How a Memo Cost Big Banks $37 Billion

Justice Department Lawyer Jump-Started Probe That Led to Three Giant Settlements

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Richard Elias, a former Justice Department lawyer, spotted a memo that jump-started the investigation that helped the Justice Department get nearly $37 billion in financial-crisis-related settlements from J.P. Morgan, Bank of America and Citigroup. Mr. Elias, shown above, now is in private practice in St. Louis.
Jennifer Silverberg for The Wall Street Journal

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Assistant U.S. Attorney Richard Elias was leafing through a pile of J.P. Morgan Chase & Co. documents while tending to his newborn son in 2012 when he found something that came back to haunt the three largest U.S. banks.

In a memo, one J.P. Morgan employee warned her bosses they were putting bad loans into securities being created before the financial crisis hit.

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The U.S. attorney's office in Sacramento, Calif., soon started sending subpoenas to J.P. Morgan officials tied to the memo. Three months later, top Justice Department officials in Washington told investigative teams across the country to hunt for similar ammunition in tens of millions of documents from other banks, especially Bank of America Corp. and Citigroup Inc.

In a move meant to shake money from the banks, the Justice Department decided to go after them with an unusually potent law created to clean up the savings-and-loan crisis of the 1980s. The law has a lower burden of proof than other laws used by the agency to punish alleged fraud, a much longer statute of limitations and potentially astronomical financial penalties.

Mr. Elias's discovery has delivered a whopping payoff so far: $36.65 billion, representing the cost of the government's three separate settlements with the banks since late 2013, including the $16.65 billion deal with Bank of America in August that is the largest ever between the U.S. and a single company.

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The total is by far the biggest single chunk of an estimated $128 billion in crisis- and mortgage-related settlements, fines and other costs incurred by the six largest U.S. bank holding companies, according to SNL Financial. Ongoing investigations could push the tally higher.

"Given the magnitude of the conduct, I believe the settlement was fair and just," says Mr. Elias, 39 years old, who got the Justice Department's second-highest employee-performance award for his work on the J.P. Morgan case.

Like so much else about the 2008 financial crisis, though, the final reckoning is more complicated. Privately, executives at Bank of America, Citigroup and J.P. Morgan are seething. They say numbers used by the government as a prod to settle were arbitrarily huge, and the banks claim the Justice Department's maneuvering with the S&L-era law was used to bully them.

Government officials say they wanted to punish the banks but not cripple them financially.

Bad blood runs especially deep at Bank of America and J.P. Morgan. They acquired Merrill Lynch & Co., Countrywide Financial Corp., Bear Stearns Cos. and most of Washington Mutual Inc. with government encouragement as it scrambled to contain the crisis. Most of the securities attacked by the government were created before those takeovers.

One of the country's best-known banking lawyers, H. Rodgin Cohen, senior chairman of law firm Sullivan & Cromwell LLP, says the three gigantic settlements have deepened the distrust between bankers and regulators as the crisis recedes. As a result, "ultimately, the banks are reluctant to be innovative and make loans," Mr. Cohen says.

Critics counter that the government let the banks pay too small a price for sloppy and fraudulent loans, the pell-mell assembly line of mortgage securities that disintegrated into staggering losses for investors, and other negative consequences that spread throughout the world.

The $36.65 billion which Bank of America, Citigroup and J.P. Morgan agreed to pay the Justice Department, seven states and other government agencies or as aid to borrowers is roughly equal to the U.S. banking industry's third-quarter profit.

A spokesman for the Justice Department said it has "taken historic actions to hold banks accountable for pervasive schemes to defraud investors in residential mortgage-backed securities." The agency "will continue to devote energy and resources to these investigations," he added.

This description of the Bank of America, Citigroup and J.P. Morgan investigations and settlements is based on interviews with people on both sides.

Things weren't going well for the Justice Department before Mr. Elias found the J.P. Morgan memo. In January 2012, President Barack Obama announced in his State of the Union address that a new group of federal lawyers and state attorneys general would expand government probes of "abusive lending and packaging of risky mortgages that led to the housing crisis."

