BANKS

Stop beating up on Wells Fargo and John Stumpf

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Cramer: Stumpf in 'no-win' situation

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The scandal that has rocked Wells Fargo revolves around 5,000 employees - encouraged by financial incentives for meeting aggressive sales targets - who opened up accounts for customers without their consent. As many as 2 million deposit and credit card accounts had fraudulently been opened by employees over a four year period.

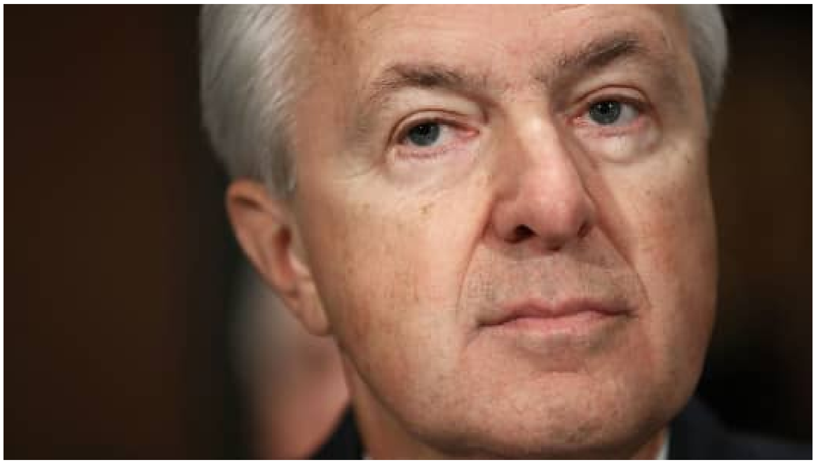
At first sight, it seems that these fake accounts would have elevated Wells Fargo's performance, attracted the attention for Wall Street analysts and investors, generated additional revenue and boosted Wells Fargo's stock price. Lawmakers, on Tuesday, claimed that senior management at Wells Fargo was able to put millions of dollars in their pockets, in part because of these fake accounts.

But seriously, how big a scandal is this and how large was its impact on Wells Fargo's stock price (and hence executive bonuses)? Consider the fact that the fake accounts generated $2.6 million in fees over a four-year period. That is a drop in the bucket (0.011 percent to be precise) compared to Wells Fargo's annual net income of $23 billion. If this is the full extent of the fraud (something that we don't know, yet!) then this is certainly not the most egregious example of corporate misconduct to boost accounting profits/bonuses we have seen in recent years.

These fake accounts certainly did not cause Wells Fargo valuation to double over 2011-2015, and they should certainly not cause the recent steep decline in its stock price. It would seem that the $25 billion drop in its valuation and a slash of its ratings (by analysts at its competitor J. P. Morgan) is an over-reaction.

If the fraud is not more widespread than it currently appears, and if further investigation does not reveal any new material facts, I would think that in time, pessimism about the bank will peak, the share

U... to enforce "Know Your Customer" g... counts are opened only by "genuine" customers, with documentation that establishes identity and legality of funds.



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John Stumpf, chairman and CEO of the Wells Fargo & Company, testifies before the Senate Banking, Housing and Urban Affairs Committee September 20, 2016 in Washington.

"If the fraud is not more widespread than it currently appears, I would think that in time, pessimism about the bank will peak, the share price will stabilize, and there will be no serious repercussions or consequences."

From my personal experience I know that all banks, including Wells Fargo, take their roles in enforcing KYC requirements very seriously. This seems to be a rare case where Wells Fargo unintentionally dropped the ball. However, Wells Fargo has already agreed to tighten controls, fire implicated employees, and pay restitution of nearly $200 million to regulators. That will (and should) be the end of the story.

At a broader level, the entire scandal raises an interesting systemic issue. Employees at banks (like at any other firms) are rewarded for meeting aggressive sales targets. In theory, what happened at Wells Fargo can happen at any other firm. To meet sales targets employees can book fake orders which are then subsequently "cancelled by customers." This is known as earnings management via accruals manipulation. The practice is common enough that auditors, accountants, and analysts keep an eye out for it.

a ehavior on their part, but hardly requires that w go.

In addition, if the conventional wisdom is that it is wrong to reward frontline staff for meeting cross-sales targets, where were regulators, shareholders, and analysts who downgraded the firm till now? Any of them could have spotted the risk, objected to it, and forced a change.

And by the way, if (as is the case) Wells Fargo is to stop rewarding employees for performance, what do they replace this policy with? How else are we to recognize productive employees? Note also that no amount of compliance, oversight, or regulations can guard against employees who are intent on engaging in fraudulent behavior.

All of this is certainly not to say that senior management should entirely be excused. The Senate hearings suggested one way in which senior management can be held accountable is via pay clawbacks. Clawbacks, which were first enacted via the Sarbanes-Oxley Act and have since been expanded by the Dodd-Frank Wall Street Reform and Consumer Protection Act, make sure senior management is "on the hook" in case of misconduct.

An increasing number of firms have added clawbacks to their compensation contracts. Most of these require an employee to refund pay in case of misconduct, fraud, or misrepresentation of performance metrics (that result in higher performance-based pay) and it seems the board at Wells Fargo is looking to see if the clawback agreements against Carrie Tolstedt (chief of consumer banking) and John Stumpf (CEO) should be triggered.

Finally, lawmakers should investigate, but not rush to enact a new regulation which is their typical reaction after each scandal. The solution may not be additional regulations but better enforcement. We already have all the laws on the books that should allow regulators to prevent financial misconduct by banks and firms. The number of financial regulations in the U.S. is already very high and the regulatory regime in the U.S. is considered one of the strongest in the world.

Additional regulations if enacted will be particularly burdensome for small banks and if anything will lead to a decline in the number of banks in the U.S. (there are already 800 fewer banks in the U.S. than in 2007). Fewer banks means less competition and implies that do not happen in the future.

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