When a profitable company is hit by a very large liability, as was the case in 1985 when Texaco lost a $12 billion court case against Pennzoil, the solution is not to have the government buy its assets at inflated prices: the solution is Chapter 11. In Chapter 11, companies with a solid underlying business generally swap debt for equity: the old equity holders are wiped out and the old debt claims are transformed into equity claims in the new entity which continues operating with a new capital structure. Alternatively, the debtholders can agree to cut down the face value of debt, in exchange for some warrants. Even before Chapter 11, these procedures were the solutions adopted to deal with the large railroad bankruptcies at the turn of the twentieth century. So why not use this well-established approach to solve the financial sector’s current problems?

The obvious answer is that we do not have time; Chapter 11 procedures are generally long and complex, and the crisis has reached a point where time is of the essence. If left to the negotiations of the parties involved this process will take months and we do not have this luxury. However, we are in extraordinary times and the government has taken and is prepared to take unprecedented measures. As if rescuing AIG and prohibiting all short-selling of financial stocks was not enough, now Treasury Secretary Paulson proposes a sort of Resolution Trust Corporation (RTC) that will buy out (with taxpayers’ money) the distressed assets of the financial sector. But, at what price?

If banks and financial institutions find it difficult to recapitalize (i.e., issue new equity) it is because the private sector is uncertain about the value of the assets they have in their portfolio and does not want to overpay. Would the government be better in valuing those assets? No. In a negotiation between a government official and banker with a bonus at risk, who will have more clout in determining the price? The Paulson RTC will buy toxic assets at inflated prices thereby creating a charitable institution that provides welfare to the rich—at the taxpayers’ expense.

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If the RTC subsidy is large enough, it will succeed in stopping the crisis. But, again, at what price? The answer: Billions of dollars in taxpayer money and, even worse, the violation of the fundamental capitalist principle that she who reaps the gains also bears the losses. Remember that in the Savings and Loan crisis, the government had to bail out those institutions because the deposits were federally insured. But in this case the government does not have to bail out the debtholders of Bear Sterns, AIG, or any of the other financial institutions that will benefit from the Paulson RTC.

Since we do not have time for a Chapter 11 and we do not want to bail out all the creditors, the lesser evil is to do what judges do in contentious and overextended bankruptcy processes: to cram down a restructuring plan on creditors, where part of the debt is forgiven in exchange for some equity or some warrants. There is precedent for such a bold move. During the Great Depression, many debt contracts were indexed to gold. So when the dollar convertibility into gold was suspended, the value of that debt soared, threatening the survival of many institutions. The Roosevelt Administration declared the clause invalid, de facto forcing debt forgiveness. The Supreme Court upheld this decision.

My colleague and current Fed Governor Randall Koszner studied this episode and showed that not only stock prices, but bond prices as well, soared after the Supreme Court upheld the decision. How is that possible? As corporate finance experts have been saying for the last thirty years, there are real costs from having too much debt and too little equity in the capital structure, and a reduction in the face value of debt can sometimes benefit not only the equityholders, but also the debtholders.

If debt forgiveness benefits both equity and debtholders, why do debtholders not voluntarily agree to it? First of all, there is a coordination problem. Even if each individual debtholder benefits from a reduction in the face value of debt, she will benefit even more if everybody else cuts the face value of their debt and she does not. Hence, everybody waits for the other to move first, creating obvious delay. Secondly, from a debtholder point of view, a government bail-out is better. Even talk of a government bail-out reduces the debtholders’ incentives to act, making the government bail-out more necessary.

As during the Great Depression and in many debt restructurings, it makes sense in the current contingency to mandate a partial debt forgiveness or a debt-for-equity swap in the financial sector. It has the benefit of being a well-tested strategy in the private sector and it leaves the taxpayers out of the picture. But if it is so simple, why has no expert mentioned it? The major players in the financial sector do not like it. It is much more appealing for the financial industry to be bailed out at taxpayers’ expense than to bear their share of pain. Forcing a debt-for-equity swap or a debt forgiveness would be no greater a violation of private property rights than a massive bailout, but it faces much stronger political opposition.

The appeal of the Paulson solution is that it taxes the many and benefits the few. Since the many (we, the taxpayers) are dispersed, we cannot put up a good fight on Capitol Hill; while the financial industry is well represented at all the levels. For 6 of the last 13 years, the Secretary of Treasury was a Goldman Sachs alumnus. But, financial experts are also responsible for this silence. Just as it is difficult to find a doctor willing to testify against another doctor in a malpractice suit, no matter how egregious the case, finance experts in both
political parties are too friendly to the industry they study and work in.

The decisions that Congress must make now will matter not just to the prospects of the U.S. economy in the year to come; they will shape the type of capitalism we will live in for the next fifty years. Do we want to live in a system where profits are private, but losses are socialized? Where taxpayer money is used to prop up failed firms? Or do we want to live in a system where people are held responsible for their decisions, where imprudent behavior is penalized and prudent behavior rewarded?

For somebody like me who believes strongly in the free market system, the most serious risk of the current situation is that the interest of a few financiers will undermine the fundamental workings of the capitalist system. The time has come to save capitalism from the capitalists.

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