Cornerstone Capital Group

Flagship Report

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Global Thematic Research

"Legitimacy" in the Banking Sector

A New Framework for Analyzing the Quality of Stakeholder Relations

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- **Earnings and valuation uncertainty** - In a post Global Financial Crisis world, investors are questioning long-term earnings and valuation prospects for the banking sector. Tougher regulation, particularly on capital, liquidity and structure, are exerting pressure on the traditional banking business and clouding the outlook for investors.

- **A new framework** – To better understand an evolving banking landscape, we offer a new framework based on the concept of "legitimacy". Our framework is designed to help investors assess the quality of an institution's relationships, as they convey a willingness to continue to engage with a bank – whether as a customer, shareholder, regulator, employee or community member.

- **Structure and application** – We discuss the key elements of "legitimacy" and outline the steps and structure of the framework. We then provide an illustrative example where we assess the relationship between 1) Wells Fargo's (WFC) corporate officers and non-management employees and 2) Wells Fargo and its consumer lending clients.

- **Investment implications** – We believe that assessing "legitimacy", or the quality of a bank's relationships with key stakeholders, enhances investors' analysis of factors that influence that bank's valuation. Our legitimacy framework is not limited to the banking sector and can be applied broadly across other sectors and industries.

Background & Introduction to Legitimacy

While investors typically analyze a variety of financial statements and ratios to determine the relative attractiveness of a sector and individual institutions within it, starting from a different viewpoint may illuminate an otherwise less obvious set of opportunities. In this instance, it is the theory of legitimacy.

In a report titled *Rethinking Legitimacy and Illegitimacy – A New Approach to Assessing Support and Opposition across Disciplines*, Robert D. Lamb analyzes the concepts of legitimacy[1] and illegitimacy, discusses issues involved in measuring them in the real world, and introduces a new framework for assessing them in situations where the sources and dynamics of support of opposition need to be better understood. [2]

The legitimacy framework, developed by Lamb and published by Rowman & Littlefield and the Center for Strategic and International Studies (CSIS), originates in Lamb's interest in understanding how gangs in Medellin, Colombia governed different neighborhoods. He examines legitimacy and governance where the unit of analysis is a gang instead of a state, and he studies how that affects the patterns of violence in particular neighborhoods. To address this, he designs a general framework that can be applied not just to gangs in Colombia, but to any number of situations where the dynamics of support, opposition and authority needed to be understood.

Lamb's legitimacy framework is particularly interesting for investors given the need to understand the nature of a company's stakeholders. Assessing legitimacy is helpful for – and in many cases similar to – assessing an organization's governance structure. With this in mind, the legitimacy framework is helpful in understanding companies and the sources of friction in their business relationships. The focus of this report is on the global banking sector due to the reputational damage incurred in the Global Financial Crisis, but the framework isn't sector specific. With modest modifications, it can be applied broadly across other sectors.

On the surface, it is easy to contemplate how detrimental regulatory fights, shareholder suits, high employee turnover, and poor client retention impact a particular bank's earnings and returns. It would be virtually impossible to miss the differences in standard deviation of these two metrics over a five or ten year period – just eyeballing a long list of banks for business mix and credit acumen. Conducting a detailed analysis that involves quantifying the impact of each of these issues, however, is more difficult.

The legitimacy framework isn't a silver bullet, but it does provide a way to begin the discussion. It is based on the quality of an institution's relationships, as they convey a willingness to continue to engage with that bank – whether as a customer, shareholder, regulator, employee or community member. A bank with low quality stakeholder relationships may face more opposition and friction, and therefore more costs to overcome, than one with strong relationships.

[1] Legitimacy, according to many fields of study and practice, is something that induces voluntary support. It is therefore an important intellectual resource for decision makers. Because it cannot be observed, however, measuring and assessing legitimacy is difficult.

[2] Robert D. Lamb, *Rethinking Legitimacy and Illegitimacy: A New Framework for Assessing Support and Opposition across Disciplines* (Washington, D.C.: CSIS and Rowman & Littlefield, May 2014), available at http://www.csis.org/publications.

Relationships and Long Run Costs

Relationships matter to the long-term profitability of any business. Strong customer relationships and stable supplier relationships save on costs of finding new customers and suppliers. A sour relationship with regulators can put an individual company under greater scrutiny or an entire sector at risk of more public oversight, increasing costs of doing business. Low worker morale harms productivity and increases turnover and recruitment and training costs. A greater degree of trust between businesses translates into lower costs for monitoring and enforcing business deals. A company with a reputation for harming the environment or local communities is likely to find opposition when expanding into new communities, or might face lawsuits stemming from past harms. Such risks can affect a company's valuation in a future public offering or private sale. Strong stakeholder relationships can keep a business stable during inevitable rough periods.

