Such traits include education [93–96], professional experience [93], early-life traumatic experience [11; 97–99], birth order [10–102], tenure [93; 103] and age [104–111]. For the purposes of our research, the above-mentioned personality traits are not of particular interest, since they are unlikely to be affected by CEO power. However, we can assume that power use may be dependent on CEO experience, age, or tenure, and there is still insufficient literature coverage of this issue.

CEO power, personality traits and risk-taking

Agency theory predicts that CEO power has a negative impact on corporate risk-taking. On the one hand, unlike shareholders, CEOs cannot diversify risks since their assets and wealth are directly connected to the firm they manage. On the other hand, agency conflict implies that CEOs are prone to extract personal benefits at the expenses of shareholders. Effects of these motives on corporate performance are expected, so that companies with powerful CEOs will have lower leverage [46], lower R&D expenses [37], etc. However, as already stated, agency theory, which views CEOs as economic agents, assumes that CEOs are homogenous in power use and, more importantly, ignores heterogeneity in CEOs personality traits.

Up until now we have considered the relationship between CEO power, personal traits and risk-taking behavior independently to prepare the ground for their further consolidation. Based on the existing studies, we are proposing that CEO power may be one of the factors affecting CEO risk-taking. Still, this relationship may be an indirect one, with personal traits being the key intermediate point. On the one hand, CEOs' power can affect their personality traits, producing or enhancing them. On the other hand, CEOs' personality traits affect their risk-taking behavior both by changing their perception of risk, and by means of behavior patterns inherent in those traits. Either way, this relationship expands the existing theories, which connect CEOs' power and risk-taking, including corporate risk-taking.

These findings force us to revise the existing studies linking CEO power and CEO personal and corporate risk-taking, especially those with contradictory results. The fact that power can affect a person's psychological processes and engage with personality traits has implications for empirical research. It is reasonable to assume that CEO narcissism, overconfidence and hubris may be significant mediators in the relationship between CEO power and corporate decisions, especially those that require risk-taking. The same is expected for the impact of personal traits on corporate decisions, since power can act as a mediator [enhancer] of the influence of personal traits. Inclusion of such variables will allow us to account for the heterogeneity of CEOs' behavior, their motives, risk attitude, and power use patterns.

Several limitations are worth noting. First, in this study we do not address the question of possible moderators of the power–traits–risk-taking relationship. From literature on corporate governance we know that the corporate board, exchange regulation and market conditions can act as significant mediators of CEO power [43; 112–114]. At the same time, studies demonstrate that personality traits may also be affected by external conditions. For example, A. Chatterjee and D.C. Hambrick [80] found that risk-taking behavior of narcissistic CEOs is highly dependent on social praise. Thus, the impact of such mediators may yield interesting results. Secondly, as it was stated in the second part, risk-taking decisions are dependent on the personal characteristics of the decision maker and the decision domain. While the relationship between personality traits and risk-taking is explained in the second part, decision domain remained out of the scope of discussion. Considering the high level of CEOs' responsibility to shareholders for corporate performance, as well as the possible pressure from the market environment, the relationships between power, personality traits and risk-taking observed in psychological studies may not be applicable for CEOs. Still, there is no evidence of that, so this is a limitation and an opportunity for future research. Lastly, we assume that CEO power indirectly affects CEO personal risk-taking, with personality traits being an intermediate factor. However, we do not rule out the possibility that CEO power may have a direct impact on risk-taking. Empirical testing would shed the light on this, but in order to test this relationship, we must correctly assess the level of CEOs' personal risk-taking, which is highly problematic. Thus, we are leaving this question for future research.

Conclusion

Existing studies on CEO power and corporate risk-taking mostly rely on assumptions of agency theory, which ignores the heterogeneity of CEO power use, as well as the CEO personality. Motivated by these shortcomings, our study aims to address these questions by analyzing relevant managerial and psychological literature. We hypothesize that a CEO's personal risk-taking [which, in turn, has an impact on corporate risk-taking] may be dependent on CEO power, with CEO personality traits being intermediate point. Results of psychological studies show that power can affect a person's risk behavior, causing overconfident conduct or nurturing narcissism and other traits. Managerial studies contribute to the common psychological view and depict these patterns among CEOs in real-life situations.

These findings have implications for empirical research in the field of corporate decisions, performance, and corporate governance. There are some limitations still, but together with results they provide ground for future research.

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