Wells Fargo Fake-Accounts Scandal

By Eve Tahmincioglu

"Wells Fargo board gets black eye in shareholder vote," was the glaring headline from Reuters following the financial giant's annual meeting earlier this year.

The contentious meeting included an investor shouting at directors about whether they were complicit in the fraud or just incompetent, and a largely anemic shareholder vote of support for the 15-member board.

“Wells Fargo stockholders today have sent the entire board a clear message of dissatisfaction,” said Stephen Sanger, Wells Fargo's board chairman in a statement after the vote. “Let me assure you that the board has heard that message, and we recognize there is still a great deal of work to do to rebuild the trust of stockholders, customers and employees.”

The Wells Fargo scandal, which including thousands of employees creating fake customer bank accounts, led to a $142 million government settlement, congressional hearings and the ouster of the firm's CEO and chairman, John Stumpf.

A report by Wells Fargo meant to explain the fiasco found: “The root cause of sales practice failures was the distortion of the community bank's sales culture and performance management system, which, when combined with aggressive sales management, created pressure on employees to sell unwanted or unneeded products to customers and, in some cases, to open unauthorized accounts.”

As for bank's directors, the report stated that “the board was regularly engaged on the issue; however, management reports did not accurately convey the scope of the problem.”

Indeed, much of the responsibility fell on management, says Clifford Rossi, finance professor at the University of Marylands' Robert H. Smith School of Business.

"A lot stopped at the senior management level, and didn't bubble up to the board," he explains. "That said, fundamentally the buck stops with board. The board has to keep pressing, asking a lot of questions like, 'Are there any issues you have identified that could come back to bite us?'"

These days most of bank risk isn't coming from the financial risk, he notes. "It's coming more from the operational risk, people, process and technology."

"The board's duty is oversight," says Robert Zafft, an attorney with Greensfelder, Hemker & Gale in St. Louis, Mo., who writes the "Ethics Talk" column for American City Business Journals. The rules increasingly are more specific about financial controls and risk management, he adds. "Where was the spot-checking and the big data audits that should have caught this relatively quickly?"

Understandably, he continues, there was deference to the CEO who had much success driving shareholder value, but therein lies the problem. "The reason you have the board is to ask questions, not cheerlead the CEO," he adds.

So could the board have done more and what are the lessons learned?

Sheila Hooda, CEO of Alpha Advisory Partners, offered a rundown on what she sees as the board issues at the core of the Wells Fargo debacle.

It's about:

• The board not setting the right tone at the top in terms of ethics, values, culture, customer orientation, incentives and compensation.

• The board relying too much on the information provided by management and the CEO, who was also the board chair, a clear and huge example of asymmetric information risk.*

***Defining "Asymmetric Information Risk" — Its Importance**

Management typically has more detailed firm-specific knowledge about the daily operations of the company.

Boards in their independent, external role bring professional experience, alternate perspectives and objectivity, and exercise oversight.

This information imbalance – or asymmetric information – is a positive and complementary to management's internal views. However, it could also present a serious governance challenge and risk if the information, underlying assumptions and analyses that are critical i.e., risk-related measures and assessment, performance metrics etc., is not received in a timely manner and thoroughly discussed at the board level.

Management's presentation of the information could include their biases. Relying on this information could preclude boards from asking good questions or using a healthy dose of skepticism for effective monitoring and independent oversight. In this context, to overcome asymmetric information risk, boards are increasingly expanding their sources of external information and using consultants, experts and surveys, and other independent third parties including analysts, customers and employees at different levels.

Hooda *is CEO & president of Alpha Advisory Partners and serves on the boards of Mutual of Omaha Insurance Company and Virtus Investment Partners.*

• The board not seeing the early red flags or understanding the risk and gravity of the fraud and not asking the hard questions in a timely manner.

• The board being slow to meet its duty of oversight, failing to take immediate ownership and action to address the issue, even when the fraud became public.

As early as 2002, there were warning signs, points out Hooda, who serves on the board of Mutual of Omaha Insurance Company and Virtus Investment Partners.

The "extreme pressure on meeting sales goals and cross-selling," she continues, "was causing increasingly suspicious activity and sales gaming, along with an increase in terminations of employees." But, "the fallout from the toxic sales culture was largely ignored and downplayed by the CEO and department management, and viewed as isolated incidents across a sprawling decentralized bank."

When the board reportedly became aware of the fraud in 2011, she adds, tough questions should have been asked and investigations heightened, especially when thousands of employees were being fired.

Even in 2015 when the board became more engaged following public disclosure of millions of fraudulent accounts being opened, she notes, the board did not take the serious steps needed, including pushing out Wells Fargo's Community Banking Department head and Stumpf.

The board should have made immediate changes to the organization's structure, she explains, to centralize the risk function and bolster transparency and accountability. And they should have goaded management to revamp the sales incentive and performance systems.

"While the above is clearly a very significant governance and oversight lapse on the part of the board, subsequent actions by the board indicate a general reluctance to take ownership of their responsibilities," she says.

Recent developments

"Only recently," she adds, "there has been a refocus to better understand the needs of customers, employees and other key stakeholders, indicating a shift in the tone at the top and a changing organizational culture."

A bright line in this debacle, Hooda points out, is that the board has withheld 2016 bonuses of the new CEO and several direct reports as it pushes for stronger management accountability.

Further, recent announcements by the new CEO indicate a focus on changing the incentive system and an emphasis on teamwork, customer service and account usage. Clearly, she continues, it appears that the lessons of the debacle, albeit late, are being learned and a new top-down culture of customer focus, ethical behavior and reestablishment of trust is being put in place.