These observations apply to the global banking sector as well as any other. Banking has long faced challenges with confidence and trust among its stakeholders, though this problem was magnified by the Global Financial Crisis. In the United States, for example, confidence in the banking sector declined by half after 2008, from 41% to 21 %, recovering to 26% only in 2013, still less than half its 2004 peak.[3] Retail, investment, and commercial banks worldwide have faced similar reputational problems. Risky behaviors and perceptions of breached trust have led to bank closures, tighter regulation, and in some countries prison time for executives.

One should not overstate the case. There is little hard evidence, beyond anecdotes, that poor relationships lead to poor returns on investment. Even banks with serious reputational problems can make money for their investors. However, a bank that manages stakeholder relationships particularly well might, all else equal, have a long-run financial advantage over its competitors. Harmful corporate behavior can trigger opposition from key stakeholders, needlessly increasing costs by having to defend lawsuits, pay fines, sell off assets, and rebrand. Poor relationship management can cost money that could otherwise be capitalized. And corporate leaders capable of managing complex stakeholder relations successfully might well be better managers overall.

For investors, assessing the state of a bank's stakeholder relationships can help identify potential sources of opposition—and therefore potential costs and risks—as well as potential sources of stability. This information can be useful when deciding which banks have a more promising long-term outlook, all else equal.

The application of legitimacy to investing may be new, but legitimacy has been a topic of study for political theorists, sociologists, psychologists, anthropologists, and military historians for almost as long as those disciplines have existed. It is strongly associated with stability, because when people believe something has legitimacy they tend to voluntarily support it, morally and materially. But because legitimacy is not something that can be easily observed, measuring it has always been a challenge. It is our belief, however, that Lamb's framework overcomes some of the challenges of previous attempts.

In the next section, we describe this method and show investors how it can be used to identify potential sources of opposition and the risk that accompanies it. This will enhance investors' ability to identify banks with a stronger capacity to manage relationships and higher prospects for long-term stability and avoid those whose stability might be more costly to achieve.

[3] Dennis Jacobe, "Americans' Confidence in Banks Up for First Time in Years," Gallup Economy, June 14, 2013,; see also Bernard Condon, "Families Hoard Cash Five Years after Crisis," Associated Press, October 7, 2013.

Assessing Support and Opposition

It is sufficient to define legitimacy concisely as a "worthiness of support," as judged by a particular population (called "referees"). When something is considered legitimate, support is offered voluntarily. Having legitimacy, therefore, means support does not need to be purchased or coerced. That, in turn, reduces costs associated with sustaining one's operations. By contrast, illegitimacy is a "worthiness of opposition" that tends to trigger resistance and thereby increase transaction and friction costs.

To see how these ideas apply to the banking sector, consider two fictional retail banks. Trusty Bank has loyal investors, a reputation for excellent customer service, high employee morale and low turnover, a history of cooperating with regulators and auditors, and good relations with community leaders in the neighborhoods its branches serve. Its policies are transparent, it keeps promises and complies with laws and regulations, its managers and staff treat people fairly and with respect, and it is responsive to questions and complaints it receives.

By contrast, Infidelity Bank has faced shareholder lawsuits, consumer complaints, high staff turnover, failed audits, legal fines, and community protests. Its policies are opaque, its staff are occasionally deceptive (at times illegally so), its employees are rude to each other, they discriminate against some of their customers, and the bank is generally unresponsive to complaints unless compelled by legal action or media pressure.

All else equal[4], which company is better managed? Which is likely to end up spending more money than necessary on legal fees, customer retention, marketing, staff recruitment and training, public relations, scandal management, arbitration, legal settlements, or fines? Which can be trusted to maximize shareholder value with minimal oversight?

In reality, the contrast between how different banks manage relationships with different stakeholders is not usually so stark. Some have happy customers but miserable employees while others face supportive regulators but hostile communities. Their relationships with each stakeholder group might be complicated: investors who make money but feel disrespected, or customers pleased with frontline service providers but infuriated by the company's policies. Even within stakeholder groups there is likely to be a diversity of experience as well. A lower-income community might feel customer service is worse in their branch than it is in a more upscale neighborhood. The relationship with state regulators might be different from that with federal regulators. And individual stakeholders might like everything about the bank except one aspect—unethical behavior in a single division, or a perception that executive compensation and bonuses are excessive—that overshadows everything else and damages the relationship.

