Point of view

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Wells Fargo: what did the board have to do with it?

Yet another misconduct scandal has hit a major financial institution. This time the bank in question, Wells Fargo, was considered best in class having sailed through the financial crisis relatively unscathed and, as a result, boasting the best bank valuation among its global peers. Wells Fargo is a "plain vanilla" commercial bank and retail is its most important division. Selling the maximum number of products per customer was at the core of the Bank's success and its capacity for cross-selling largely admired by its competitors. It has now emerged that its ambitious sales goals were partly achieved through rogue practices: front office staff inflated sale numbers to hit performance targets. In September, Wells Fargo admitted that it opened over two million "phantom" accounts and issued credit cards to a large number of customers, without their knowledge or consent.

Upon discovery of these activities, supervisors, regulators and shareholders reacted fast and hit hard: Wells was fined a total of US$185 million, billions of dollars have been wiped out from its stock market value, and it is now facing downgrading of its credit rating. John Stumpf, Wells Fargo's Chairman and CEO, was grilled by two congressional committees and, following a month-long public backlash, resigned from his position.

Wells Fargo disclosed that 5,300 staff had been fired over the past five years for illegal practices. In addition, the Board decided to clawback the unvested stock awards, and the bonuses for the past year of Mr Stumpf and Carrie Tolstedt, former Head of Retail, who also lost her pension. Also, the Board has launched an official investigation and is expected to review findings by the end of the year.

In spite of the Board's reaction, there was a lot of reputational risk that crystallised in the aftermath of the scandal. In addition to the US$185 million and the certain-to-come law suits, the State of California has suspended all business relationships with the Bank for at least 12months.

So, what governance lessons can be learned from this debacle? What could the Board have done differently?

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Issue Date:
14th November 2016

To begin with, one may wonder how it is possible that the Board was not alerted to that type of misconduct given various similar scandals in retail banking unveiled in recent years, for example the PPI scandal in the UK. Instead, under the Board's watch management created incentives that put cross-selling at the core of Wells Fargo strategy and abetted rogue behaviour. In contrast, several bank boards today are devising ways to review the culture of their main businesses and are quite focused on the impact of incentives that drive the conduct of the troops.

Another interesting perspective: Wells Fargo's board members have been there for a long time, probably too long. The tenure of its directors is twice as long as the average Non-Executive Director tenure in other European G-SIBs (Global Systemically Important Banks) peers, and well above the average for US G-SIBs. The tenure length should be read in conjunction with the fact that Wells Fargo shows the highest average director age (66 years) among its American and European peers. Maybe after all these years the Board felt too cosy to intrude in the Bank's front line culture.

Until October 12, the Board was led by John Stumpf, a charismatic Chairman-CEO whose power was counterbalanced by the presence of an independent Lead Director, Stephen Sanger. However, Sanger does not have banking experience, and following Mr Stumpf's resignation, the former Lead Director took over the chairmanship of the Board. Tim Sloan, the Bank's COO, was nominated CEO. While the separation of the two roles will likely be welcomed by stakeholders, Mr Sanger's lack of banking experience remains a cause for concern.

