All was not well in Wells Fargo
This time the fraud is different and simple!

- Many frauds in the past were complex - many involved derivatives the ‘financial weapons of mass destruction’
- In Lehman Bros it was Repo 105; in Goldman Sachs it was Abacus; In UBS it was Delta trading...
- This one is pretty simple
- Employees were under tremendous pressure to open new accounts, opened millions of accounts which customers had not approved; some were fake!
The bank

- Till recently when JP Morgan chase overtook it, Wells Fargo was the bank with largest market cap in the world.
- It was one of the four biggest banks in USA and one of the oldest.
- It weathered the 2008 financial crisis very well and came out unscathed.
- It had such sterling reputation that Warren Buffet had his second largest investment of $23B in this bank and his Berkshire Hathaway owned 10% of the bank.
The CEO

- John G. Stumpf 63
- Humble roots – grew up on a dairy/poultry farm in Minnesota
- Was with the bank for 34 years
- Was CEO from 2007 and also Chairman
- One of the best paid bankers – was paid $19.3 m in 2015
- Got Banker of the year award from American Banker
- Walks away with millions of dollars including $20M pension, $4.3 M deferred compensation and stock worth $109M!
- Last year bank awarded him $4M among other things for ‘growing primary consumer small business banking checking customers’ and also for ‘reinforcing a culture of risk management and accountability across the bank’.
What happened?

- 1.5 million checking accounts and 565443 credit card accounts were opened by employees without the customers knowing about it or authorising it.
- Employees were paid huge incentives and also were under huge pressure to open accounts.
- The target was ‘8 financial products per customer’ and monitored through daily employee reports on actual sales made.
- They used the names, data and even funds of real customers.
- Customers did not even know about it till they were hit with fees.
- Customer credit scores took a hit due to such activities which they did not know about.
- In some cases, the customers were surprised when debt collection agencies called them for ‘dues’!!
“I want to apologize for violating the trust our customers have invested in Wells Fargo; and I want to apologize for not doing more sooner to address the causes of this unacceptable activity.”
How employees were driven mad

- Listen to this podcast which gives direct account of how the employees were pressurized
- Managers were constantly behind employees to open new accounts and progress was monitored closely 4 times a day and the pressure was crippling
- One ex employee says how when a bank robbery was on in the branch, the manager asked her to continue dialing – the mantra was ‘dial for dollar’ continuously
- If targets not met employees had to work overtime without pay!
- Managers encouraged employees to hunt for sales prospects at bus stops and retirement homes!
- To get to their targets employees cheated - for instance a $15000 was split into 10 accounts of $1500 to show more accounts; when customers signed papers employees slipped in additional forms to open extra accounts; fake pins and email ids were used; even elderly people were not spared
- If a customer found out and called, then they used to close the account and reverse the charges!
The main person retired and kept all her pay!

- Carrie Tolstedt headed consumer loan division that created fake accounts.
- She left the company ahead of retirement at year end;
- She did not receive bonus or severance and forfeited $19M of unvested stock awards. Also has agreed not to exercise $34M in stock options.
- She however owns $43.3 M in stock which she accumulated during her career with the bank!
- So she could leave with $77M worth of stocks and options at today's value.
- Stumpf fully protected her and also called her 'standard bearer of our culture'.
Whistle blowing as per policy

- Stumpf told lawmakers: “Each team member, no matter where he was in the organization was encouraged to raise his hands; we want to hear from them’

- Wells Fargo spokesperson said “ we do not tolerate retaliation against team members who report their concerns in good faith’ ;’employees are encouraged to report unethical behavior to their manager, HR representative or 24 hour ethics line; everything submitted to Ethics line is investigated’

- Number of statutes including SOX say it is against law to try and suppress whistle blowing

- **BUT** That’s exactly what happened here!
Whistle blowing was stifled

- Whistle blowing was only working on paper
- If employees complained to ethical hot line or HR or any top management they were fired
- HR used to look for some misstep (like employee arriving at 8.32 instead of 8.30 am) and fire them
- Employees were also warned that if they complained they would not get a job anywhere
- In the Plant money podcast they find out that for an ex-employee who had complained and left, Company had filed a U-5 form (Uniform termination notice) with the remarks ‘failed to do job duties’- ensuring no other bank would touch her.
- One other employee who complained was fired for ‘tardiness’
- Another said “I endured harsh bullying.. defamation of character and eventually pinned for something I didn’t do”
Insider trading

- Stumpf reported to have sold $61M of bank shares one month prior to settling the investigation and pocketed $26M in proceeds.
- This is a potential violation of insider-trading regulations and will be investigated.
Reactions

- Senator Elizabeth Warren, the Massachusetts Democrat, slammed Stumpf for ‘gutless leadership’ in part for his refusal to cut compensation for Tolstedt, the person in charge of consumer loan division.