Using the framework in *Rethinking Legitimacy and Illegitimacy,* these complicated relationships can be assessed in a way that untangles stakeholder attitudes and behaviors that are likely to be costly to the bank in the long run (a potential drag on earnings or a threat to stability) from those that are beneficial and costless.

After identifying the bank to assess, the first step is to identify the particular stakeholder group whose relationship with the bank one wants to better understand. These could be customers, employees, regulators, investors, community members, or activists.

[4] We recognize that many investors look for securities with pricing anomalies and that valuation may well reflect the differences between Trusty and Infidelity.

Each relationship then needs to be broken down into three levels and five dimensions.[5] The three levels are individual belief, group behavior, and the bank as a whole.

- *Belief.* The first level measures the beliefs, opinions, or attitudes of individual stakeholders, usually through surveys, focus groups, or interviews. What are their perceptions of the bank?

- *Behavior.* The second level measures the behaviors of the stakeholder group, using existing data, observation, and documentation. How do they act toward the bank?

- *Bank.* The third level measures objective features of the bank, also using data, observation, and documentation but in some cases surveys, focus groups, and interviews of bank representatives as well. What does the bank do, and what is it like?

At each level, indicators for each of the following five dimensions must be identified:

- *Predictable.* Can the bank be relied upon to do what it says and what people expect it to do? Is it transparent in how it operates? Are its commitments credible? [NOTE: Here it is necessary to identify the expectations, commitments, etc. that are most relevant to the banking sector specifically, i.e., those that, if not met, could adversely affect the relationship in the future. This is different for every sector.]

- *Justifiable.* Does the bank act in ways that are consistent with the values of its stakeholders and the broader society in which it operates? Is its behavior consistent with its own values? [NOTE: Not all stakeholder and societal values are relevant to the analysis. Investors who care only about profits will value the bank's governance differently from investors who care about social concerns. Therefore, it's necessary to identify a few key values, the violation of which would be damaging.]

- *Equitable.* Does the bank treat all stakeholders fairly? Are differences in treatment justified by differences in the stakeholders? [NOTE: In some situations, acting fairly toward certain groups could damage the bank's relationship with a majority or elites; this analysis does not necessarily need to assume that liberal values are correct, only that it's necessary to study relevant stakeholders in depth and in context.]

- *Accessible.* Do the stakeholders have a reliable way to communicate with the bank, resolve issues, and influence operations or policies (at a level appropriate to their position)? [NOTE: Again, it is necessary to identify relevant indicators: accessible customer service is probably important while customer access to many corporate governance decisions is probably not. Similarly, the board need not have access to decisions about day-to-day operations barring a unique circumstance.]

- *Respectful.* Does the bank treat the stakeholders with dignity and respect? [NOTE: Here is where cultural understanding is completely necessary.]

The risk of resistance or opposition to a bank's operations tends to be higher the more the bank acts toward its stakeholders in ways that are unpredictable, unjustifiable, inequitable, inaccessible, or disrespectful. Studying these five dimensions across three levels, therefore, makes it possible to uncover potential sources of risk resulting from poor relationships.

[5] See Lamb, *Rethinking Legitimacy and Illegitimacy,* Chapters 3–4, for details.

Consistency between dimensions and across levels indicates the presence of legitimacy. If individuals say they consider the bank equitable and behave in ways that reflect such a belief (i.e., referring others in their community), and if the bank itself seems to treat its customers equitably, then there is little reason to be concerned the bank might be at risk, for example, of a discrimination lawsuit (this does not eliminate the risk of frivolous lawsuits, however). Inconsistency, by contrast, identifies a trouble spot. For instance, if individual customers say the bank is accessible but rarely call customer service to resolve an issue, then further investigation may be warranted. Perhaps on-hold times at the call center are unpredictable and occasionally excessive (i.e., the bank is accessible but unpredictable). In itself, that is not a reason to fear a risk to long-term stability. But it does suggest a potential trouble spot that is worth exploring further to determine if a competitive disadvantage exists.

