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Let those who venture absorb their own losses

From Mr Daniel J. Aronoff.

Sir, Martin Wolf is concerned that the UK government is not going to demand that banks reduce leverage enough to avert danger of another financial meltdown ("Two cheers for Britain's banking reform plans", June 15).

I am sure Mr Wolf is aware that the British government (like all other governments) is confronted with an apparent dilemma: imposing lower leverage requirements now is likely to cause balance sheet contraction – which means less lending – as part of the adjustment, which the UK economy can ill-afford.

How, then, to reconcile the contradictory pressures for loan expansion and balance sheet restructuring? It can be done in two ways. One is by setting minimum capital requirements based on the current size of a bank. This would make adjustment by shrinking the loan book less attractive. The other is to force an immediate conversion of a portion of unsecured debt into equity, such that the bank would then meet the new leverage requirement. The reduction in leverage will remove the motive to channel capital into reserves for anticipated future losses, and normal lending is likely to resume.

In response to the financial crisis, governments have placed it upon the taxpayer to provide equity capital to insolvent banks. This ill-advised and inequitable policy has rendered peripheral European governments insolvent and brought Europe to the brink. There is another way to solve the banking crisis. It is time to opt for the quintessentially capitalist solution of requiring those who have made ventures to absorb their own losses, immediately. It is simply amazing that this straightforward and equitable approach has not yet been pursued.

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