- She criticized Stumpf “when it all blew up, you kept your job, you kept your multi million dollar bonuses and you went on TV to blame thousands of $12 an hour employees who where just trying to meet cross-sell quotas that made you rich”

- She blasted Mr. Stumpf (in a now famous viral video) who appeared before Senate –” You should resign, return every nickel you made while this scam was going on and face investigation by Justice department and SEC.”
The fall out

- Penalty of $185M (including $100M by Consumer protection bureau - the highest in its history)
- Stumpf testified before Congress twice
- He announced his resignation on Oct 12, 16
- He has agreed to surrender stock grants of $41M and to give up his annual salary for the duration of Board investigation (This is an unusual real claw back in US history which is normally never deployed though widely adopted and available in paper)
- Board is conducting internal investigation
- 5300 employees lost their job (including 500 managers?)
- California treasury cut the bank off its large business and Illinois has followed
- Facebook page “Hold Fargo accountable”
The fall out-2

- Bank has lost around $20B in market value
- Labor dept. starting top-to-bottom review of compliance with wage related laws
- Class-action suits by former employees $7.2B
- Federal regulators and Los Angeles City attorney began looking into the issue in 2013
- Department of Justice has opened its own enquiries
The unanswered questions what went wrong

- We get email/SMS alerts for every transaction from our banks—how come Wells Fargo customers did not get this?
- The actual power base is with top management and Boards may not even be aware of what’s happening—how much did the Board or Audit committee know?
- Here again the position of Chairman and CEO was with one person—not a good combination.
- How were SOX entity level controls on tone at the top including Board oversight, Internal audit, whistle blowing documented and agreed as effective by all?
- How was risk management considered effective by the Board? Was there a chief risk officer? Chief compliance officer? What did they report to Board?
- When employee whistle blowing did take place, how that was stifled so long and in so many cases?
- How come customer complaints were not investigated for root cause?
- Did the Internal audit charter extend to such areas? If not why not? How was audit committee satisfied?
The unanswered questions and what went wrong - 2

- There have been past practices of ‘opening fake accounts’ and a two day ethics workshop was held in 2014 telling employees not to open fake accounts! What additional controls were put in place after such a revelation? How was this aspect audited since then? (Concerns raised as far back as 11 years!)

- The bank was known as ‘king of cross sell’ - knowing this and the growth in the no. of accounts which was very much higher compared to competition, were the antennas of auditors not raised? Especially since this is in customer acquisition a high risk area related to revenue?

- In Credit Suisse where assets were improperly classified as ‘AUM’ bank agreed the power to review and classify client assets would be re-assigned to bank’s central banking division – similar internal controls should have been in place for account opening in Wells Fargo - why was such basic control missing? If it was there why was it ineffective? Was there no maker checker in this most crucial area?!
Lessons for future - 1

- Is this penalty system effective at all?
  - The penalty is very small – in this case it is 3.3% of banks net income for second quarter - what effect can it have? Is it just a slap on the wrist?
  - The penalty is on Company not on perpetrators! Who smile all the way to the bank- here same bank!
  - Small time employees face the music - is it justified?
  - The companies pay the fine and go back to their bad old ways
    - HSBC paid $1.92B; Barclays paid $298M; Credit Suisse paid $536M; StanChart paid $330M
    - Only shareholders suffered!!
- The short termism and pressure of meeting quarterly numbers leads to many such malpractices - Greed drives every one - How to curb this?
- Huge compensation to top management often in the form of stock options leads to manipulation - they resort to stock buy backs and unrealistic targets. Should stock options be given after a period of five years when the results of their actions will be clear in the longer term?
- How to make ‘claw back’ provisions effective?
Lessons for future - 2

- Based on William Lazonick book - 'a new study on CEO pay':
  - Before 1982 SEC considered stock buy backs as potentially unlawful form of stock price manipulation; **should it be banned?** (440 companies in S&P 500 index used half their earnings to buy back stock)
  - The remuneration reported on stock options is based on Black-scholes model - EFV (estimated fair value) where as CEO’s make much more in real terms - ARG (actual realized gains)
    - Stumpf compensation as per EFV $179M; per ARG $259M!
  - Japanese companies - CEO package is topped out at around $150k - **should there be a similar cap?**
  - Like Mylan increasing EpiPen price, CEO’s are willing to do anything to raise their stock value in short term - pressure from activist investors make them take risk
  - Proforma earnings (also called 'earnings before all bad things') and not GAAP profit drive CEO remuneration - This should not be the case
Lessons for future-3

- Ms. Clinton has said she will bring law to curb the prevalence of 'forced arbitration' clauses in contracts that make it difficult for workers and consumers to bring legal action against companies and invoked by Wells Fargo.
  - When they have a complaint, employees/customers are forced to go for arbitration and not able to sue the company.
  - Many people do not read the 'small letters' in what they sign and this leads to problems.
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