If you ask me...

"WHY DIDN'T WE SEE THIS ONE COMING?"

Our regular expert columnist Annie Searle on how looking back at past risk events can pose more questions than it answers

Annie Searle

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I led two conduct risk workshops on March 13 in New York City that preceded the Operational Risk North America conference which should have begun on March 14, but got cancelled because of a severe winter storm. In the first workshop, I looked at the root causes of conduct risk – tone at the top, culture and conflicts of interest – and in all types of companies, not just banks. In the second workshop, I analysed Wells Fargo and Washington Mutual, as prime examples not only of operational risk failures, but also of conduct risk. Throughout the day, participants, who included both regulators and international bankers, searched for signs, other than those produced by standard risk assessment and reporting, of imminent conduct risk failures. And isn't that the question that most of us have when we look back to try to understand why costly failures were not caught? *Why didn't we see this one coming?*

Once a robust risk management programme is rolled out in a firm, it should complement what the other two lines of defence are identifying – but it should also be positioned for proactive identification of outliers and/or anomalies. As former US secretary of defence Donald Rumsfeld once so inelegantly said: "There are known knowns. There are things we know that we know. There are known unknowns. That is to say, there are things that we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know." What Rumsfeld left out of this list are the things we know we don't want to know more about.

How does that work, you might well ask. Without going into a great deal of detail, it's easy to see that a board of directors or even the CEO and CFO might prefer not to be briefed on the means used to deliver wallopingly large profits. At Wells Fargo, when standard sales pitches could not do the trick, employees resorted to using customer data to create additional accounts or services to hit the "eight is great" goal on cross-selling. Quotas were monitored daily and employees understood from observing their managers and other employees that if they did not make their goal, they would have to work nights and weekends to hit the goal. It is estimated that a total of 2.1 million accounts were opened without the customer's permission. Assuming there was a risk management organisation present and that some form of balanced scorecard was presented to the executive suite and to the board of directors, how is it possible that the firing of 5,300 employees for "improper conduct" over five years was not significant enough to register on the radar of the board of directors? The irony is, of course, that revenue did not actually grow that significantly from this retail group misconduct. After former CEO John Stumpf and retail banking head Carrie Tolstedt had retired and had their bonuses clawed back last fall, Wells recently fired four senior managers in the retail group. The corrective action comes three to four years after the *Los Angeles Times* printed an investigatory piece on the practices. The question remains whether or not the board of directors did not see this one coming.

Are there other key risk indicators that could have been established at either Wells Fargo or Washington Mutual? That would of course presume that there was someone in charge who could have read and interpreted the warning signs present in such a report. It is still too easy to look the other way when profits are flowing or (as in the case of Washington Mutual) executives believe they have managed all the threats sufficiently to survive. At Washington Mutual, toward the end, risk reporting was debunked and ignored. The chief risk officer who had tried to reason with the C-suite was fired the morning after he met with a board member. (I dislike telling that story to my students because it is a graphic illustration of the point that delivering negative risk news is not necessarily a rewarding activity for a risk manager.) I suspect that many other banks have boards and C-suite executives who are also capable of ignoring risk indicators and/or firing the messenger. As we also saw at Washington Mutual, those who had historically delivered reliable information – the former CFO and the former chief credit officer, each in turn move into the position of chief risk officer until they retired or withdrew to an "advisory" position, no longer part of the executive committee – were sidelined or eliminated in order to put more risk on the balance sheet and to ignore certain information that they were producing as part of their job. It's easy enough to see in retrospect. But, as far as I know, there is not a way to produce a key risk indicator for greed, dishonesty, avarice and outsized ambition. TRU

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