

WHEN DOES 'TAKING FULL RESPONSIBILITY' HAVE CONSEQUENCES?

Risk expert and regular columnist Annie Searle shares her thoughts on recent incidents of major misconduct in the industry and asks whether financial institutions and regulators will ever get to grips with the conduct challenge



Annie Searle

Annie Searle is a faculty lecturer at the University of Washington's Information School, where she teaches courses she designed on operational risk, ethics, policy and law as relevant to information technology. She is also principal of Annie Searle & Associates LLC, engaged in research and consulting through the ASA Institute of Risk and Innovation

Rarely has there been such lag time between the onset of a high risk event and executive consequences, as we've recently seen in the case of Wells Fargo. The bank's conduct risk issues took several years to be acted upon, with a cast of characters that included a *Los Angeles Times* reporter, the Consumer Financial Protection Bureau (CFPB), the State of California, the US Senate and House Banking Committees and the bank's board of directors. In the US, quarterly Sarbanes Oxley Act (SOX) financial reporting by publically traded corporations to the Securities and Exchange Commission (SEC) under Section 302 can be broken down into three areas: an accurate and fair presentation of the reporting and its disclosures; attestation on well-established and maintained disclosure controls and procedures; and reporting of deficiencies in, and changes to,

internal accounting controls. In other words, "A. all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarise, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

B. any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls;"

■ Section 302, Numbers 5A and 5B

We can count the number of quarters Wells Fargo executives failed to report accounting control deficiencies based on fraudulent activity to boost sales numbers around cross sells. Executives sailed along for nearly three years under this cross-sell programme, established by the former CEO and cheerfully upheld by the current

CEO, as reports should have accrued on why employees were fired and what corrective action(s) needed to be taken.

How is it that, after a 2013 *Los Angeles Times* investigative report on fraudulent practices at Wells Fargo was published, both John Stumpf, the bank's chief executive officer and Carrie Tolstedt, its former head of community banking, did not respond and report the scale of the problem? Where was internal audit, external audit, regulators or the board of directors? In a *New York Times* article titled 'Policing the banks is an inside job', Jordan Thomas argues we need better pathways at the regulatory level for whistleblowing; while a day later Gretchen Morgenson illustrates just how rare it is for boards of directors to claw back pay or stock from problematic executives in a column titled '[Executive pay clawbacks are gratifying, but not particularly effective](#)'. Though the





SEC has a relatively successful whistleblower programme in place, none of the regulatory agencies really do. It seems that none of the 5,000+ employees fired by Wells Fargo for following orders had an appeals process external to the bank. Retaliation appears to have been a standard practice: those who tried to report the fraudulent activity to human resources (HR) or via an [anonymous ethics hotline](#) found that it was not so anonymous when they were fired. On the clawback issue, even though firms are now encouraged but not required to have their own internal (rarely utilised) clawback policies, Morgenson points out that on the regulatory side: *“Even with its prosecutorial power, the SEC has brought just 40 cases against top executives since 2011. Only 18 of those have generated cash payments from executives; some US\$17m was returned to their companies. (Many of the cases are*

still being litigated.)”

The US\$185m fine makes a very small dent on Wells Fargo’s US\$23bn in earnings last year. The US\$2.6m returned to customers whose identities were used to open fraudulent accounts is likewise just a small ripple on a very large surface. The estimated US\$60m in invested stock options clawed back from the two executives is also only a modest dent in future earnings. Though congressional committees called for the resignation of the CEO – and for sheer oration, I recommend the

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remarks of US Senator [Elizabeth Warren](#) – it should be noted it took the Senate Banking Committee’s questioning of Stumpf to prod the Wells Fargo board of directors into action that led to the clawbacks on bonuses, base salaries and Tolstedt’s exit pay. Even more surprising, the very cross-sell practices that had led to the fines were still in place when Stumpf’s first round of testimony took place. By the time he came back to appear in front of the House Banking Committee, he was able to announce that the cross-sell goal would be scrapped not at the end of 2016, but at the end of the week.

So what are we to make of this particular series of events? Firstly, it goes without saying that most large firms (not just Wells Fargo) have not yet managed to create policies and programmes which reward compliance to regulations, establish safe pathways for those who have thought about reporting →



wrongdoing, or which truly hold those at the top to the same behavioural standards as those on the front line. It is said that Wells Fargo prided itself on its 'Main Street' reputation, on its distance from Wall Street fraud and 2008 economic woes. Morgenson points out that the board of directors clawed back on the basis of damage to Wells Fargo's reputation. I have argued elsewhere that there are three root causes of conduct risk: tone at the top (check), corporate culture (check) and conflicts of interest (check). Yes, they all play out in this example. If you set the cross-sell goal at the top, that's part of the tone you set for all employees and you should probably continuously monitor what consequences that goal produces (how much staff turnover, of which how many were firings? How often are sales goals exceeded? What's the role of the manager in meeting the sales

goal? How often are managers reported to the 'anonymous' ethics line?). In his senate testimony, Stumpf said over and over what an ethical culture the bank had established. Obviously he had not been asking any of the questions I outlined above. Finally, conflicts of interest abound in such a pressure cooker. From the employee's perspective, the daily hectoring from the manager on how much had been accomplished that day or that week is not necessarily an incentive to do more or better. Being required to stay after hours or work on weekends to support the overall sales goal should be a large flag, but could easily be interpreted as

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professional failing. Finally, hearing about others being fired for reporting irregularities is not an incentive to report them.

Last but certainly not least, where was the board of directors? What types of reports were its members reviewing since 2013? Had they read the investigative article when it was published and did it prompt them to ask any questions of the CEO, himself a member of the board? There were several former regulators on the board; did the full board review the quarterly reports or the 10K statement? I suspect there will be some fine-tuning of regulatory guidance after the Wells Fargo drama, but it is hard not to conclude this is not a one-off instance and we have still not managed, neither in guidance nor in the character of our banking leaders, to clean up practices which feed the bottom line but are just plain wrong. **TRU**