WELLS FARGO AND THE UNAUTHORIZED CUSTOMER ACCOUNTS: A CASE STUDY

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CASE DESCRIPTION

The case discusses the controversial sales practices at one of the largest financial institutions in the country that led to unprecedented penalties by the Federal Reserve. The case exposes students to corporate governance policies within an organization, especially the ethical responsibilities of those charged with governance. The case can be used in an undergraduate or advanced auditing class and students can utilize the Committee on Sponsoring Organization or COSO framework to formulate responses. The COSO framework defines internal control, including corporate governance, and provides a systematic approach to internal control evaluation and assessment. The case can also be used in a management course that discusses leadership and/or corporate governance issues. The case is designed to be taught in one class period and is expected to require approximately two hours of outside preparation by students. The case is based on real events as reported in various media outlets.

CASE SYNOPSIS

$185 million! This was the initial combined fine levied by the oversight bodies against Wells Fargo (the Bank). They alleged that the Bank engaged in improper activities by opening or applying for over 3.5 million bank accounts and credit cards without customers' knowledge or approval. This action was done using a customer intensity model in which the Bank aspired to be the market leader in the cross-selling of products and services to existing customers. Employees who noted inappropriate activities by their colleagues reported the issues to the Bank's ethics hotline and to those charged with governance. These employees faced retaliation for reporting the potential violations and were either demoted, resigned, or terminated. Facing mounting pressures from various regulators and Congress, the Bank acknowledged the controversial sales practices and agreed to discontinue their use. The Bank eventually reached an agreement with the Federal Reserve that imposed significant penalties and restricted it from future growth until risk management practices were addressed.

THE ORGANIZATION

A Brief History

Wells Fargo (the Bank) was founded in March 1852 by Henry Wells, William Fargo, and other investors. The Bank's first office was opened in July 1852 in San Francisco, California and soon after more offices were opened in other cities and mining camps. The company's initial focus was to offer banking and express services to the western part of the United States. These services included buying gold, selling paper bank drafts that were equivalent to gold, and delivering gold and other valuables to customers.

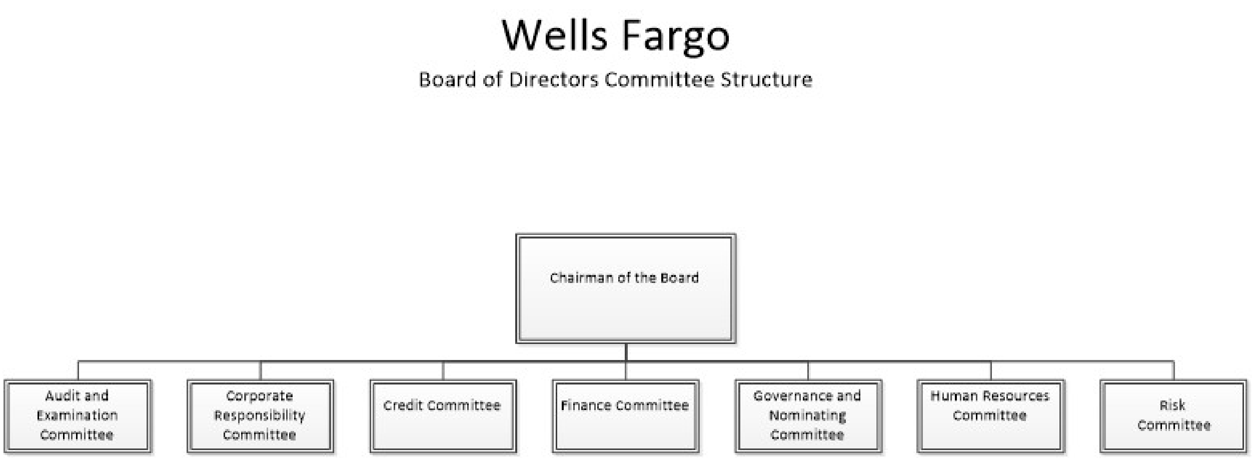
Throughout the 1920s, Wells Fargo played a key role in developing businesses, agriculture, fledgling auto, aerospace, and film industries in the western U.S. Starting in the 1980s, the Bank engaged in a series of mergers to create the current institution. Most notable was the 2008 merger with Wachovia which allowed the Bank to expand operations throughout the country.

Today, it is one of the premier financial services companies in the world with such diverse offerings as personal and small business banking, wealth management, investment banking, retirement services, and treasury management. It operates with approximately 269,000 team members, in over 8,600 locations worldwide. Wells Fargo is rated 26 on Fortune’s 2017 rankings of America’s largest corporations, and it provides services to approximately 33% of all households in the United States.

