

## VI. *Citigroup Settles with DOJ for Illicit Mortgage Activities in 2006 and 2007*

### A. Introduction

In 2006 and 2007, financial institutions—including Citigroup Inc. (“Citigroup”)—engaged in massive subprime lending of mortgage backed securities.<sup>1</sup> According to the Department of Justice (“DOJ”), Citigroup failed to perform proper due diligence and comply with certain state and federal laws, primarily through misrepresentations concerning the quality of their loans.<sup>2</sup> Citigroup often combined these loans together as mortgage backed securities that were in turn sold to other investors.<sup>3</sup> This allowed Citigroup to dodge the financial ramifications of their failed loans.<sup>4</sup> Lender misrepresentations, such as those Citigroup made, led to a major wave of mortgage defaults in 2007, causing housing prices to plummet and igniting a complete market crisis.<sup>5</sup> Citigroup is among a number of large banks that recently settled DOJ charges that they engaged in illicit mass subprime lending and significantly contributed to the recent financial crisis.<sup>6</sup> Pursuant to the DOJ settlement, Citigroup must pay \$7 billion dollars that will go to the U.S. government and towards initiatives to help homeowners

---

<sup>1</sup> U.S. DEP’T OF JUSTICE, CITIGROUP SETTLEMENT: STATEMENT OF FACTS 1 (2014) [hereinafter STATEMENT OF FACTS], available at <http://www.justice.gov/iso/opa/resources/558201471413645397758.pdf>, archived at <http://perma.cc/Y2PJ-7DJS>.

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> See Steven L. Schwarcz, *The Future of Securitization*, 41 CONN. L. REV. 1313, 1318–21 (2009) (discussing how the originate-to-distribute model creates moral hazard issues for banks like Citigroup, by allowing banks to avoid the consequences when borrowers default).

<sup>5</sup> Marilyn Geewax, *Citigroup Settlement Offers Former Homeowners ‘Cold Comfort,’* NPR (July 15, 2014, 10:55 AM), <http://www.npr.org/2014/07/15/331444471/citigroup-settlement-offers-former-home-owners-cold-comfort>, archived at <http://perma.cc/DMM4-FE93>.

<sup>6</sup> See Peter J. Henning, *Blurred Lines in Big Bank Mortgage Settlements*, N.Y. TIMES DEALBOOK (Aug. 22, 2014, 9:44 AM), <http://dealbook.nytimes.com/2014/08/22/blurred-lines-in-big-bank-mortgage-settlements/>, archived at <http://perma.cc/PL6T-JXCC> (discussing how JPMorgan Chase and Bank of America recently settled similar charges from the DOJ).

affected by the illicit lending practices.<sup>7</sup> While this penalty is substantial, it still begs the question of whether the DOJ is being tough enough on the institutions that allegedly triggered a major U.S. economic crash.<sup>8</sup>

This Article provides an overview of Citigroup's actions leading up to the 2008 crash, outlines the Citigroup settlement with the DOJ, and analyzes the severity of the imposed punishments. Part B provides the history of Citigroup's faulty loan practices that contributed towards the financial crash. Next, Part C discusses the DOJ settlement with Citigroup. Part D discusses whether the DOJ settlement is substantial enough to sufficiently punish Citigroup. Part E asks whether the penalty will deter similar behavior in the future.

### **B. Citigroup's Subprime Lending Leading Towards the 2008 Crash**

In the early and mid 2000s, banks including Citigroup issued thousands of residential loans and then sold these loans as "residential mortgage-backed securities" to a variety of investors, including federal institutions.<sup>9</sup> In securing these loans, Citigroup represented in offering documents to investors that the loans complied with all laws and "originated generally in accordance with the loan originator's underwriting guidelines."<sup>10</sup> Citigroup conducted due diligence on the loans "by reviewing certain loans in [each] loan pool," instead of the collective loan pool, which led to an inaccurate depiction of the loan pool's status.<sup>11</sup> Citigroup also used outside due diligence vendors to review the loans.<sup>12</sup> The due diligence vendors focused on "credit," determining whether the loan met the underwriting guidelines, or in the alternative, whether the originator found the loan had other "compensating factors" that allowed it to deviate from the underwriting guidelines.<sup>13</sup> The vendors also focused on "compliance," or whether the

---

<sup>7</sup> Andrew Grossman & Christina Rexrode, *Citigroup to Pay \$7 Billion in Mortgage Probe*, WALL ST. J. (July 14, 2014, 7:45 PM), <http://online.wsj.com/articles/citigroup-to-pay-7-billion-to-resolve-mortgage-probe-1405335864>.

