Cornerstone Capital Group

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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.

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Robert D. Lamb, PhD is an expert on governance, international development, and conflict with an emphasis on analysis of intangibles, complex crises, informal processes, and hybrid political and economic systems. This academic year he is a visiting research professor at the U.S. Army War College's Strategic Studies Institute, where he is researching the effectiveness of international donors and the private sector in fragile and conflict environments. He is a nonresident senior fellow at the Center for Strategic and International Studies, where he previously directed the Program on Crisis, Conflict, and Cooperation, and is a nonresident research scholar at the Center for International and Security Studies at the University of Maryland. He earned a Ph.D. in policy studies from the University of Maryland School of Public Policy and received a B.A. from Gettysburg College.

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Ms. Glossman's current emphasis is on corporate board service, with governance experience dating to 1998. These assignments have spanned a variety of industries and geographies, start-ups and distressed situations. She is a member of SASB's financial industry working group and is also serving on the Board of Directors of the Bucks County SPCA. Ms. Glossman spent 25 years as an investment analyst, working on both the buy- and sell-sides. Over the course of her career, she covered all aspects of banking and financial services industries, with research distinguished by it's in depth coverage of banking technology and the international operations of US banks (visiting banks in over 60 countries). Ms. Glossman earned a B.S. in economics from the Wharton School at the University of Pennsylvania with a double major in finance and health care administration, having also attended the University of California at Davis. Ms. Glossman was awarded her Chartered Financial Analyst designation (CFA) in 1981.

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