Leadership and Governance

The Bank is governed by a 15-member board of directors (BoD) headed by the chairman. The BoD conducts its oversight role through the following committees – audit and examination, corporate responsibility, credit, finance, governance and nominating, human resources, and risk. The risk committee is charged with the organization’s enterprise risk management (ERM) oversight and is supported by approximately 14 management level committees. These committees include business group risk, regulatory compliance risk, operational risk management, and fiduciary and investment risk oversight. The risk committee interacts on a regular basis with the chief risk officer, the executive responsible for assessing and mitigating the enterprise risks. The BoD committee structure is depicted in Figure 1.

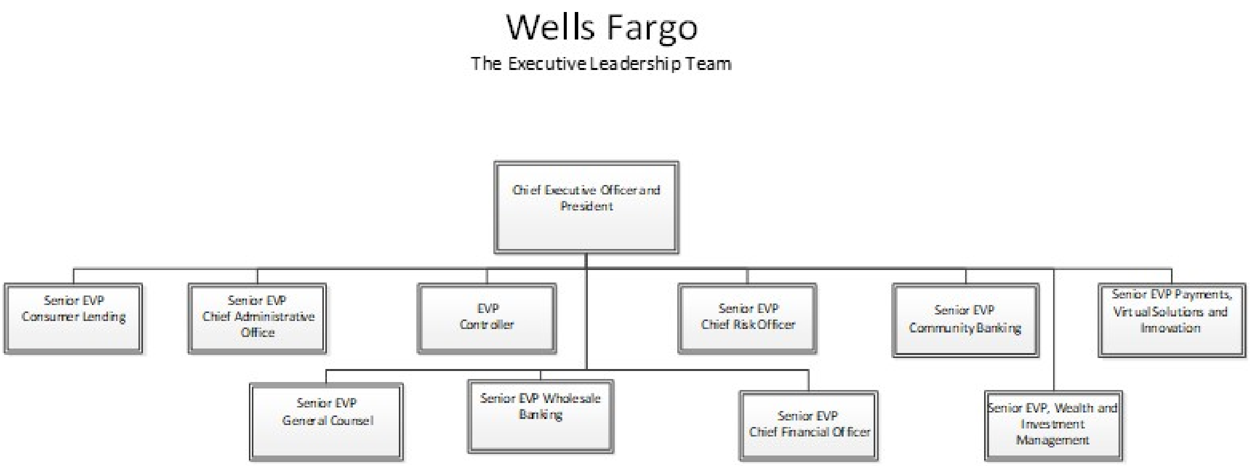
Figure 1: Board of Directors Committee Structure



The executive leadership team is headed by the Chief Executive Officer (CEO)[1]and President. This position is supported by executive officers, including the general counsel, and chief risk officer. Each executive has responsibility for a specific business area. The leadership team structure is depicted in Figure 2.

[1] The CEO was also the chairman of the board during the duration of the controversial sales practices.

Figure 2: The Executive Leadership Team



THE ALLEGATIONS AND RELATED ACTIVITIES

The Community Banking Division

The Community Banking Division (CDB) was a key driver in the organization's growth. The CBD was headed by a senior executive vice president who was supported by three senior vice presidents (SVP) with responsibilities for Digital Channels, ATM Banking and Store Strategy, and Deposit Products. These executives were supported by more than 50 regional presidents who oversaw 120 area presidents, each responsible for several branches. The branches were managed by more than 600 and 5,700 district and branch managers respectively, who reported to the area presidents.

The CBD defined itself as 'America's Community Bank'. This was probably reflected in the approximately 22 million retail households and the 2.5 million small businesses that it served. It also had over 30% credit card penetration of retail bank households and was the leader in small business loans for five consecutive years.

The CBD developed a basic density and cross-selling model in which it defined revenue as the number of households multiplied by the revenue generated per household. To advance this model and thus maximize revenue, it introduced a new level of growth called customer intensity. Simply stated, the more intensely customers used its channels, the better the density and the sale opportunity.

Opening of Customer Accounts

In approximately 2009, the Bank developed a new sales program to distinguish itself from its competitors. The main objective was to be the market leader in the cross-selling of banking products and services to existing customers. The bank established a target for each customer to have at least eight accounts or relationships with it.

To achieve the sales targets and thus earn additional compensation, employees used customers' information to open additional checking and credit card accounts, often without their consent. Signatures were often forged on the applications and in some instances, the Bank sent unsolicited credit cards to customers. The ideal customers were ones that employees thought might not notice any discrepancy in their banking relationship, such as elderly clients, and those who were not fluent in English. Employees and management earned financial rewards under the Bank's incentive compensation program for satisfying these sales goals.

Sales volume was the ultimate performance measure and managers encouraged workers to boost daily sales. Branch personnel were assigned sales targets that kept increasing over the years. Employee progress was tracked and reported daily to managers and other executives. Supervisors pressed low performers to achieve their quotas and the CEO communicated with high performing managers by email or in person, to congratulate them on achieving goals.