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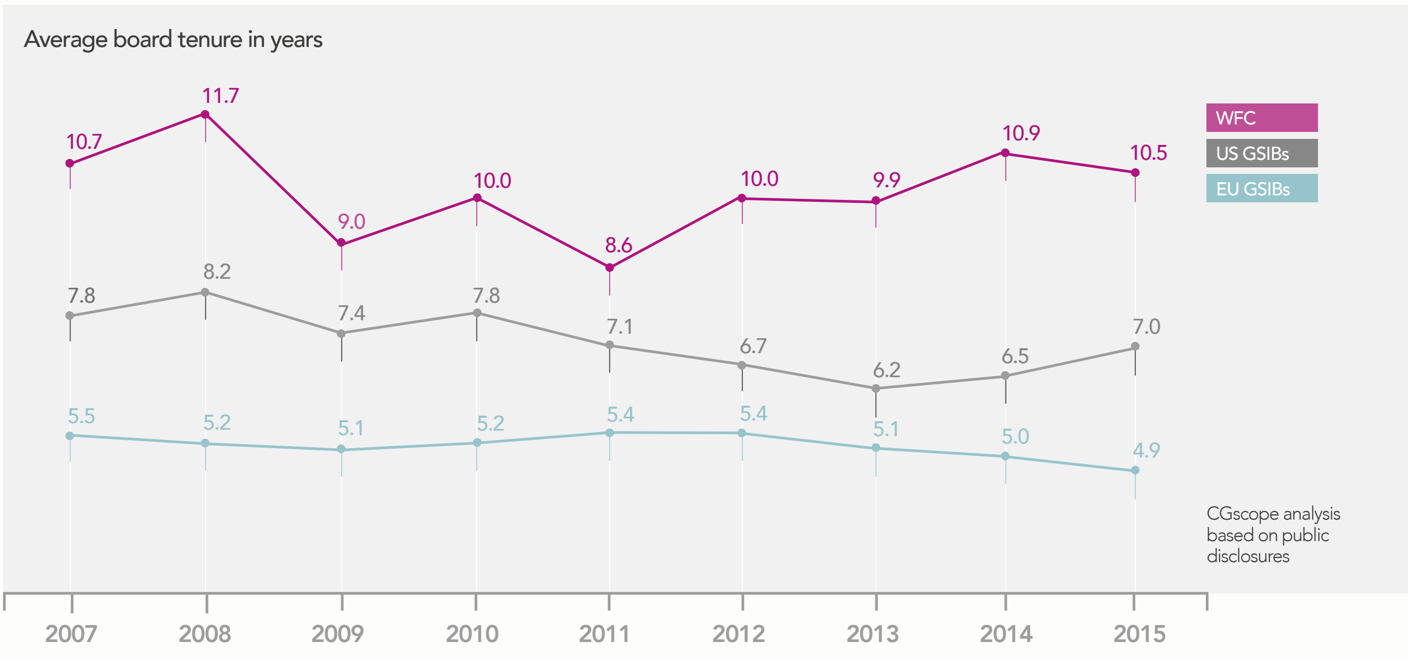
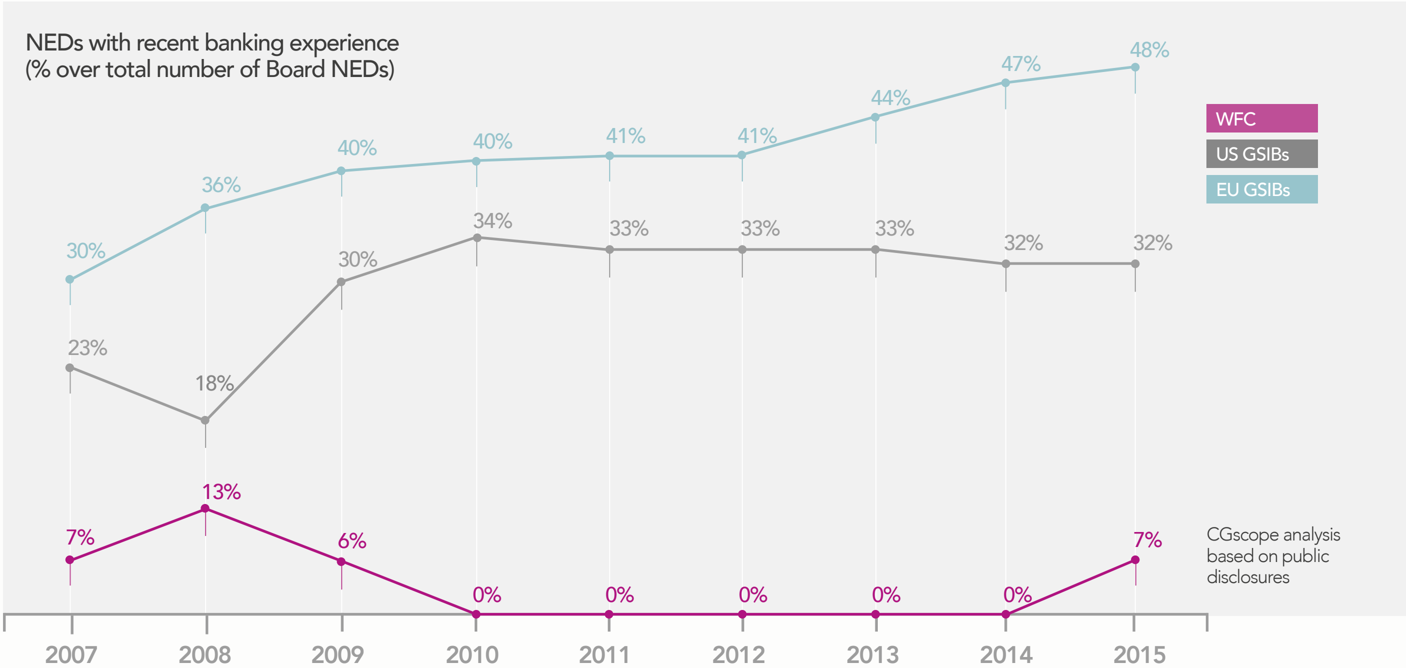


The Board's level of formal independence is very high at 94%, well above that of other G-SIBs. However, only one Non-Executive Director has recent banking experience. Furthermore, between 2010 and 2014, none of the Non-Executive Directors on the Board was a banker. This is well below international best practice and supervisory guidelines. The result is that Wells Fargo board committees often do not have any members with direct banking experience. Most importantly for the case in hand, the Human Resources Committee (the HRC) which oversees the incentive structure (in the words of its own charter, the HRC "shall oversee the Company's incentive compensation practices to help ensure that they are consistent with the safety and soundness of the Company and do not encourage excessive risk-taking") had no bankers among its members.



Wells Fargo's problems are linked to incentives, but also to broader cultural issues that drive conduct. Supervisors around the world expect bank boards to pull the right levers in order to encourage the development of an appropriate culture – particularly risk culture – in their institutions. Incentives, internal conduct rules and controls are among the most powerful ways a board can influence institutional culture.

