The Wide Angle

Bank analysis needs to move with the times

Sam Theodore | April 2024

When assessing banks, high customer satisfaction, progress in digitalisation or brand value do not win arguments in investment, credit, or rating committees if financial metrics-based analysis is not sufficiently reassuring. Questions about these topics are almost never asked on investor and analyst calls with top bank executives. They should be.

Over the last decade, the European banking sector has been a relative island of stability, defying the regular cadence of market warnings about the imminence of a new crisis. For the time being, concerns have been laid to rest, except perhaps for lingering worries about commercial real estate. Reassured that safe prudential metrics, supervisory vigilance, and more contained risk appetite are here to stay, analysts are shifting back from CET1 to ROE as the top financial metric. At this stage, the main relevance of regulatory capital metrics is to keep regulators happy, secure generous dividends and ideally engage in share buybacks.

Europe's large banks, asset-big and important as they are in international finance, are manifestly underwhelming when it comes to global capital rankings. Only two Europe-based banks, HSBC and UBS, are in the top 20 (8th and 19th, respectively). And only two euro area (EA) banks, BNP Paribas and Santander, are in the top 30 (22nd and 26th). Deutsche Bank, Germany's flagship bank internationally, ranks 73rd (USD 30bn market cap vs. USD 564bn for top-ranked JP Morgan Chase).

These relatively low rankings are partly macro-driven, reflecting the fact that Europe is not in the leading peloton of economic growth. Bank profitability has improved markedly since 2022 when rates started to rise, but significant further revenue growth from current peak rates is less probable. This appears to be another factor influencing European bank share prices.

The sector's prudential strength and respectable distance from crisis or failure scenarios do not count as much in bank valuations. Beyond sustainable bottom lines and reassuring prudential metrics, few non-macro drivers are influencing European bank valuations. Should some of those be considered, even partially, the sector's image and valuation could be adjusted.

The limits of the shareholder value-creation approach

Banks sit in the space between public utilities and profit-seeking private-sector firms. They don't like to admit this, and the markets don't like to talk about it. But the current ROE-driven shareholder-value approach is only of partial relevance when it comes to large nationally important banking groups in developed economies.

Banks with high ROEs should in principle be better positioned to raise fresh equity than banks with lower returns. This is a key reason why markets and supervisors both focus so intensely on the metric. The reality is that in recent years only financially challenged banks have issued or have considered issuing new equity. Financially strong banks have not done so and by the look of their current or even stress-tested capital positions, they are not likely to any time soon. This will not change. In the foreseeable future, it is unlikely that we will witness a major bank acquisition financed with new equity. In the digital age, it makes little sense.

Primary markets for bank equity remain empty. They are extremely crowded for bank debt, however, including for Tier 2 and (more infrequently) AT1.

Furthermore, I believe that a properly supervised and generally risk-averse banking sector has a true cost of equity much lower than the double digits bandied about (often without any pertinent credible analysis substantiating it). This challenges the market view that European banks are unable to earn their cost of capital, a perennial negative for their market valuations.

As for credit investors, they should in principle be reassured that banks are moving closer to the public-utility end of the spectrum into the "boring bank" category. But do not seem to be. Their view is that a bank that is safe but marginally less profitable will be at a disadvantage if it needs to cover large, unexpected losses. But that would be related to the bank's risk appetite, management and control more than to ROE metrics. Earnings may be a bank's first line of defence, as the ubiquitous analytical mantra goes, but more essential than that is preventing what the bank is supposed to be defending against in the first place.

The public role of private-sector banks

Banks have not been truly operating in open-market economies since the Global Financial Crisis. Europe's highly bank-intermediated economies (and implicitly the social contract they underpin) would not have been able to function without prompt and massive public-sector intervention. We witnessed the positive impact of government action during the pandemic, even at the cost of widening public deficits (France being a vivid example). The ECB's recently published operational framework review calls for a substantial reduction in its balance sheet and gradual pullback from a dominant role in market operations. However, in a future crisis, it is unrealistic not to expect renewed interventionism should market forces be overwhelmed.

In this context, Europe's large banks remain key pillars both in financing economic growth and as transmission mechanisms into the real economy. Low ROE or high ROE, if they remain prudentially sound, they will continue to lend to businesses and individuals and play their role in society. Annoying as windfall taxes or capping banking fees may be for shareholders, they add value from the broader perspective of the role of banks.

How do investment decisions reflect the value created by banks?

My view is that a bank's value should be derived not only from using traditional metrics like ROE – specifically the extent to which ROE exceeds a foggily-defined cost of equity – but also by assessing the value that all banks add in general and that each bank adds in particular. First to customers, and second to a wide range of stakeholders, not just shareholders. In this broader context, society at large is a legitimate stakeholder.

There are two realities framing the answer to this question. The first is that regulators are banks' best defenders. Without a credible and effective regulatory and supervisory framework, banks would simply not exist in their current form. Who would deposit funds in highly leveraged entities lacking transparency with no controls on how those funds are being utilised?

There should only be negative value for a bank engaging in regulatory arbitrage or taking unwarranted risks just for the sake of boosting the bottom line. From this angle, properly pursued supervision – the case now in the EA, UK, and Scandinavia – is levelling the playing field in a positive way.

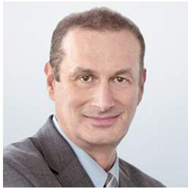
The second reality is that most financial products and services are highly commoditised. Wherever they are, large European banks all offer a similar range of products to their retail and business customers (although tax and legal differences do exist between countries). If one bank comes out with an innovative product that gets customer traction, competitors will replicate it very quickly. No bank has a unique product factory in the digital age with open banking and finance growing. "Unique selling points" are fake even though banks, like other businesses, still showcase USPs for marketing.

If profit maximisation is constrained by regulations, and if no product they offer is unique, how else can banks create value? First, through the quality and service provided via customer relationships: safety, reliability, transparency, consistency over time, and ease of access. The more the bank identifies with its customers, the better. Second come the cost and speed at which banks serve customers. All this can be done more effectively than in the past, using data collection and management as well as AI. These value-creation characteristics are more visible in the digital ecosystem in which banks must compete or need to co-operate increasingly with fintechs and big techs.

A recent BIS report lays out a vision for what it calls the Finternet: multiple interconnected financial ecosystems. Much like the internet and designed to empower individuals and businesses and lower barriers between financial services and systems thus promoting access for all. The system envisioned leverages innovative technologies such as tokenisation and unified ledgers, underpinned by a robust economic and regulatory framework.

Should such a framework were to become reality, which is totally plausible, I strongly believe that the valuation metrics for banks and other financial actors will have to change dramatically. Which means that the analytical culture will have to evolve as well. Good sell-side, buy-side, and rating analysts will move in this direction faster than the rest.

Analyst



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