Bank of the United States

At first glance, Citigroup's endorsement last week of a Senate plan to allow bankruptcy judges to break mortgage contracts looks like a scene from "Goodfellas."

AP

Since October, the government has invested $52 billion in Citi, while agreeing to eat up to $249 billion in losses on the bank's toxic real estate portfolio. And so it's really hard to say no when those Washington "investors" call for a favor. In the 1990 Martin Scorsese movie, a restaurant owner realizes too late that a partner big enough to protect him is big enough to take everything he has. As Ray Liotta narrates, "Now he's got Paulie as a partner. Any problems, he goes to Paulie. Trouble with a bill, to Paulie . . . But now he has to pay Paulie."

The problem with Citi's capitulation is that it means that not just Citi will have to pay the Beltway outfit if the bill passes. Other banks, borrowers and taxpayers will also suffer. In fact, this deal is looking more and more like a case of Citi colluding with its new political owners in order to force competing banks to break contracts and take more losses. This kind of politicized banking is precisely why the Bank of the United States was shut down in the 19th century.

After years of resisting, Citi has suddenly signed off on Senator Dick Durbin's plan to allow judges to rewrite mortgage contracts for borrowers in Chapter 13 bankruptcy. Under the Illinois Democrat's plan, which is earmarked for inclusion in the pending stimulus bill, judges could reduce the amount of principal, lower the interest rate, and change the length of the mortgage term.

Until Washington embraced the politics of housing panic, even sensible Democrats recognized that allowing such mortgage "cramdowns" was a terrible idea, sure to punish future borrowers with higher rates as lenders calculate the increased risk. The Congressional Budget Office warned in January 2008 that such a change could result in higher interest rates for homeowners and bigger caseloads in bankruptcy courts. In 2007, 16 House Democrats signed a letter opposing similar legislation.

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They realized that the consequences would fall hardest on those hoping to buy a home, if markets logically respond by setting mortgage interest rates closer to those on, for example, auto loans or credit cards. A bankruptcy judge is now free to reduce amounts owed on many types of consumer debt. For mortgages, the iron-clad requirement to pay off the loan or lose the house is precisely to encourage lower rates on a less risky investment.

Supreme Court Justice John Paul Stevens described the importance of this principle in 1993 in Nobelman v. American Savings Bank: "At first blush it seems somewhat strange that the Bankruptcy Code should provide less protection to an individual's interest in retaining possession of his or her home than of other assets. The anomaly is, however, explained by the legislative history indicating that favorable treatment of residential mortgages was intended to encourage the flow of capital into the home lending market."

Mr. Durbin argues that borrowers won't be able to enjoy the benefits of a cramdown until they first make an effort to negotiate new terms with their lenders before declaring bankruptcy. Also, to counter the perception that they are harming the mortgage market, Mr. Durbin and Senate colleagues Chris Dodd and Chuck Schumer are proposing that cramdowns only be available for mortgage contracts signed before their bill becomes law. But of course lenders will have every reason to assume that, whenever the going gets tough, Washington will let future borrowers break contracts too.

Mr. Durbin and his allies have tried and failed several times to break the cramdown opposition, and they believe Citi finally gives them the club to prevail. As Mr. Schumer noted in a press release, "Citigroup's support means that the dam has broken across the banking industry. We now have a real chance to pass this legislation quickly." Talking point number one for Democrats is that if giant Citigroup is for this plan, why would anyone oppose it?

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In fact, Citigroup may support this plan precisely because it isn't a big player in the mortgage market. Sure, it has some dodgy mortgage-backed securities on its books, but they've been written down and the feds cover 90% of losses beyond $29 billion in any case. When it comes to making loans, however, Citi originates less than 10% of American mortgages.

Citi is falling further behind J.P. Morgan Chase, which acquired Washington Mutual; Wells Fargo, which acquired Wachovia; and Bank of America, which bought Countrywide. J.P. Morgan's mortgage business is now twice the size of Citi's, while Wells and BofA each originate almost three times as much dollar volume as Citi. So in agreeing to Mr. Durbin's offer, Citi is also volunteering its competitors to write down more mortgages, giving Citi a comparative advantage.

But the unintended consequences could make even Citi rue the day it got in bed with the goodfellas on Capitol Hill. If the possibility of this refinancing-via-bankruptcy encourages more people to declare bankruptcy, that would mean additional losses on Citi's credit cards and auto loans.

Having spent the past year committing taxpayer trillions to support American banks, Washington now seems not to mind at all if its latest bailout drives up bank losses on mortgages, credit cards and other loans. The Senate could soon make Paulie look like a reasonable business partner.