Employees were encouraged to use misleading sales pitches, such as telling customers that a checking account was bundled with a credit card. Other examples of techniques used by employees to achieve sales targets included:

- Branch employees invented fake businesses and subsequently used them to open new bank accounts.
- Bankers in one branch opened new deposit accounts in existing customers' names and established the resulting pin numbers on the new accounts debit cards as "0000." The bankers would also enter false data into the customer contact information fields to avoid customer communication responses using email addresses such as 1234@wellfargo.com and noname@wellsfargo.com
- Bankers at another location moved funds from existing accounts to newly created accounts to reflect artificial growth.

Opening unsolicited accounts created unexpected consequences for customers. For instance, multiple credit card inquiries could negatively impact their credit scores. Also, frequently applying for and opening credit cards could impact the average age of accounts, an item that factors into the individual's overall credit score. Checking accounts opened and not funded incurred annual maintenance fees, plus accrued interest if such fees were not paid on time.

Communicating with Bank Management

Some employees grew uncomfortable with the Bank's sales practices and reported their concerns to local and national management, to the Bank's ethics hotline and, in some cases, to the chief executive officer. Employee notifications were not positively received and some were either demoted, forced to resign, or terminated for reporting the controversial sales practices. This was despite the Bank policies prohibiting retaliation against employees who report suspicious conduct.

The following are a few examples:

- A branch employee filed a report with the branch manager, the manager's boss, and the Bank's ethics hotline. The report alleged that a colleague was opening and closing accounts without customers' permission. The reports were ignored, and the employee was fired a year later for insubordination while the managers involved were rewarded with promotions.
- An employee in the wealth management group was terminated after reporting concerns about the Bank's sales practices to management and the ethics hotline. This action occurred despite the employee's past positive job performance reviews.
- An employee filed approximately 50 ethics complaints while working at the Bank. However, no action was ever taken by management and the employee was denied bathroom

breaks as part of intimidation efforts. The worker's employment was finally terminated for not reporting to work on time.

- An employee was fired after a five-year career as a telephone banker at one of the Bank's call centers. The worker handled incoming customer service calls and was expected to refer approximately 23% of the callers to a sales representative for additional product sales. The underlying customers had financial difficulties with mortgages in foreclosures, credit cards in default, and cars being repossessed.

Executive management was highly compensated for the earnings increases reported due to the controversial sales practices. For instance, the Bank paid approximately $76.5 million to its most highly compensated employees in 2016, a 14.71% increase from the previous year. Looking specifically at the 2012-16 timeframe, the CEO and chairman received total compensation of $104 million, while the head of the CBD received $45 million. The chief risk officer was paid $5.3 million for 2016 (the only period available).

Board members also received generous compensation for their services. In 2016, members received cash and stock-based compensation from $300,000 - $486,000. This was much higher than the $245,000 median pay for directors of Standard & Poor's 500 companies.

Management's Response

In approximately 2015, the Bank finally acknowledged that it had a problem with unauthorized accounts and began an internal investigation. Unfortunately, it was too late. The issue had captured the attention of the local prosecutor's office and two federal regulators ("the parties") which collectively fined the Bank $185 million and issued a consent decree.

The parties alleged that the Bank opened or applied for more than two million bank accounts or credit cards without customers' knowledge or permission. The allegation covered the period from May 2011 to July 2015. The alleged misconduct also caught the attention of other oversight bodies including the FBI, federal prosecutors in multiple states, and the U.S. Congress; each opened its own investigation.

Bank management could no longer ignore the problem and its initial action was to terminate approximately 5,300 low-level employees (1% of its workforce) who were suspected of being involved in the fraudulent activities. However, no senior level employee was terminated at this point. Meanwhile, management hired an outside accounting firm and the board of directors hired a law firm, to help each governing body better understand the root cause of the improper sales practices within the CBD.

Actions of Those Charged with Governance

The Bank announced in September 2016 that it would end its sales program effective January 1, 2017, and introduce a new performance plan based on customer service, growth, and risk management. Meanwhile, the accounting firm found that between the period 2011 to 2015, approximately 565,000 credit card accounts were opened without customers' approval. An additional 1.5 million deposit accounts were opened and probably not authorized by customers.

Employees whose careers were impacted for failing to meet sales targets and/or for reporting managers to the Bank's ethics hotline initiated their own lawsuits against the Bank. Some 500 employees joined a class action lawsuit claiming wrongful termination and retaliation. In one settled lawsuit, the court ruled in favor of an employee who was unlawfully terminated by the Bank and it was ordered to pay the employee $5.4 million to cover back pay, compensatory damages, and legal fees. The Bank was also required to rehire the employee.

