SCOPE

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For analysts and investors, the Q4 European bank reporting season had a distinct whiff of déjà vu. Fears about pandemic-induced asset-quality deterioration have subsided while anxiety about new prudential regulation is now contained. Once again, the market focus is on potential M&A deals, maximising revenues, share buybacks and other events and narratives likely to impact equity prices and bond spreads.

The banking industry and the banking environment have been changing dramatically in the last few years, but not necessarily in the directions pursued by analysts and investors. The speed and depth of digitalisation are driving current changes. The strategies and avenues that banks need to pursue in the post-pandemic world are existential and not just about moving products and activities into the digital space.

Everybody is relying on the European banking sector as the main channel for financing post-pandemic economic growth. This may create image problems for banks aiming to inhabit a different sphere. Banks are also expected to steer clear of misconduct events such as money laundering or unsavoury practices. Equally, they know that they must tackle climate and environmental challenges, managing related risks and re-directing lending to greener pastures.

One-off events with global relevance, like a Russian invasion of Ukraine, can materially impact European banks' activities. Especially if they are caught up in follow-up sanctions. It is hazardous to assess the financial impact of such scenarios on the sector but neglecting them just because it is impossible to assign a metric to it should not be an option either.

Narratives vs. metrics

All of this suggests that bank analysts – buyside, sell-side or rating – need to be much more than financial analysts with in-depth but narrow sector expertise. To mirror the new realities, bank analysis needs more than ever to be anchored less overwhelmingly in financial ratios and no longer discount non-parametric narratives which can be equally relevant. That means new skills and new angles.

In practical terms, financial metrics-based analysis results in earnings-forecast models for pricing bank equity, and in peer-ranking prudential ratios (CET1, leverage, MREL etc.) and seniority rankings to estimate bond spreads. But narratives around banks' non-financial risks and opportunities, which cannot all be translated

into financial metrics, are bound to carry an increasing weight in investment decisions.

Too many analysts assume that if their recommendations are not based on specific metrics, the recipients of their research will find them less useful. This is simply not true. An investor's opinion about a name or a sector can be shaped as forcefully by a convincing narrative with teeth as by a specific number.

In fact, the weight of a powerful non-financial narrative can often dwarf a set of financial metrics that would point in a different direction. Examples exist of banks with reassuring prudential metrics, good asset quality and decent profits having been severely upset by misconduct or poor conduct. Or by the own goal of material IT errors. Or by failing to deal with climate risks or customer-reputation risks in its lending. Especially at a time when investigative journalism and social media can disseminate shocks in real time.

So, what are some of these desired knowledge areas and skills for bank analysts?

Non-prudential regulations

When assessing the impact of regulations on banks, analysts and investors focus on prudential aspects, mainly related to capital and liquidity. But banks' activities are also being guided by a growing range of non-prudential regulations. These look to address existing regulatory gaps or the new shape and horizons of the industry.

Examples of the former are the EU's anti-money laundering directives; both AMLD5, the existing regulation, and AMLD6, a draft of which was published last July. The upcoming establishment of a new anti-money laundering authority (AMLA) with supervisory powers across the EU should be closely followed. The same goes for the workings of national Financial Intelligence Units (FIUs) and their links with the future AMLA.

The most relevant example of the latter is the revised Payment Services Directive (PDS2), adopted four years ago and which has enabled the growth of open banking and finance across Europe. A previous edition of ***The Wide Angle*** has covered this important regulation and its impact on the industry[1].

We are also witnessing a gradually wider role of crypto assets in finance, albeit less evident in Europe than in the US. Nevertheless, this is an area of risk which needs proper regulation. Analysts may want to pay particular attention to the progress of the forthcoming markets in crypto assets (MiCA) regulation[2].

The digital space

More than ever, bank analysts need familiarity with new technology advances and the dynamics of the digital economy and finance. A good bank analyst will need to master with relative confidence the fundamentals of key components of digital banking and finance. Which could have a disruptive effect on banks that neglect them or fall behind but be a positive competitive element for those which make full use of them.