A systematic assessment of the strength and sources of support or opposition can be as simple as a quick study of the five dimensions at just the bank level or as comprehensive as an in-depth analysis of the bank's relationships with all stakeholder groups. The choice depends on the time and resources available to the investor conducting the assessment. The *Rethinking Legitimacy* framework describes four types of assessments that can be made:

- *Rapid.* This method uses only the bank-level indicators for the five dimensions. First, for each of the five dimensions, an investor should identify a set of indicators relevant to this bank's relationship to the stakeholder group in question. The *predictable* indicator might include a look at expectations for timeliness, which are likely to differ from country to country. A culture whose religion forbids the charging of interest will have different *justifiable* indicators than others who have no such prohibitions. Then, using those research methods that are feasible, measure the indicators. Does extended observation suggest that managers treat employees equitably and respectfully? Do interviews with investors suggest they have some say over decisions they care about?

  For those indicators deemed relevant, it is necessary to identify whether the bank's performance on each is generally positive, negative, or neutral. (An even more sophisticated look would also determine whether they are improving or deteriorating.) The resulting analysis provides a useful and quickly generated qualitative picture of the bank's relationship with one particular stakeholder group. Any negative indicators, or inconsistencies between indicators, suggest potential problem spots that are worth exploring in greater depth.

- *Multilevel.* A multilevel assessment begins with a rapid assessment, but then adds the other two levels to the analysis: group behavior and individual belief. Just as in the rapid assessment, a set of indicators needs to be identified for each dimension at each level. Indicators for individual beliefs are reasonably straightforward—and measuring them is not more complicated than standard opinion surveys or interview methods. Group behaviors take a little more work, because it is necessary to think through what types of behavior would imply an underlying belief.

  If employees don't believe they are appreciated by management, they might tell that to an interviewer (a belief indicator) and a high turnover rate might also be evident (a behavior indicator). This suggests a problem. On the other hand, if employees tell the interviewer they are appreciated by management in the face of high turnover, there is a disconnect between belief and action, and that also suggests a problem worth exploring. Again, negative indicators and inconsistency between indicators (across dimensions and across levels) both suggest potential problem spots*. (A simpler multilevel assessment* *reviews indicators for general support or opposition at just the three levels, without breaking them out by dimensions; see tables on pages 9 & 10).*

- *Bilateral.* A bilateral assessment offers a deeper level of analysis. In effect, it takes a multilevel assessment and reverses the actors, under the conclusion in *Rethinking Legitimacy* that legitimacy is a two-way street. In addition to studying, for instance, investors' beliefs about the bank, their behaviors toward the bank, and the bank's objective treatment of investors, this assessment studies the bank officials' beliefs about the investors, their behaviors toward the investors, and the investor's objective treatment of the bank's officials.

  There is some obvious overlap in indicators here. But this bilateral approach offers a much more detailed picture of the relationship and identifies some potential problem spots that might not be identified in a simple multilateral assessment. One side might have positive feelings about the other side, but the feeling might not be mutual. That is problematic not only because there is a negative indicator but also because one side seems oblivious to the problem, which is itself a potential problem.

- *Comprehensive.* Finally, a comprehensive assessment is a bilateral assessment that is repeated for the rest of the bank's stakeholders. If the multilevel or bilateral assessment focused on the bank's relationship with regulators, then a comprehensive assessment would do the same analysis of the bank's relationships with customers employees, the community, relevant activists, regulators, and whatever other group whose relationship could complicate the bank's current or future operations.

Each of these four approaches is more labor-intensive than the previous: a multilevel assessment is about three times as labor-intensive as a rapid assessment; a bilateral assessment twice as labor-intensive as a multilevel; and a comprehensive assessment four or five times as labor-intensive as a bilateral assessment. A mix is possible; for example, one can do a rapid assessment for more than one stakeholder group. And for many assessments, it might not be necessary (or possible) to do a comprehensive assessment. The amount of time and resources available limits how much can be done. The risk, however, is that the simpler methods have fewer layers of validation and are therefore more subject to investor bias.

Applying the Framework

Understanding the theory of legitimacy is important, but applying the framework in practice is more valuable for investors. It is therefore useful to provide examples that assess each stakeholder relationship by level (belief, behavior, bank) and dimension (predictable, justifiable, equitable, accessible, respectful). Specifically, we will analyze the relationships between 1) Wells Fargo's (WFC) corporate officers and non-management employees and 2) Wells Fargo bank and its consumer lending clients.

There are a few points worth noting. First, we are providing examples for a subset of stakeholders (in this instance, non-management employees and consumer lending clients), but it would be of greater value to an investor to have a view about most, if not all, of the major stakeholder groups. Also, there is a greater level of specificity in the second example (consumer lending clients) due to information availability. Indeed, if an investor is able to collect and analyze information about non-management employees within business divisions, then this method is preferred.

