VW'S TROUBLES

This article by Peter Montagnon explores the initial governance lessons from the Volkswagen emissions scandal. The critical issue facing the company is not only what has gone wrong but why the crisis arose. Only if it addresses the question "why" will it be able to protect itself from future problems. This is a universal lesson for companies in trouble.

It will take us a long time to discover what really went wrong at Volkswagen. We know that the firm and its subsidiaries have been hit by the shock discovery that 11m of their cars contained software designed to mislead regulators into thinking that they were compliant with emissions standards. We still don't know much about who actually put the software in and how far top management knew or encouraged them to do so.

The first task is to establish the facts, but neither Volkswagen nor the broader community can afford to stop there. In this type of corporate scandal it is critical to know not only what happened but also why. The trouble is that, all too often, the enquiry stops at the question "what?" This may help the company to put a lid on the problem. What is needed however is a real solution which would prevent a recurrence. That in turn requires an honest examination of the root causes of the crisis.

It would be very convenient for Volkswagen, the German government and the broader car industry if the problem could be pinned to a few rogue employees who could be unmasked and punished. The rules of conduct could be changed to block loopholes, and business could quickly return to normal.

Yet what has happened here is far too serious for that. This is organised cheating on a grand scale with consequences potentially far more damaging than the notorious rigging of the Libor interest rates by cliques of money market traders. VW cars have emitted more particulates than people believed. Their customers have been deceived, the environment has been damaged and the increased pollution seems likely to contribute materially to human health risks. As for the giant VW, it has forfeited the trust it needs for its cars to sell at their traditional premium and faces remediation costs that could pose existential risks to the company.

The evidence so far is that the company has still not properly understood the magnitude of the problem. True its chairman and chief executive have resigned, but they were quickly replaced with internal appointments. VW has indicated that it will start recalling cars next year so that the software can be amended, but this is scant consolation to those who bought the cars on the basis of fraudulent emission statements. More needs to be done to restore their trust.

There are three related strands to this enquiry. Volkswagen has an unusual governance structure which allows few control rights to outside shareholders and gives a large degree of power to family interests and to the state of Lower Saxony. Second, the company is very well connected politically. The German government has been a keen supporter and, within Europe, has lobbied on the company's half for lower emissions standards. Third, as in all cases where there has been a collapse of this nature, it is important to examine the business model and ask if it was trying to achieve the impossible. It looks as though this might have been the case. The question must be asked: was the company trying to build market share for its diesels in the US on the basis of cars that were both impossibly clean and impossibly fuel-efficient?

There is no doubt that governance deserves critical scrutiny. Ferdinand Piëch, who was Chairman until April this year when he was forced to resign after attempting to oust (the now also departed) Chief Executive Martin Winterkorn, was previously Chief Executive in contravention of the now widely accepted principle that Chief Executives should not go on to become Chairman of the same company. That may not be that important in itself, but it is unhelpful when the background points to a particular need for independent challenge on the board. Mr Piëch is grandson of the engineer who created the legendary Beetle. Some might say that gives him legitimacy but there is a background of disagreement and rivalry between the Piëch and Porsche families who between them control the business. Porsche Automobil Holding controls a majority of the votes although it has only just under a third of the economic interest in the company. Another large slice of votes (20 per cent) is controlled by the State of Lower Saxony in which VW's Wolfsburg headquarters are located. The State government's interest is primarily to preserve jobs and employment.

In short VW's governance structure never provided adequate scope for independent challenge, which was certainly dangerous when power was shared between squabbling families, unions focused on jobs and regional politicians with a similar local objective. This is not the first time that weak governance has contributed to scandal. A few years ago it was caught bribing the Works Council with outrageous payments and favours. One task must be to reform the governance, but we need to look beyond that to how the culture developed that allowed the deception to occur and whether the company's business model made the problem worse.

As Chief Executive, meanwhile, Mr Winterkorn was known for his attention to detail, but he did not apparently know about the deception. Either way round this is a damning admission. If he did not know, he should have. And as Chief Executive he had primary responsibility for developing a corporate culture which would have prevented people perpetrating the deception that happened. But it seems that the governance structure did not allow for challenging questions to be raised about culture.

Volkswagen does have a code of ethics and behaviour. Among other things it states that the company considers compliance with laws to be the basis for a sustainable and successful company, that employees should make sure that their behaviour does not damage the group's reputation, that it will deal fairly with business partners and third parties, that all its reports are true, and that it is committed to continuous improvement in the environmental tolerability of its products. Fine words indeed, but it seems that no one stopped to check how far they matched reality.

One further consequence of the weak governance has been sense of hubris. Volkswagen was not good at self-criticism, but perhaps that, alongside its proud history and iconic status in the industry, gave the company an exaggerated sense of inviolability and self-importance. Its very size in terms of both exports and employment gave it a critical political and economic status within Germany. Does this mean, that, like banks before it, it had become simply too big and important to fail? Certainly it was supported by the German government. There seems to have been very little government interest in challenging its emissions record, and European tests are in any case weak.

Within the company, lack of challenge from the top seems to have led to factionalism. Did internal power struggles influence the choice of technologies that in the end had to be bolstered by fraudulent emissions tests to justify themselves?

At this point it is important to recall that those who perpetrate deceptions such as those at Volkswagen are not necessarily bad people in the moral sense of the word. They are more likely to be responding to pressures that in the end become unbearable. Thus those who misreported the profits at Toshiba appear to have been driven by a misguided tribal sense of corporate loyalty rather than an innate criminal nature. In the UK, pressure on executives to deliver impossibly high margins appears to have led to similar mis-statements at the food retailer Tesco. These failings all seem to owe more to the fact that people behave differently as part of a group than when they are on their own, especially when the group is under pressure. And that raises questions about whether the business model really works.

Volkswagen has a particular problem. Even though it does manufacture in other locations, its German base and the need to keep employment within that country means it has a high cost base, which in turn means that its cars need to command a premium. At the same time its aspiration for global dominance meant it has always needed to seize a strong market share. It has been able to do this as a result of its reputation for reliability, durability and outstanding technology. This approach was tested in particular in the US when it sought to build up a share of the diesel market and found it could not offer both the very high emission standards and the fuel efficiency that the public and customers demanded. In those circumstances, it is not perhaps surprising that some- or perhaps many - of its employees were driven to cheat, especially when they were also trying to hold their own against rivals within the organisation and defend their own diesel technology against that adopted by rivals.

One question the corporate leadership will have to ask is whether this business model is viable in future. Premium pricing is built on the back of trust and this trust is now shattered. Reform will have to go deep if the problem is to be addressed. It will not be enough just to find a few responsible individuals and punish them severely.