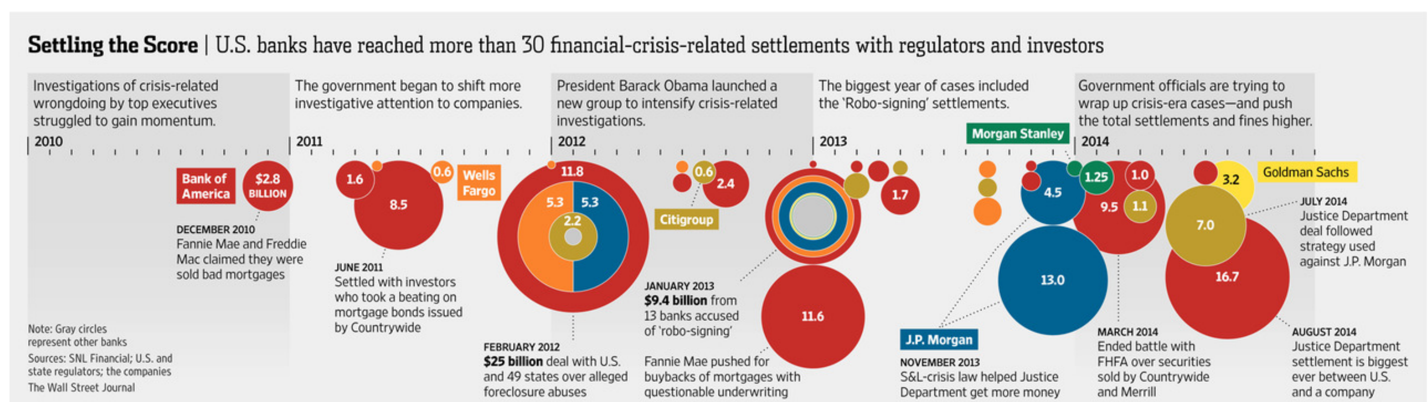
The group got off to a slow start. Investigations were distributed to U.S. attorney's offices across the country, but federal officials could find little evidence needed to win a big civil or criminal case alleging fraud.

Near the end of conference calls, Mr. Elias, who became a federal prosecutor in 2011 and worked in a satellite office in Fresno, Calif., said the U.S. attorney in Sacramento didn't have a case but wanted one. In October 2012, Justice Department officials in Washington asked his boss, Benjamin Wagner, to start digging into J.P. Morgan.

As soon as he saw the memo, Mr. Elias believed the government had a case against the bank. Summoned to Justice Department headquarters in January 2013 for a meeting scheduled to last 45 minutes, Mr. Elias and two colleagues were peppered with questions for twice as long.

The agency's No. 3 official, Tony West, turned to a deputy and said: "This case has to be our model. We need to be doing this with the other districts."

Justice Department officials set a deadline: They wanted a big win by the end of 2013. Attorney General Eric Holder, who had begun making plans to step down, felt heat from Democratic lawmakers impatient about the lack of crisis-related charges against a big bank or top executive.



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Investigators across the U.S. were told to scour other banks' internal documents for similar incriminating evidence. Lawyers searched company records for some of the same words Mr. Elias saw in J.P. Morgan documents, such as "fallout" and "kick" as nods to the percentage of bad mortgages in a certain pool.

Lawyers soon found suspicious documents at Citigroup and Merrill. For example, due-diligence companies hired by the firms had assigned "event grades"—one was the best, and three was the worst—to loans to signify whether they met the firm's own underwriting standards.

Investigators concluded that some loans with the lowest event grade wound up in mortgage securities pitched to investors with prospectuses that promised higher-quality loans overall.

“These are the worst mortgages I’ve ever seen,” a J.P. Morgan banker emailed about a deal.

In a 2007 email, a Bank of America trader complained about efforts to add low-quality loans to one deal. Traders faced risk if problems erupted with the underlying loans. “Like a fat kid in dodgeball, these need to stay on the sidelines,” the trader wrote.

The J.P. Morgan memo also breathed life into an idea Mr. West mentioned to U.S. attorneys after taking over the Justice Department’s civil division in 2009. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 includes a provision for civil penalties for fraudulent conduct “affecting a federally insured financial institution.”

Lawmakers wrote the provision to go after fraud in which a bank was the victim, and it was rarely used after the S&L mess’s cleanup. As government lawyers became convinced that banks knowingly sold flawed mortgage securities, the agency decided to aim Firrea directly at the banks.

The government jolted the banks with a February 2013 civil lawsuit against bond-rating firm Standard & Poor’s Ratings Services, seeking $5 billion under Firrea’s civil-penalty provision. The suit was filled with internal emails that the government cited as evidence S&P defrauded investors by assigning good ratings to mortgage-backed securities it knew were bad.

