**Restraining overconfident CEOs through credit ratings**

Overconfidence is at the root of many historic failures. In a new working paper, a group of researchers shows that it is possible to tame managerial overconfidence. One would expect that CEOs behave rationally and base their decision making on facts, statistics, and sound logic. However, if the collapse of Bahamas-based cryptocurrency exchange FTX in 2022 taught us something, it is that this may not always be the case. CEOs despite the level of responsibility and expectations regarding their decision-making process, are as likely to showcase irrational decisions as anyone else. Therefore, at that time a vital lesson was taught to the world of business, overconfident CEOs who overestimate their abilities may lead their businesses to financial ruin with bad decisions.

Overconfident CEOs may not only take more risky decisions, believing them to be worth the inherent risk, but they may also downplay the riskiness of investment itself and overestimate its potential future value. Therefore, the judgements made in the process are faulty, resulting in overinvestment behaviour that may turn out to be detrimental to company's value and its long-term success, particularly if the company has access to large internal capital and debt capacity. In worst cases, such overinvestment behaviour can lead to corporate failure.

Corporate credit ratings play an important role in key corporate decisions. Concerning the effects of rating downgrades (e.g., increased cost of capital and limited access to the external capital markets), CEOs deliberately undertake corporate decisions that avoid jeopardising firms' ratings. In theory, mergers and acquisitions (M&As) are perceived to be worthwhile for companies, reducing credit risks while improving profitability. However, empirical studies find that M&A transactions negatively impact the credit rating of acquiring firms due to increased credit risk. Interestingly, the risk of being downgraded after an acquisition deal is higher for high-rated firms.

In an interview with *The Guardian*, the psychologist and bestselling author of *Thinking, Fast and Slow* – Daniel Kahneman – said that he would eliminate overconfidence if he had a magic wand. Considering the potential rating downgrades following acquisition activity, the question is whether credit rating could become that *magic wand* in the corporate world. Utilising a sample of 916 US companies rated over the period 2006–2019, the research conducted by Shee-Yee Khoo, Thanos Verousis, Huong Vu and Patrycja Klusak find that overconfident CEOs engage in more acquisition activity than rational CEOs at low rating levels, but opposite behaviour is found at high rating levels. The authors also discover that overconfident CEOs learn from negative credit rating signals and subsequently take more corrective actions in their investment decisions that is appreciated by the market participants.

Their results suggest that credit ratings could serve as an external control mechanism of CEO overconfidence. This can be particularly useful for companies, which could potentially utilise credit ratings to restrict the overinvestment behaviour of overconfident CEOs, whilst still able to exploit their risk appetite and over-optimism. This paper will be presented on the 12th International Conference of the Financial Engineering and Banking Society (FEBS), which is held between 1–4 June, 2023 at the Conference Center of the Mediterranean Agronomic Institute of Chania, Greece.