In September 2016, the CEO testified before two congressional panels that were investigating the Bank's handling of the developing scandal. During the same period, the State of California, one of the Bank's most important customers, suspended it for at least one year from underwriting some of its municipal bond offerings. The state attributed the move to the Bank's on-going account scandal.

By October 2016, the CEO opted for early retirement from the Bank ending a 34-year career due to public outcry resulting from the accounting scandal. The CEO's retirement package was estimated at $134 million inclusive of cash, stocks, and other compensation amassed during his tenure. He forfeited his 2016 salary and bonus, as well as stock awards of approximately $41 million. His roles as CEO and chairman of the board were split, with the chief operating officer assuming the CEO role and a board member assuming the chairman role. In July 2016, the head of the CBD took a leave of absence interrupting her ten-year tenure in the role. In early 2017, she was retroactively terminated by the board of directors for her role in the scandal.

The board's independent review report, released in April 2017, attributed the scandal to the Bank's decentralized structure. It also exonerated the board of directors, including the risk committee, suggesting that it was misinformed by various executives during their board meetings and other presentations. The review further suggested that the chief risk officer had limited authority over the CBD since the risk assessment and response were completed within the CBD unit and not adequately communicated to the appropriate oversight bodies.

The executives connected with the scandal were not as fortunate. In 2017, the board clawed back prior compensation from executive leadership for their role in the scandal. This included $69 million and $66 million from the former CEO and the CBD senior EVP, respectively. The board also fired four mid-level executives who played prominent roles within CBD denying them any bonus or unvested equity or stock options. In July 2017, the new head of the CBD eliminated 70 senior managers' positions as the division continued to deal with the fallout from the scandal.

The Aftermath

The Bank continued to struggle to end the fallout from the controversial sales program. In August 2017, its internal review revealed that the fraudulent account scandal was bigger than previously estimated. The expanded review identified an additional 1.4 million accounts (for a total of 3.5 million accounts) that customers may not have authorized. The review also found 528,000 cases in which customers signed up for online bill payment without their knowledge or consent. The Bank agreed to refund approximately $1 million to those customers who incurred fees or other charges for this service.

As the scandal continue with new disclosures, the U.S. Congress is acutely interested in the outcome. In fact, one senator proposed in September 2017 that the Federal Reserve Bank remove the Bank's board of directors who were on the board during the time of the scandal. Other members of Congress are exploring new investigations into the bank that might include requiring a testimony from the current CEO. Time is no longer a luxury for the Bank and it must act quickly to resolve the scandal and regain its stakeholders' trust.

A summary of the actions taken by those charged with governance is provided in Table 1 below

Table 1: Activities Summary

Dates	Actions
September 2016	• The Bank announced the end of the controversial sales program • An accounting firm identified 565,000 unauthorized credit card and 1.5 million unauthorized deposit accounts • The CEO testified before two congressional panels
October 2016	The CEO opted for early retirement ending a 34-year career
Early 2017	The head of the CBD is retroactively terminated by the board of directors
April 2017	The independent report (ordered by the board of directors) determined that the CBD was responsible for the fraudulent activities and not ineffective board oversight
Mid 2017	The board of directors clawed back compensation from executives involved in the controversial sales program
August 2017	The Bank's internal review identified an additional 1.4 million unauthorized accounts

DISCUSSION QUESTIONS

Answer the following questions:

1. The "tone at the top" is considered a key component of an organization's corporate governance process. Use the fundamental principles within the control environment component of the Committee of Sponsoring Organizations of the Treadway Commission (or COSO) framework to discuss:
   i. The company's commitment to integrity and ethical values
   ii. The Board of Directors' independence from management
   iii. The structures, reporting lines, and appropriate authorities and responsibilities established by management in the pursuit of objectives
   iv. The organization's commitment to attract, develop, and retain competent individuals
   v. The organization's ability to hold individuals accountable for their internal control responsibilities

   [Note: Use Appendix A to answer each of the above in terms of both the *design* and *operating* effectiveness of the control environment]
2. Comment on the effectiveness of the Bank's overall control environment
3. Comment on the effectiveness of the corporate governance process at the Bank and its ability to respond timely to the controversial sales practices.
4. Did the board of directors adequately fulfill its oversight responsibilities?
5. Do you agree with the senator on the removal of the directors who were on the board during the scandal?

Appendix A: The COSO Framework – Control Environment

COSO Component – Control Environment	Related Principle	Comment on the design or existence of this principle within the Bank	Comment on the operating effectiveness of this principle within the Bank
	i. The organization demonstrates a commitment to integrity and ethical values.		
	ii. The board of directors (BoD) demonstrates independence from management and exercises oversight of the development and performance of internal control.		
	iii. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.		
	iv. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives		
	v. The organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives		

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