<sup>8</sup> See Henning, *supra* note 6.

<sup>9</sup> STATEMENT OF FACTS, *supra* note 1, at 1–2.

<sup>10</sup> *Id.* at 2.

<sup>11</sup> *Id.* at 3.

<sup>12</sup> See *id.*

<sup>13</sup> *Id.*

loan “had been originated in compliance with federal, state, and local laws.”<sup>14</sup> Vendors gave the loans a grade based on the loan’s acceptability.<sup>15</sup> Vendors assigned a grade of “EV1” when the loan complied with all underwriting guidelines and laws governing loan origination, “EV2” when the loan “did not comply with applicable underwriting guidelines” but “had sufficient compensating factors . . . to justify the extension of credit,” and “EV3” when the loan was not in compliance with necessary laws or underwriting guidelines.<sup>16</sup>

In 2006 and 2007, Citigroup’s third-party due diligence vendors reported that a “significant percentage[]” of the graded loans were EV3, or unacceptable.<sup>17</sup> With this knowledge, Citigroup chose to have its internal due diligence group reevaluate the loan grades of many EV3 loans and change them to acceptable grades of EV1 or EV2.<sup>18</sup> The vendors also notified Citigroup that many of “the properties securing the loans had reported or appraised values that were higher than the vendors’ valuation determination.”<sup>19</sup> In other words, it appears Citigroup artificially inflated the appraisal values of certain properties in order to make the loans seem healthier.<sup>20</sup> In one instance, a vendor gave a due diligence report to Citigroup indicating that more than 25% of the sampled loans were graded EV3.<sup>21</sup> That same report indicated that 67% of the loans were EV2, and only 6% of the loans were EV1.<sup>22</sup> Nonetheless, Citigroup securitized the loans from this particular pool and sold them to investors.<sup>23</sup> In sum, Citigroup engaged in “sleight of hand” by reclassifying many of their loans to appear better than they actually were, and “then misrepresent[ing] [the loans’] quality to investors.”<sup>24</sup>

---

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* (“For each sampled loan reviewed for “credit” and “compliance,” the due diligence vendor assigned a grade.”).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 3, 5.

<sup>18</sup> See *id.* at 5. In other instances, Citigroup simply ordered the due diligence vendors to change the loans to acceptable grades. See Grossman & Rexrode, *supra* note 7.

<sup>19</sup> *Id.*

<sup>20</sup> See *id.*

<sup>21</sup> *Id.* at 6.

<sup>22</sup> *Id.*

<sup>23</sup> See *id.*

<sup>24</sup> Grossman & Rexrode, *supra* note 7.

### C. Citigroup's Settlement with the DOJ

#### 1. Terms of the Settlement

In July 2014, the DOJ announced it reached a record-breaking \$7 billion dollar settlement agreement with Citigroup for misleading investors about the quality of their securities, which were in fact backed by “toxic mortgages.”<sup>25</sup> Of the \$7 billion settlement, Citigroup must pay \$2.5 billion as consumer relief.<sup>26</sup> The settlement also provides that Citigroup must pay penalty payments of \$4 billion to the DOJ, \$200 million to the Federal Deposit Insurance Corporation (“FDIC”), and hundreds of millions to various state governments including New York and Delaware.<sup>27</sup> In addition to the consumer relief payments, Citigroup will also have to help struggling homeowners through mortgage refinancing, modification, and down payment assistance.<sup>28</sup> Since Citigroup has significantly downsized their mortgage business following the financial crisis, Citigroup doesn’t have enough struggling mortgagors they can help in order to meet this quota.<sup>29</sup> Accordingly, the bank “agreed to finance affordable rental housing in . . . ‘high cost of living areas.’”<sup>30</sup>

