How to fix the credit mess without a government bailout: quickie bankruptcies.

Countless kibitzers told Hank Paulson that there was a better way to rescue the financial system than to buy up bad mortgage paper. Many believed the government should buy preferred stock, the way Warren Buffett is doing. Here’s a third way to end the crisis. It's simple and it doesn't cost taxpayers a dime. My proposal is to streamline bankruptcy in a way that would allow banks to restructure their debt and restart lending. This special Chapter 11 would be temporary, lasting only one year.

Congress would pass a law that sets up a new form of prepackaged bankruptcy. Prepackaged means that all the terms are prespecified and banks could come out of it overnight once a federal judge signs off.

Firms who enter into this special bankruptcy would have their debt converted to equity. This would immediately transform a bank's books. As it stands now, banks have lost so much in junk mortgages that the value of their equity has tumbled to zero. (In many cases the stated book value is still healthy-looking, but that's only because troubled banks have been slow to mark down weak assets.) This special Chapter 11 would allow them to convert all their debt (commercial paper, bonds and interbank lending with a maturity longer than three days) into equity. This would make them solvent and ready again to lend to customers.

My plan would exempt individual depositors. Though all deposits are considered debt, my plan would protect the little old lady in Omaha who has a $175,000 certificate of deposit. The entire amount would be exempt from the equity conversion, while at the same time the conversion would make that deposit safe.

Potential losers are institutions and individuals who hold commercial paper and other forms of debt. But there is a possible upside for these debt holders. If a bank can regain its footing and restore itself to health, then the equity could be worth quite a bit someday.

Another provision: Banks would not be considered in default as far as their contracts are concerned. Credit default swaps and repo contracts these banks hold with other financial institutions would remain in place. This would avoid any potential ripple effect.

Most people equate bankruptcy with liquidation. They think that filing for bankruptcy causes a firm to go under. On the contrary, for a firm with a healthy business, bankruptcy is simply an opportunity to renegotiate its financial claims, so that it can get its ratio of debt to equity back on track.

Ordinary bankruptcies take a long time. That's why these bankruptcies would be on automatic pilot. Unlike traditional prepacks, terms would not have to be negotiated; they would be preset for all parties in the same way. This would allow the bankruptcy to be implemented overnight.

How would the government get banks to voluntarily declare special bankruptcy? One way is to have the Fed limit access to liquidity. Currently both banks and investment banks can go to the Federal Reserve's discount window, meaning that they can, by posting collateral, receive cash at a reasonable rate of interest. Under my plan, for two years, only banks that underwent special bankruptcy would get access to the discount window. In this way solid financial institutions that do not need restructuring would stay away from bankruptcy, while insolvent ones would rush into it to avoid a government takeover.
Certainly old shareholders who think their bank is solvent but faces a temporary liquidity problem might feel expropriated by this procedure. But there is a simple solution. After the filing of the special bankruptcy the bank gets one week to decide, individually, whether to buy out new shareholders by paying the face value of the old debt claim. In this way the old debt holders can get paid in full and the old equity holders can recapture the value of their claim.

The beauty of my approach is threefold. First, it recapitalizes the banking sector at no cost to taxpayers. Second, it keeps the government out of the difficult business of establishing the price of distressed assets. If all of an institution's debt is converted into equity, its total value--its assets plus its going-concern value--remains the same. The bankruptcy changes only the legal nature of the claims on this value. Third, my plan takes away from the government the possibility of playing God and deciding which banks are allowed to live and which should die. The market will make those decisions.

Most important, this plan upholds the free market principles we live by. Any other plan brings heavy-handed government intervention, weakens market incentives and sows the seeds of the next crisis.

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