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# Regulators should not go too far in fixing rules on leverage

*From Mr Daniel J Aronoff.*

Sir, Daniel Shäfer points to a "frightening" trade-off some banks may be undertaking by depleting liquidity in order to reduce leverage ("Contradictory rules are pushing banks to be riskier", Inside Business, August 6). His appeal to fix definitions of leverage so that liquid assets do not add to regulatory leverage, is sensible. But regulators should not go too far in compromising the rules on leverage.

In a choice between solvency and liquidity, it is solvency that should have the priority. The reason is that central banks can always provide liquidity, which was once their raison d'être. In the financial crisis, central bankers were able to rapidly restore liquidity once they set their minds to it. They did so by lending on illiquid securities held by banks and dealers; in effect liquefying the balance sheet of the private sector.

Solvency is a different matter. Once the value of a bank's assets slips below its liabilities (or even if it gets close), it cannot extend new credit. The debt overhang plaguing banks since the financial crisis has been a major drag on economic recovery in Europe and the US. Until governments pass the legislation and acquire the political will to force a timely deleveraging, the damaging effects of banking insolvency will always be long-lasting.

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