S&P, a unit of McGraw Hill Financial Inc., has vehemently denied the allegations but has been open to a possible settlement.

Mr. West asked one of the lead lawyers in the S&P lawsuit, Geoffrey Graber, to use Firrea to help accelerate the mortgage-bond investigations. Some investigators were making progress, while others seemed stuck in “rabbit holes,” one federal official recalls.

Bank lawyers said the S&P suit was a warning to banks that the Justice Department could come after them with Firrea. The law has a 10-year statute of limitations, compared with three to five years in most civil cases. It is a powerful alternative to criminal prosecutions because the government must prove the defendant’s guilt only by a “preponderance of the evidence,” rather than “beyond a reasonable doubt.”

Government lawyers were emboldened by a federal court judge’s refusal in April 2013 to throw out a non-crisis-related civil suit in which the Justice Department wielded Firrea against Bank of New York Mellon Corp. The bank was accused of cheating customers on foreign-exchange transactions.

The bank’s lawyers claimed Firrea wasn’t meant to target banks as the alleged perpetrator. The judge disagreed but hasn’t ruled on the overall case.

In response to sprawling subpoenas, banks responded with dozens of terabytes of data. “It was almost like

decoding the DNA of the individual bonds by tracing it back over the generations of due diligence to the original pools," says John Walsh, the U.S. attorney in Colorado and co-head of the group announced by President Obama in 2012.

By mid-2013, Mr. Elias and other lawyers were nearly done drafting a lawsuit alleging that J.P. Morgan misled investors about the quality of mortgages packaged into bonds. Other U.S. attorneys' offices were deploying more employees to sort through bank data.

J.P. Morgan executives were eager to settle. Bank lawyers hired mock juries to gauge how their side of the case might play out in a courtroom. The results were disheartening, especially when the "jurors" saw internal emails. J.P. Morgan offered $1 billion to settle some allegations.

The offer brought a curt reply from Justice Department lawyers, who said J.P. Morgan ought to be thinking about a number closer to $20 billion. The agency's lawyers believed they could win cases alleging that Bank of America, Citigroup and J.P. Morgan were each responsible for at least tens of billions of dollars in investor losses on mortgage deals.