Finally, we should emphasize a critical point: legitimacy is imprecise and the process of assessing it is flexible. The examples below provide a starting point for investors to evaluate legitimacy in the banking system, however, the framework can and should be adapted to reflect an individual investor's perspective.

1. **Identify the subject** whose stakeholder relationship is to be studied. Which bank? Which division? What domain of activity?
2. **Identify the stakeholder** whose support or opposition is to be studied. Institutional investors as a whole? Specific institutional investors? Customers of which service or product line? Employees? Which group of employees? Which regulators? Be very specific about whose views and actions you're studying.
3. **Identify the indicators**. The framework of indicators is drawn from research on the dynamics of support and opposition in relationships between two parties. Each indicator is framed as a question, the answer to which is, essentially, "Evidence suggests a positive/neutral/negative relationship." The questions need to be answered in the positive or the negative. The simplest scoring system would be –1 if the data for the indicator suggest the relationship suffers from opposition or friction, 0 if it is a normal or neutral relationship, or 1 if the data for the indicator suggest it is particularly positive. A scale including fractions between –1 and +1 could be developed as well if there is a need for more nuance. If trend data are available, the investor could indicate not just a score but also a direction: does the evidence suggest the score for each indicator is rising, falling, or stable?
4. **Collect evidence**. Begin with the assumption that in almost all cases the stakeholder in question is in an instrumental relationship with the bank under study. Employees do their job in exchange for pay, shareholders hold stock to earn a return, and regulators are carrying out oversight obligations. This is a "normal" or "neutral" relationship that, if graded, would have a score of zero. The relationship is not especially warm, nor are there any significant points of friction. What one is seeking is evidence that the stakeholders' views, the stakeholders' actions, and the bank's treatment of stakeholders significantly diverge from neutral, suggesting a particularly positive or particularly negative relationship. The evidence can come from quantitative data, the analyst's subjective impressions drawn from qualitative evidence (media reporting, interviews, focus groups, etc.), or, in most cases, a mix of these and other factors.

The following tables suggests data sources for each indicator. Each indicator might have multiple sources of data that can be used to determine the score for that indicator; in some cases, no data will be able to be found for a particular indicator, which can be fine if there is sufficient data for other indicators.

Example 1: Wells Fargo Corporate Officers ("Management") vs. Wells Fargo Non-Managerial Employees ("Stakeholders")

Simple Multilevel Assessment

Indicator	Validation Check: Look for consistency across levels What do the stakeholders say?	What do the stakeholders do?	How does management act?	Analysis
General Support (General Opposition)	**Stakeholder views:** Do employees say they feel particularly positive or particularly negative toward management? Or are their views in line with expectations?	**Stakeholder actions**: Do employees act in ways that seem unusually supportive or unusually obstructive toward management? Or in line with expectations?	**Bank behavior**: Does management treat employees particularly well or particularly poorly? Or is their behavior generally consistent with employees' interests and expectations?	All three levels positive or neutral: Minimal risk One negative: Cause for concern More than one negative: Source of risk
Illustrative data sources and indicators	Employee engagement surveys, blog postings & career intelligence sites (i.e., LinkedIn, Indeed.com, Vault.com), news sources	Employee turnover , employee productivity, content analysis of lawsuits, complaints filed, data measuring morale, employee productivity	Company filings, compensation/benefits policies, interviews with management	

Multilevel Assessment

Indicator	Validation Check: Look for consistency between levels What do the stakeholders say?	What do the stakeholders do?	How does management act?	Analysis
Is the bank predictable (arbitrary)?	Do most employees think management is credible and transparent? Are rules and expectations disseminated effectively?	Do employees disobey rules or underperform due to misunderstood expectations?	Does management set clear goals that are role-specific yet tied to company objectives?	All three levels positive or neutral: Minimal risk One negative: Cause for concern More than one negative: Source of risk
Is the bank's behavior justifiable (unjustifiable)?	Do employees think management acts against their values and interests?	Have there been letters of complaints, strikes, lawsuits, etc.?	Is management behavior in line with the ethics and compliance policy? Is there an adequate whistleblower program?	
Is the bank equitable (unfair) in its treatment of employees?	Do some employees think they are discriminated against unfairly?	Have there been letters of complaints, strikes, lawsuits, etc.?	Are hiring and compensation practices uniform or are "workplace politics" common?	
Are relevant decisions and processes accessible (inaccessible) to employees?	Do many employees feel disempowered?	Do employees fail to volunteer for committees, use grievance processes, or take advantage of opportunities for input?	Does management offer career paths and/or cross-training opportunities? Is employee feedback considered when making business decisions?	
Is the bank's treatment of employees respectful (disrespectful)?	Do many employees feel disrespected?	Is employee morale low?	Has management enacted programs or polices on freedom of association, discrimination and diversity?	
Illustrative data sources and indicators	Employee engagement surveys, blog postings & career intelligence sites (i.e., LinkedIn, Indeed.com, Vault.com), news sources	Employee turnover , employee productivity, content analysis of lawsuits, complaints filed, data measuring morale	Company filings, compensation/benefits policies, interviews with management	