#### 2. Comparisons to Other Bank Penalties

While Citigroup’s settlement was record breaking and largely unique, it is similar in some respects to the DOJ’s recent settlements

---

<sup>25</sup> Press Release, U.S. Dep’t of Justice, Justice Department, Federal and State Partners Secure Record \$7 Billion Global Settlement with Citigroup for Misleading Investors About Securities Containing Toxic Mortgages (July 14, 2014), *available at* <http://www.justice.gov/opa/pr/justice-department-federal-and-state-partners-secure-record-7-billion-global-settlement>, *archived at* <http://perma.cc/E6N9-AE6Q>.

<sup>26</sup> U.S. DEP’T OF JUSTICE, CITIGROUP SETTLEMENT AGREEMENT 4 (2014) [hereinafter CITIGROUP SETTLEMENT AGREEMENT], *available at* <http://www.justice.gov/iso/opa/resources/471201471413656848428.pdf>, *archived at* <http://perma.cc/SGC2-ELRB>.

<sup>27</sup> *Id.* at 2–4. The \$4 billion civil penalty is the largest penalty ever assessed under the Financial Institutions Reform, Recovery and Enforcement Act (“FIRREA”). Press Release, U.S. Dep’t of Justice, *supra* note 25.

<sup>28</sup> See Michael Corkery, *Citi Settles Mortgage Securities Inquiry for \$7 Billion*, N.Y. TIMES, July 15, 2014, at B1.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

with other banks, including JPMorgan Chase and Bank of America.<sup>31</sup> Most recently, the DOJ reached an even larger \$16.65 billion settlement with Bank of America concerning its comparable misrepresentations and wrong doings with mortgage-backed securities.<sup>32</sup> Bank of America, JPMorgan Chase, and Citigroup all contributed significantly to the “egregious conduct” that propagated the 2008 financial crisis, yet the DOJ reached widely ranging settlement values with the banks.<sup>33</sup> The penalties appear to partially correlate to the value of mortgage-backed securities that each bank sold.<sup>34</sup> Citigroup sold mortgage-backed securities worth \$91 billion from 2005 to 2008, while Bank of America sold an astounding \$850 billion during that same period, which helps explain Bank of America’s larger settlement.<sup>35</sup> However, each bank heavily negotiated its specific settlement numbers, and “math appears to be only a partial consideration in coming up with a payout for the banks.”<sup>36</sup> The documents released by the DOJ do not reveal what, if any, “other considerations” may have played a role in determining the settlement figures.<sup>37</sup>

#### D. Historic Justice or Insufficient Penalty?

While the settlements imposed upon Citigroup and similar institutions are some of the largest in the history of the DOJ, some observers still question whether these punishments are adequate.<sup>38</sup> The fines are large but the deleterious effects they have on banks the size of Citigroup is questionable.<sup>39</sup> Of the Citigroup settlement agreement, \$2.5 billion is going towards loan modifications and principal reductions that

---

<sup>31</sup> See Henning, *supra* note 6.

<sup>32</sup> *Id.*

<sup>33</sup> *See id.*

<sup>34</sup> Dan Freed, *Citigroup Has Edge over Bank of America in Mortgage Fine Talks*, THESTREET (June 16, 2014, 1:12 PM), <http://www.thestreet.com/story/12745719/1/citigroup-has-edge-over-bank-of-america-in-mortgage-fine-talks.html>, archived at <http://perma.cc/6XWV-A94F>.

<sup>35</sup> *See id.*

<sup>36</sup> *Id.*

<sup>37</sup> *See CITIGROUP SETTLEMENT AGREEMENT*, *supra* note 26, at 1–2.

