Uncertainty, manager bias and corporate leverage

In the past few years, we have witnessed a global rise in uncertainty due to political, economic, and social factors. The rise in uncertainty tends to impact the firm decision-making and corporate activities significantly. The literature has tried to uncover this relationship in various ways; however, a lot still needs to be discovered.

Research shows that uncertainty significantly impacts the firms' investment decisions. When the uncertainty rises, the firms are constrained by heightened financial constraints, higher capital adjustment costs, and increased risk of capital irreversibility; thus, investment decisions are impacted. In addition, uncertainty increases information asymmetry, increasing the value of real options for the firm (Bloom et al., 2007).

Meanwhile, an increasing body of literature also explores the interplay between uncertainty and corporate financing decisions. The study by Im et al. (2020) explores the difference between the book and market target debt-equity ratio of the high uncertainty versus low uncertainty firms. The firms also see a varied impact of uncertainty on their capital structure based on whether the firms are over-levered or under-levered (Im et al., 2022).

The present study aims to extend the literature on the impact of uncertainty on corporate leverage decisions by performing a detailed analysis of major firms functioning in the G-7 countries. Being nations at an advanced stage of development and evolved financial markets, the impact of uncertainty on corporate financing decisions can be established clearly. The past two decades have seen frequent spikes in uncertainty, including the COVID-19 pandemic, tariff wars, and de-globalizing initiatives; thus, we study the period from 2000-2024.

The study concentrates on uncovering managerial biases' role in impacting corporate financing decisions during periods of uncertainty, specifically focusing on the overconfidence and over optimism level of the managers. We also explore whether cultural, institutional, and financial conditions and corporate diversification moderate the financing decision.

The capital structure of the firm is expected to have lower debt levels due to uncertainty. However, we find that uncertainty spikes lead to an increase in managers' optimism and overconfidence bias. The optimistic and overconfident manager prefers more debt as the associated belief is that the rise in uncertainty shall not affect the firms operations and the fixed nature of debt repayment will not be impacted. The cultural, institutional, and financial conditions and diversification factors are expected to reinforce the overconfident and over-optimistic nature of the managers.

References:

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