Examples are the use of APIs and super-APIs, open platforms, the banking-as-a-service (BaaS) and banking-as-a-platform (BaaP) business models, the advancement to open banking and finance. The extent to which banks rely on cloud computing and on artificial intelligence for transactions, data management and operations is also a necessary element in the analysis.

Looking at financial metrics should ideally be supplemented by an assessment of a bank's digital presence though its website and mobile app, mystery shopping, the screening of social

[1] https://bit.ly/3s52GAH

[2] https://bit.ly/3JGBWwu

media and news flows. One element of digital comparability is the degree to which a customer's digital journey for an essential service (e.g. opening a current account) needs to be supplemented by the visit to a physical branch.

In other words, how the bank looks from the investor's angle should be combined with how retail and business customers experience the bank. Because ultimately subpar customer experience can weigh negatively on a bank's market position and footprint metrics.

Based on the assumption that disruptive forces will gain speed and volume, bank analysts will want to look not only at banks' attempts at pushing disruptors back. They will also aim to assess the skills, capacity and targets of the disruptors themselves. For example, understanding the dynamics of fintechs, neobanks and open-banking platforms in the UK would help the analyst better assess the competitive challenges for the large incumbent banks. Also, the extent to which the latter are up to the new game.

One area where more analyst attention is needed is that of technological competence among senior management and the role played by IT and digital aspects in the bank's overall strategy.

Climate and environmental risks

At long last, this topic is increasingly material in bank analysis – a trend noticeable especially during the last 18 months or so. But in general, it is kept separate from the central assessment of the bank. Sometimes an analyst will venture an earnings estimate that, say, transition risk will have a 15% impact on a bank's bottom line. Given the very long timeframe for climate-risk adjustments (with net-zero targets by 2050), I would not view such estimates as reliable.

The forthcoming ESG Pillar 3 risk disclosures (to be phased in from end 2022 to mid-2024), as set up by the EBA's recently published binding standards, is a case in point[3]. Two new key ratios will start being disclosed as of 2024: the green asset ratio (GAR) and the banking book taxonomy-alignment ratio (BTAR).

If we go by what we have seen with prudential ratios – such as CET1 – analysts and investors will start peer-ranking banks in accordance with GAR and BTAR and penalise laggards in both share prices and bond spreads. But more relevant as informative content would be the assessment of what is behind these ratios.

In this context, I find it odd that for far too many market participants, a key accomplishment by banks in the climate arena is the issuance of green bonds; when in fact it is the use of proceeds from these bonds, with evidence that it is being done, that should be of more relevance.

To look properly at the climate challenge for banks, analysts need to broaden their knowledge horizon into related scientific concepts, ethical aspects, and understanding the dynamics of other industry sectors such as energy, power generation, manufacturing, utilities, etc. They should also become familiarised with the detail with the recommendations and scenarios of the central banks' Network for Greening the Financial System (NGFS) and the TCFD framework.

Without working knowledge of the policy and scientific fundamentals of the climate and environmental challenges of the markets in which banks operate, analysts will be in a difficult position to properly analyse and challenge banks' statements.

[3] https://www.eba.europa.eu/eba-publishes-binding-standards-pillar-3-disclosures-esg-risks

Cyber risk

Most banks put cyber risk at the top of their bucket lists, but the disclosure transparency behind it leaves much to be desired. Cybersecurity remains a very arcane discipline, difficult to penetrate and made sense of in the absence of the right professional background. And in most cases, the career choice of cybersecurity experts is not to analyse banks for the benefit of investors.

There is also the small detail of banks being understandably reluctant to share critical cybersecurity details and strategies with outside parties like analysts and investors. It is fair to say that a comprehensive view of the cyber protection architecture of a bank cannot be easily assessable from the outside.

Nonetheless, basic knowledge of key cyber risk aspects can help the analyst: a bank's external network protection, internal vulnerability to cybercrime – phishing, malware, social engineering etc. Equally useful should be the ability to assess the quality and reliability of outside vendors such as cloud or blockchain providers.

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