Colonialism, Pizzas and Wells Fargo

What do the 17th century colonial struggles between the Dutch and the English, and pizza delivery policies, have to do with the current management meltdown at the US bank, Wells Fargo & Co? As it turns out, quite a lot.

In his book, *Empire*, eminent historian, Niall Ferguson, points out that the scale of the Dutch East India Company's business in the 17th century far exceeded that of its English counterpart. One of the reasons for this was pay structure. The managers of the Dutch company (but not the British company) were rewarded on the basis of gross revenue. This encouraged them to undertake massive expansion and to maximise the volume of their spice trade.

Any economist will tell you that incentives matter in understanding human behaviour. The positive incentives provided to the Dutch managers confirm this – they helped to put the Netherlands ahead of the rest of the colonialist pack during the 17th century.

But organizational incentives are not always positive. Fast forward three centuries and the story of Domino's Pizza Inc provides a good example of how organizations can create perverse incentives. From 1973 onwards, a key part of Domino's pizza home delivery marketing strategy was a '30 minutes or it's free' guarantee. Although Domino's employees were instructed to drive carefully, the 30 minute delivery guarantee placed pressures on them that potentially overwhelmed the 'drive safely' message. Following several accidents involving Domino's drivers, the guarantee was finally dropped in 1993, after a jury awarded an injured St Louis woman US$78 million in mainly punitive damages.

Which brings us to the Wells Fargo story. The unfolding drama at this US bank, which shares features of both the above scenarios, is a recent example of the role of incentives in creating/infecting corporate cultures. Wells Fargo is a household name in the United States. Founded in 1852, the bank has 40 million retail customers, US$1.9 trillion in assets and employs 268,000 people. It was also one of the few US banks to navigate the Global Financial Crisis relatively unscathed, and much of the credit for this feat went to its Chairman and CEO, John Stumpf.

The seeds of the current scandal were sown several years ago (at a time when Wells Fargo's management was being lionized), as a result of an aggressive growth strategy and remuneration policy. Although employees received plenty of ethics training, they were also subject to sales targets for new accounts, which quickly revealed themselves to be unrealistically high. Employees had downside and upside incentives to commit fraud. If they failed to meet the targets, they risked losing their jobs; if they met the targets, they received bonuses over and above their relatively low base pay.

It seems that these incentives were irresistible - they resulted in fraud on a stunningly broad scale. To inflate sales figures, thousands of bank employees created over 2 million sham bank and credit card accounts without customers' knowledge. Although an investigation by the Consumer Financial Protection Bureau ('CFPB') found that the illegal acts were committed since at least 2011, complaints from would-be whistleblowers date back as far as 2005.

Between 2011 and 2016, Wells Fargo sacked 5,300 employees for creating the fake accounts. After the fraud was revealed by the press in 2013, the bank kept the sales goals in

place, thereby perpetuating the perverse incentives. On 8 September 2016, it was announced that Wells Fargo would pay US$185 million in fines, including a record US$100 million penalty to the CFPB.

The events at Wells Fargo raise acutely the issue of 'corporate culture' and the responsibility of a company's management and directors for that culture. In particular, the Wells Fargo scandal shows the role of incentives in creating corporate culture. It is also a textbook example of how corporate crime arises – it typically occurs at the level of lower to middle management, in response to unrealistic goal directives from senior management.

Yet, until recently, Well Fargo went to considerable lengths to deny that it had a poor corporate culture or any systemic problems, claiming 'that's not who Wells Fargo is'. The bank argued that the fraud was due to a 'few bad apples'. The beauty of this argument is that it deflects attention away from the top of the organisational totem pole (though its credibility was somewhat dented by the sacking of 5,300 people for fraud over several years). However, attention is now inexorably moving up the bank's hierarchy. The focus has shifted away from the incentives of lower level employees, and towards the incentives of senior management to turn a blind eye to the fraud. Another emerging issue is whether management should be able to profit from a poor corporate culture.

On 12 October 2016, Wells Fargo announced the immediate retirement of its CEO and Chairman, John Stumpf, after he had received gruelling questions at two recent Congressional hearings. Although Mr Stumpf will not take a severance package, his estimated retirement benefits are around US$120 million. Senator Elizabeth Warren has been vocal in demanding that he should repay all earnings from 2011, while the fraud was ongoing. According to Richard Cordray, director of the CFPB, 'unchecked incentives can lead to serious consumer harm'. The Wells Fargo scandal highlights the danger of allowing bad conduct to flourish and proliferate, unchecked by corporate management and the board of directors.

The scandal raises important questions about the monitoring role of directors, particularly independent directors, and their responsibility for perverse organisational incentives. If boards are going to authorise performance-based compensation (and the Dutch colonial experience shows that there can be considerable benefits to doing so), it is critical that those boards select the right incentives, and have the ability to foresee, and control, any perverse incentives that are created.

Now that the spotlight has begun to shift upwards in Wells Fargo's structure, it will be interesting to discover how much (and when) the board knew about the wide-ranging fraud, and precisely how it responded to that information. If the board was left in the dark, this raises another set of other questions, given that whistleblowing attempts had been made at the bank many years earlier. The case law in the US as well as in other jurisdictions stresses the monitoring role of the board of directors, and a key issue as more facts emerge will be the board's role in the creation of, and failure to remedy, the perverse incentives. The Wells Fargo fraud is a multi-layered corporate morality tale with many governance lessons that are by no means limited to the United States.

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Republished from the Oxford Business Law Blog.