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Bank Profitability and Risk-Taking

by Natalya Martynova, Lev Ratnovski, and Razvan Vlahu

***IMF Working Papers* describe research in progress by the author(s) and are published to elicit comments and to encourage debate.** The views expressed in IMF Working Papers are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

I N T E R N A T I O N A L M O N E T A R Y F U N D

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Research Department

Bank Profitability and Risk-Taking

Prepared by Natalya Martynova, Lev Ratnovski, and Razvan Vlahu¹

Authorized for distribution by Giovanni Dell’Ariccia

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Abstract

Traditional theory suggests that more profitable banks should have lower risk-taking incentives. Then why did many profitable banks choose to invest in untested financial instruments before the crisis, realizing significant losses? We attempt to reconcile theory and evidence. In our setup, banks are endowed with a fixed core business. They take risk by leveraging up to engage in risky ‘side activities’ (such as market-based investments) alongside the core business. A more profitable core business allows a bank to borrow more and take side risks on a larger scale, offsetting lower incentives to take risk of given size. Consequently, more profitable banks may have higher risk-taking incentives. The framework is consistent with cross-sectional patterns of bank risk-taking in the run up to the recent financial crisis.

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