<sup>38</sup> See Evan Weinberger, *5 Takeaways from Citi’s \$7B Mortgage Deal*, LAW360 (July 14, 2014, 6:02 PM), <http://www.law360.com/articles/557167/5-takeaways-from-citi-s-7b-mortgage-deal>.

<sup>39</sup> *Id.*

have been dubbed “soft dollars.”<sup>40</sup> Many portions of the settlement, including the payments to the states, are tax-deductible, further reducing the burden of the penalty.<sup>41</sup> While Citigroup’s profits slid sharply after the mortgage crisis, they will still make a profit of \$181 million for the second quarter of 2014 with the settlement payments factored in.<sup>42</sup> Furthermore, following the announcement of the settlement, Citigroup’s stock price actually rose approximately four percent, in part because the \$7 billion dollar settlement was less than what analysts had predicted.<sup>43</sup> These points notwithstanding, analysts and internal sources at Citibank expected the settlement penalty to be significantly lower, which may indicate that the “historic penalty” may be appropriate.<sup>44</sup>

It is important to note that throughout the settlement process, neither the DOJ nor any other governmental body has filed criminal charges against any individuals for the subprime lending violations at Citigroup.<sup>45</sup> The DOJ announced that these settlements do not preclude the DOJ from filing criminal charges at a later date.<sup>46</sup>

#### E. A Deterrence or Mere Annoyance?

Many financial analysts question whether or not these penalties will actually deter institutions like Citigroup from similar conduct in the

---

<sup>40</sup> Corkery, *supra* note 28 (“The deal also includes \$2.5 billion in so-called soft dollars designated for the financing of rental housing, mortgage modifications, down payment assistance and donations to legal aid groups, among other measures intended to provide relief to consumers.”).

<sup>41</sup> See *id.* (“The payments to the states are tax-deductible, but the federal penalty is not.”).

<sup>42</sup> See John Kell, *Citi’s Profit Slumps 96% on Mortgage Settlement Costs*, FORTUNE (July 14, 2014, 9:55 AM), <http://www.fortune.com/2014/07/14/citi-seven-billion-settlement/>, archived at <http://perma.cc/L3EY-ARPB>.

<sup>43</sup> Chris Wright, *Citi: Where A \$7 Billion Fine Makes Your Shares Go Up 4%*, FORBES (July 14, 2014, 10:21 AM), <http://www.forbes.com/sites/chriswright/2014/07/14/citi-where-a-7-billion-fine-makes-your-shares-go-up-4/>, archived at <http://perma.cc/5V2E-TM6E>.

<sup>44</sup> Karen Freifeld & Aruna Viswanatha, *Citi, U.S. \$7 Billion Settlement Announcement Expected Monday*, REUTERS (July 13, 2014, 5:41 PM), <http://www.reuters.com/article/2014/07/13/us-citigroup-settlement-idUSKBNOFI11M20140713>, archived at <http://perma.cc/CNG9-GFP5>.

<sup>45</sup> See Geewax, *supra* note 5.

<sup>46</sup> *Id.*

future.<sup>47</sup> Since Citigroup pays the settlement, instead of the responsible executives, some analysts believe that bankers will not be deterred from illicit practices.<sup>48</sup> Since bankers have not been forced to give up their salaries and bonuses, some argue these settlements will not bring about any major change.<sup>49</sup>

While it will be hard to qualitatively measure the level of deterrence these settlements will have on financial institutions, the penalties will likely serve as a deterrent on some level.<sup>50</sup> Even if the individuals at the banks are not being punished, the shareholders of institutions like Citigroup end up losing when the company has to pay out millions of dollars that would otherwise increase the profits of the bank.<sup>51</sup> Shareholders can take action and demand more accountability for bank executives.<sup>52</sup> Furthermore, there have been some immediate indicators of change—both Citigroup and JPMorgan have significantly increased their compliance staff following their settlement agreements with the DOJ.<sup>53</sup>

#### F. New Regulations

In addition to the imposed penalties, new regulations are taking effect that place more stringent restrictions on mortgage lenders.<sup>54</sup> The Consumer Financial Protection Bureau (“CFPB”) has broad powers under the Dodd-Frank Act to supervise and enforce its rules against financial institutions by assessing and

---

<sup>47</sup> See Weinberger, *supra* note 38.

