Banks just might have too much equity

Published: December 13 2010 05:23 | Last updated: December 13 2010 05:23

From Prof Eric De Keuleneer.

Sir, On December 8 the Financial Times staged a pretty good casting. On page 12, an interesting letter by **Richard Barwell** raises once again the issue of the right proportion of equity in bank balance-sheets, in the traditional way that could be summarised as: should banks be imposed capital surcharges and higher equity levels?

On the opposing page, Adair Turner ("**We need new rules to keep bankers honest**", Comment) was in fact making a very legitimate and unconventional answer to that question, one which regulators should more deeply think about. Lord Turner is in fact saying that bankers should take less risk, and be made more responsible for better understanding and managing the risk they take. Further on this page, John Kay ("**Learn to love the candid bearer of bad news**", Comment) was describing the necessity for regulators to stop encouraging banks to outsource their credit analysis to rating agencies, and make them more responsible for their own credit assessment. As a matter of fact, the most risky activities of banks (like ill-informed lending and other risk-taking) are not only dangerous for the banks themselves, but also detrimental to society as a whole.

Altogether, this provides an unusual but very interesting solution to the two thorny regulatory problems of imposing additional capital for banks, and coping with the quality and independence of rating agencies: 1) banks do not need more equity, they need to take less risk, which they can do with their existing capital while doing more business they know and understand, and less of the often useless and risky other stuff; 2) ratings agencies should be used less and with less authority, which would make their mistakes less dangerous.

It might be interesting for politicians and bank shareholders to think about the possibility that banks do not have too little equity, but maybe too much, at least for the level of risk they can manage in the best interest of their shareholders, and the economy as a whole.

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