In 2015, Wells Fargo published a comprehensive booklet on culture and values. Their approach focused on placing customers at the core of the Bank's culture: Wells Fargo officially aims at "creating a lifelong relationship" with its clients, "building confidence" and helping them in "succeeding financially". With hindsight, it is clear how the effort to set a certain tone from the top failed to translate into everyday actions. The Bank's "shared values" emphatically put customers first and encouraged staff to build trust, offering "what is right for customers" and asking staff not to "engage in activities or business practices that could cause damage to [Wells Fargo] reputation". Instead, a sales culture based on overambitious cross-selling targets rather than customer needs developed and spread across the Bank. When push comes to shove, top down values are a poor defence against powerful monetary incentives. Boards must be aware of the limited effectiveness of explicit values when they are not embedded in the broader system of risk management and incentives. They should be focussing on a holistic view of culture and the potential tension between values and incentives.

Wells Fargo's board seems to have split cultural oversight between three different committees: the Risk Committee (RC), the Corporate Responsibility Committee (CRC) and the HRC. This may have led to a fragmented view of the front office behaviours and drivers. The CRC is responsible for matters related to internal culture and ethical behaviour, customer service and responsible lending, and reputational risk. It has a specific mandate to coordinate with the RC on items concerning reputational risk, but it does not have a mandate to ensure coordination with the HRC on incentives and remuneration, and vice versa. The HRC focuses on incentives but not values and culture.

This arrangement differs from Citigroup, the only other US G-SIB that has created a committee with a mandate for culture and ethical behaviour. In contrast to Wells Fargo, a quarter of the members of Citigroup's Ethics and Culture Committee (E&C) have recent banking experience (none at Wells Fargo) and a much lower average tenure on the Board. What is more, 75% of Citi's E&C Committee members also sit on its Compensation Committee. In the case of Wells Fargo, a mere 17% of CRC members serve on the HRC.

Finally, there is the Wells Fargo's board relatively leisurely pace of work. Over the past eight years it has consistently worked fewer days per year than the average American or European G-SIB board.

All of the above characteristics might provide some clues on how the Board missed the signals of the coming disaster. They will surely provide rich material for the next board self-evaluation. Meanwhile, Wells Fargo has to rebuild trust with its customers and other stakeholders.

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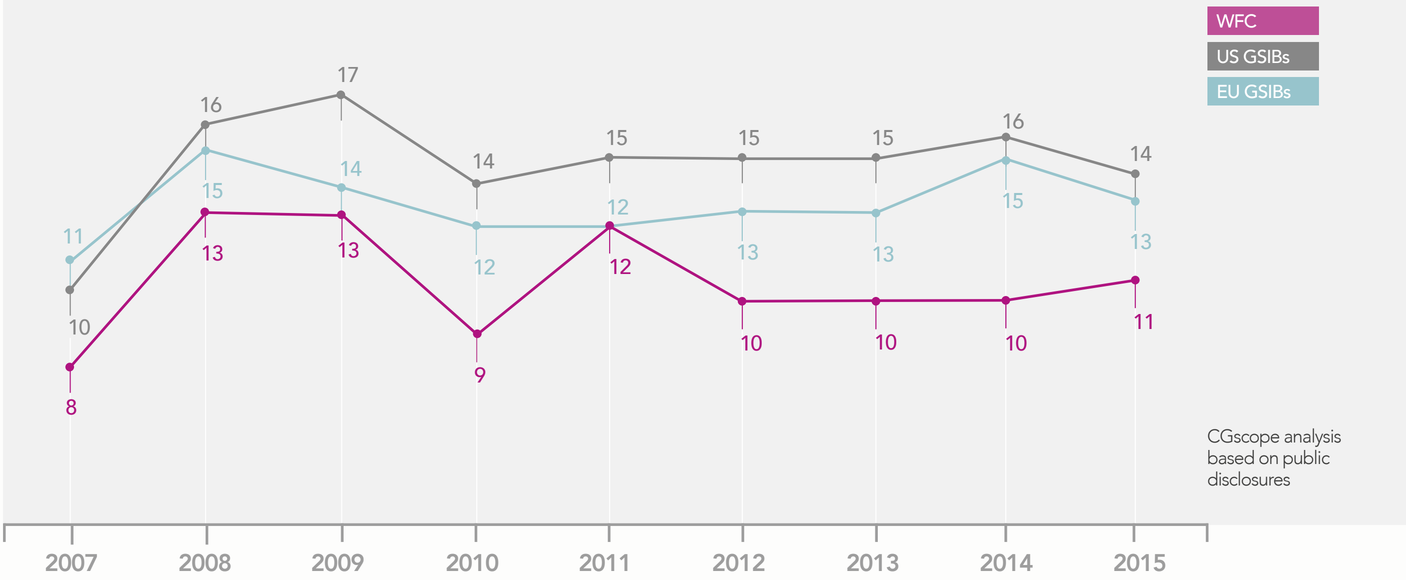
Average workload (days) of the board of directors



CGscope analysis based on public disclosures

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