[*] The company does not disclose data about employee turnover rates, but in many instances there are online surveys that, at a minimum, provide some level of qualitative guidance. This also can lead to a discussion with the company as to why this data is not disclosed.

Example 2: Wells Fargo ("Bank") vs. Wells Fargo Consumer Lending Clients ("Stakeholders")

Simple Multilevel Assessment

Indicator	Validation Check: Look for consistency across levels — What do the stakeholders say?	What do the stakeholders do?	How does management act?	Analysis
General Support (General Opposition)	**Stakeholder views:** Do consumer lending clients say they feel particularly positive or particularly negative toward the bank? Or are their views in line with expectations?	**Stakeholder actions**: Do consumer lending clients act in ways that seem unusually supportive or unusually obstructive toward the bank? Or in line with expectations?	**Bank behavior**: Does the bank treat consumer lending clients particularly well or particularly poorly? Or is its behavior generally consistent with clients' interests and expectations?	All three levels positive or neutral: Minimal risk One negative: Cause for concern More than one negative: Source of risk
Illustrative data sources and indicators	Customer satisfaction surveys (i.e., J.D. Power), blog postings, news sources	Core 1-4 Family first mortgage loan growth (absolute and relative to peers), mortgage origination share and industry rankings (Inside Mortgage Finance), Automobile and credit card loan growth (absolute and relative)	Company filings, interviews with management, disclosure of approach to data governance, Community Reinvestment Act rating	

