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## The Interaction between Risk, Return-Risk Trade-off and Complexity: Evidence and Policy Implications for US Bank Holding Companies

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### Abstract

We examine two aspects of bank risk with an emphasis on the interaction between them. Moreover, throughout the analysis we differentiate between non-complex and complex banks, the latter of which could be seen as exhibiting a further level of risk. We seek to establish how these risk factors interact with bank specific, market structure and economic variables. Key results indicate that earnings volatility (business risk) increases with market power but decrease with size and output. While risk-taking (managerial risk) decreases with market power and increases with size and output. Furthermore, in examining return per unit of risk, results demonstrate that increase return and risk-taking is associated with bank specific factors and the economic environment, whereas decrease risk taking is associated with market structure. This suggests a management of risk, which increases with factors under bank control or improving external environment but decreases with the interaction of competitors. Overall, the results suggest that policy should focus on liquidity and equity buffers that should operate counter-cyclicality but size and market structure per se are not determining factors for higher risk. In terms of the recent financial crisis, it is likely that the great moderation that proceeded the crisis led to higher risk-taking due to higher economic growth but without the necessary buffers being established.

Keywords: Banks, Risk, Earnings, Volatility, Risk-Return, Complex, Prospect Theory, Market Structure, Sharpe Ratio  
JEL: C23, G21

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