<sup>48</sup> *Id.*

<sup>49</sup> See James Surowiecki, *Punish the Executives, Not Just the Banks*, NEW YORKER (July 15, 2014), <http://www.newyorker.com/business/currency/punish-the-executives-not-just-the-banks>, archived at <http://perma.cc/83P9-W379>.

<sup>50</sup> See Devlin Barrett & Kirsten Grind, *Prosecutors Change Tune on Prevention*, WALL ST. J., July 17, 2014, at C2.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> Sital S. Patel, *Citi Will Have Almost 30,000 Employees in Compliance by Year-End*, MARKET WATCH (July 14, 2014, 4:54 PM), <http://blogs.marketwatch.com/thetell/2014/07/14/citi-will-have-almost-30000-employees-in-compliance-by-year-end/>, archived at <http://perma.cc/WPL6-GFKJ>.

<sup>54</sup> See Benjamin Goad, *CFPB Chief: Prepare for New Mortgage Regs*, THE HILL (Sept. 10, 2014, 5:01 PM), <http://thehill.com/regulation/217331-cfpb-chief-to-industry-prepare-for-more-mortgage-regs>, archived at <http://perma.cc/QH6X-4AYK>.

collecting massive penalties, among other enforcement powers.<sup>55</sup> The CFPB recently called for compliance with new regulations that require lenders to give borrowers certain disclosure forms “during the application process and again during the closing stage” of the loan process.<sup>56</sup> The CFPB regulations have also simplified the forms lenders such as Citigroup send to borrowers, thereby decreasing the chance that borrowers will be misled or confused by the loan offers.<sup>57</sup> These new regulations are in addition to the recent “qualified mortgage” rule issued by the CFPB, that requires lenders to adhere to more stringent practices to ensure that a borrower can repay a loan, which should in turn help protect investors seeking to purchase those loans.<sup>58</sup> These regulations, in tandem with the DOJ imposed penalties, should help deter the risky lending practices that occurred in the lead-up to the 2008 financial crisis.<sup>59</sup>

### G. Conclusion

Citigroup’s subprime lending of mortgage backed securities in 2006 and 2007 misled thousands of people and organizations, and eventually caused financial ruin for many.<sup>60</sup> The DOJ settlement agreement was designed to punish and deter Citigroup from participating in such egregious activity in the future.<sup>61</sup> Some analysts feel that the \$7 billion settlement agreement was not significant enough for an institution that many considered “too big to fail.”<sup>62</sup> It remains to be seen whether institutions like Citigroup

---

<sup>55</sup> See generally Alexandra Megaris, *The CFPB’s Mission Continues to Grow in Size and Scope*, LAW360 (Oct. 2, 2014, 10:40 AM), <http://www.law360.com.ezproxy.bu.edu/articles/582441/the-cfpb-s-mission-continues-to-grow-in-size-and-scope>.

<sup>56</sup> Goad, *supra* note 54.

<sup>57</sup> *Id.*

<sup>58</sup> See Ilyce R. Glink & Samuel J. Tamkin, *CFPB’s New Qualified Mortgage Rule Now in Effect*, WASH. POST (Jan. 22, 2014), <http://www.washingtonpost.com/blogs/where-we-live/wp/2014/01/22/real-estate-matters-cfpbs-new-qualified-mortgage-rule-now-in-effect/>, archived at <http://perma.cc/3X3U-6C77>.

<sup>59</sup> See Goad, *supra* note 54.

<sup>60</sup> See generally STATEMENT OF FACTS, *supra* note 1.

<sup>61</sup> See *supra* text accompanying notes 25–30.

<sup>62</sup> See *supra* text accompanying notes 38–53.

will adhere to proper due diligence and compliance in future transactions.

Sean Gordon<sup>63</sup>

---

<sup>63</sup> Student, Boston University School of Law (J.D./M.B.A 2016).