Multilevel Assessment

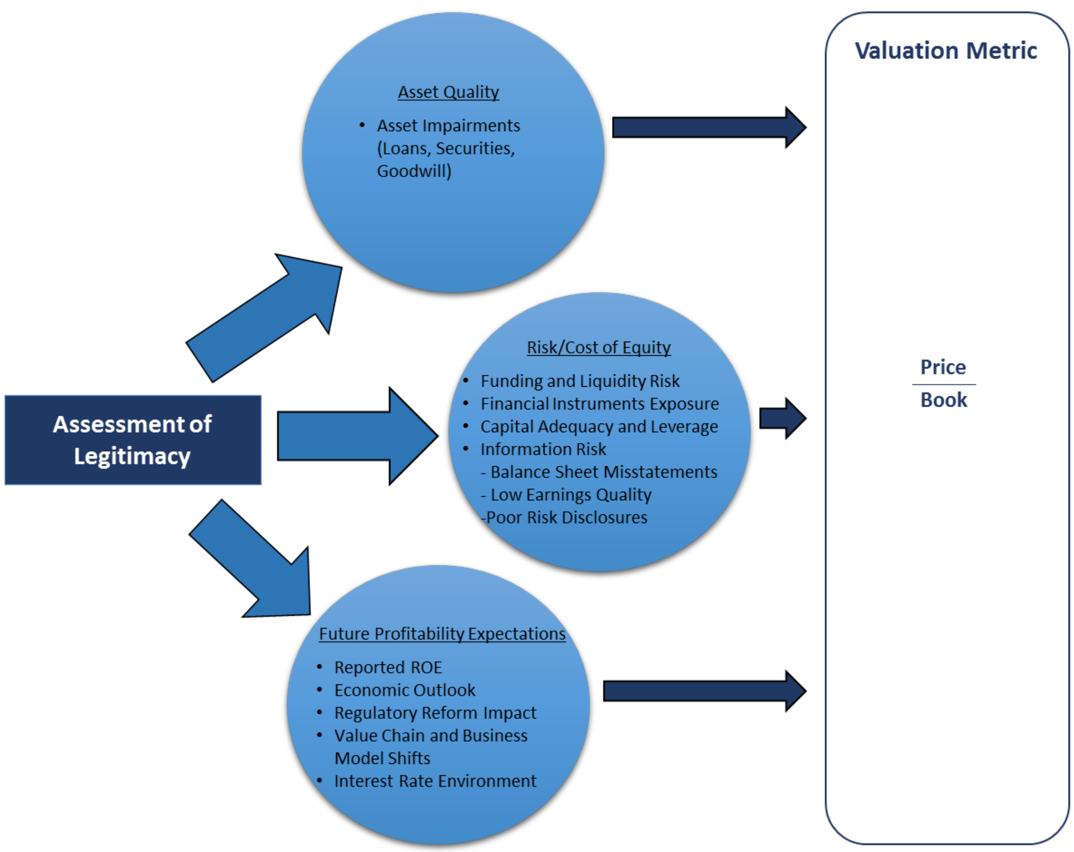
Indicator	Validation Check: Look for consistency between levels — What do the stakeholders say?	What do the stakeholders do?	How does management act?	Analysis
Is the bank predictable (arbitrary)?	Do most consumer lending clients think the bank is credible and transparent?	Do consumer lending clients turn into repeat clients or go elsewhere due to misunderstood expectations?	Does the bank have a reputation for misrepresenting the risks associated with financial products and services? Has the bank developed consistent, cross-product integration?	All three levels positive or neutral: Minimal risk One negative: Cause for concern More than one negative: Source of risk
Is the bank's behavior justifiable (unjustifiable)?	Do consumer lending clients think the bank acts against their values and interests?	Do consumer lending clients consolidate business with the bank?	Does the bank employ relationship pricing or does a silo structure prevent bundling and pricing tailored to meet the needs of different customers?	
Is the bank equitable (unfair) in its treatment of clients?	Do some consumer lending clients think they are discriminated against unfairly?	Have there been complaints, lawsuits, or protests about unequal treatment?	Does the bank have a program that promotes financial inclusion? Does the bank have adequate measures in place to prevent discriminatory lending practices?	
Is the bank accessible (inaccessible) to clients?	Do consumer lending clients have a reliable way to communicate with the bank and resolve issues in a timely fashion?	Do consumer lending clients utilize the customer resources available to them? If so, do they provide referrals based on positive experiences?	Has the bank invested in customer service? To what extent is it utilizing technology to improve the quality and timeliness of service?	
Is the bank's treatment of employees respectful (disrespectful)?	Do many consumer lending clients feel disrespected?	Have consumer lending clients taken business elsewhere due to disrespectful business practices?	Has the bank been involved in serious business ethics incidents? How does the bank approach data governance?	
Illustrative data sources and indicators	Customer satisfaction surveys (i.e., J.D. Power), blog postings, news sources	Core 1-4 Family first mortgage loan growth relative to peers, Automobile and credit card loan growth relative to peers, mortgage origination share and industry rankings (Inside Mortgage Finance), news sources	Company filings, interviews with management, disclosure of approach to data governance, Community Reinvestment Act rating	

Investment Implications

As with any economic sector, there are various factors that contribute to bank valuations. For instance, it's well known that profitability, measured by return on equity (ROE) and return on assets (ROA), affects bank valuations (P/B). In most cases, there is a positive correlation where higher (lower) profitability results in higher (lower) valuation. In a similar but opposite manner, capital markets' measures of risk, such as cost of equity, have a negative correlation with valuation.

In response to the Global Financial Crisis, market practitioners, regulators and academics proposed policy measures with the goal of restoring investor confidence in the banking sector. One suggestion is that enhanced risk disclosure would help investors better understand the bank business model and reduce the equity risk premium assigned by investors due to the limited transparency of bank financial statements.[6] In this regard, we believe that assessing bank legitimacy, or the quality of the banks relationships with key stakeholders, enhances investors' analysis of factors that influence P/B ratios.

Figure 1: Legitimacy Analysis and Factors That Influence P/B Ratios



Source: Financial Crisis Insights on Bank Performance Reporting (Part 1), Cornerstone Capital Group

[6] Papa, V.T. & Peters, S.J., *Financial Crisis Insights on Bank Performance Reporting (Part 1) - Assessing the Key Factors Influencing Price-to-Book Ratios* (July 2014). CFA Institute. Retrieved from http://www.cfainstitute.org/learning/products/publications/ccb/Pages/ccb.v2014.n3.1.aspx

Potential for Additional Applications

We apply our legitimacy framework to the global banking sector in light of the reputational damage incurred by the Global Financial Crisis, but the framework has applications beyond banking. Indeed, our framework can be employed by investors across sectors to evaluate a company's intangible assets. As noted in our *ESG Essentials – A Guide for Investors* report, intangible assets constitute a larger proportion of market value than in the past, and this shift from tangible assets to intangible assets introduces more variability and uncertainty into the assessment of overall value to shareholders.