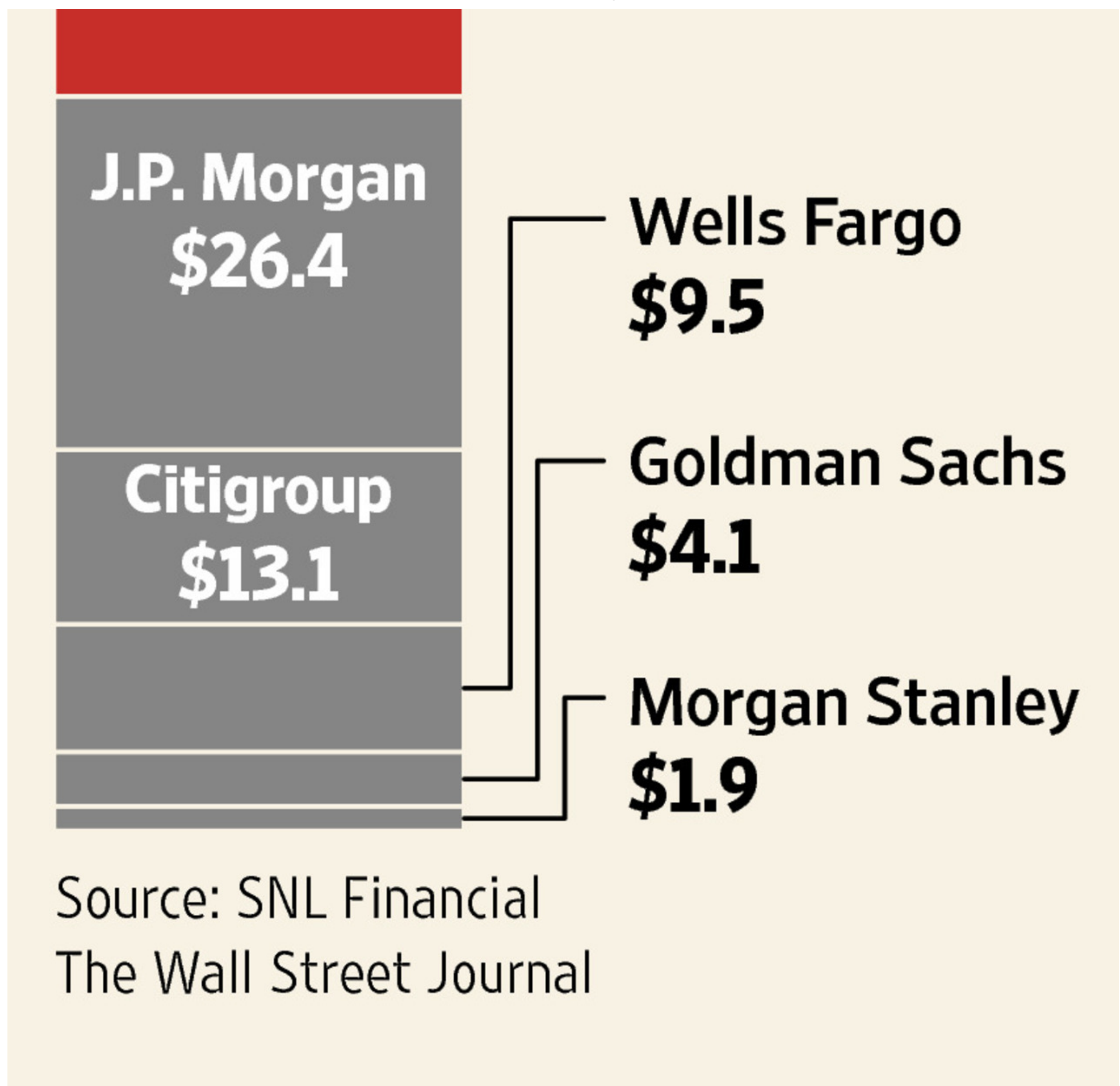
During negotiations, the government's numbers shrank when considering factors often weighed in civil cases, such as potential deterrent value, the defendant's ability to pay and case law, which was relatively sparse.

The banks got few answers when lawyers "asked where the numbers came from," says a person close to the banks. "We were told they came from the attorney general of the United States."

$128 Billion

Financial-crisis-related settlements, fines and other costs by the six biggest U.S. banks since 2010:

Bank of America
$73.5
BILLION



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In a follow-up meeting with J.P. Morgan, federal officials told the bank it was being offered a good deal. Executives were shaken by the possibility of huge financial damages and feared potential restrictions on acquisitions, bank-branch expansion and new-product development.

Still, the two sides were far apart during September 2013 settlement talks in Mr. Holder's conference room. In addition to the settlement amount, lawyers sparred over whether the deal would end an ongoing criminal investigation into misleading investors. That probe is continuing.

Deputy Attorney General James Cole, the No. 2 official at the Justice Department, interrupted the squabble, told J.P. Morgan executives and lawyers that it could end the criminal probe by pleading guilty, stood up and left for another meeting. But the bank and government still couldn't reach a deal.

Later that month, the Justice Department was hours away from plowing ahead with a civil suit against J.P. Morgan when Chairman and Chief Executive James Dimon called Mr. West on his cellphone to say the bank could increase its offer.

About eight weeks later, the government announced a $13 billion settlement with J.P. Morgan. The bank neither admitted nor denied wrongdoing, but it agreed to a "statement of facts" that included damning details.

Negotiations with Citigroup and Bank of America had a similar tone. " 'We don't care' was the response to every substantive argument the banks made," says a person close to the banks. Justice Department officials say they weighed the counterarguments and adjusted some demands.

In May, Citigroup was told the government wanted roughly $12 billion. The bank dug in its heels at $7 billion, and the government eventually agreed. The deal was announced in July.

Bank of America executives were aghast at the government's demand for $20 billion. Chief Executive Brian Moynihan later asked to speak to Mr. Holder. Federal officials said no.

A crucial turning point came when a federal judge ordered the bank in July to pay $1.27 billion tied to a Countrywide loan program known as "Hustle." The government had invoked Firrea in the civil case.

Mr. Moynihan got more bad news when Mr. Holder called the same day to say a U.S. attorney was ready to file a civil suit over Merrill bond deals. The settlement was announced three weeks later. Bank of America says it will appeal the judge's Hustle ruling.

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