As investors address this issue, they would be keen to consider the legitimacy framework in evaluating intangible assets – specifically those that are dependent on a company's relationships with stakeholders. Customer relationships, brand names, corporate reputation and management quality are examples of intangible assets that can add or detract significant value based on the perception of legitimacy or illegitimacy, and investors must understand what drives these perceptions.

Directly quantifying the impact of legitimacy is not the goal. Instead, our legitimacy framework will enable investors to identify companies with a stronger capacity to manage relationships and greater prospects for long-term stability.

An Interview with David Korslund – Senior Advisor at the Global Alliance for Banking on Values

What is the Global Alliance for Banking on Values (GABV)?

Founded in 2009, the GABV is a not-for-profit foundation with members consisting of the world's leading sustainable banks. As of December 2013, the GABV had 25 members with nearly $100 billion in assets under management. The members are socially progressive and innovative banks focused on delivering sustainable economic development and environmental improvement throughout the world. Although they operate in many different markets and with a variety of business models, all of them have at the core of their activities a focus on the Principles of Sustainable Banking.

What are the Principles of Sustainable Banking and the Sustainable Banking Scorecard?

The Principles were developed as part of research undertaken by the GABV and funded in part by the Rockefeller Foundation to look at the capital requirements and returns for sustainability focused banks. Although all the principles are important, the Triple Bottom Line principle is critical with its focus on economically and sustainably delivering banking products and services to clients meeting the needs of people (social empowerment), planet (environmental regeneration), and prosperity (economic resiliency).

The Sustainable Banking Scorecard, based on the Principles, is a tool for bank self-assessment and improvement as well as providing external stakeholders an assessment of a bank's sustainability profile. The Scorecard takes a holistic approach in assessing a bank's business model, using a combination of basic requirements, quantitative factors and qualitative elements to derive a relative Sustainability Score. Members of the GABV have been piloting the Scorecard over the last year and it is expected to move from its current "beta" version to Version 1.0 in the near future.

The institutions that have signed up for the GABV Principles appear to be relatively small in size compared to the overall financial services universe. How can you encourage larger banks to join?

The GABV's goal is not to be largest banking organization in the world. Instead, it seeks to identify and support banks that are focused on delivering sustainable and innovative banking within their communities. For instance, a number of GABV member banks were early participants in the financing of alternative energy. Many larger banks have since followed into this market. While this creates competitors, it leads to more financing of alternative energy based on the initial proof of concept. Instead of looking at size as an indicator of success, the GABV is looking to increase the impact of sustainable banking through spreading its innovative practices as well as growing its members through support from its networks of practitioners, developing new sources of capital, and creating programs to develop human capital and assess bank sustainability.

Do you believe that providing access to capital markets products for corporations, NGOs and governments is at odds with your Principles?

We are currently debating how to better define the split between the financial and real economies. A capital market instrument in itself is not a bad thing. It is more about the number of degrees of separation from the real economy that determines whether a financial instrument supports the real economy or is more speculative in nature. For instance, a company that uses futures contracts for delivery of a commodity used directly in their business activities receives tangible benefits in terms of hedging their business risk with only one degree of separation from the real economy.

Is regulation in certain jurisdictions hindering transparency, particularly in serving clients internationally?

There is evidence that elements of regulatory system are not fully effective. In particular, some elements of Basel II and III have significantly increased complexity in the system. Regulation can also directly or indirectly reduce diversity within the banking sector. Indeed, many smaller institutions are struggling to address and manage certain new regulatory standards because they lack the resources. It is therefore no surprise that we have seen more concentration among the largest banks since the Global Financial Crisis.

Where do you see synergies between the legitimacy framework and the GABV Scorecard?

It's clear that culture is important for any company, and its importance cannot be understated in banking. Research from the GABV shows that banks that maintain consistent client relationships and focus on the "real economy" and Triple Bottom Lined enterprises have cultures that deliver more stable earnings over time. With this in mind, the legitimacy framework can be used to assess the culture of an institution.

It is different though consistent with and supportive of the Principles underlying the GABV's Scorecard.

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