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The market continues to assess banks primarily from the angle of shareholder value-creation, focusing on traditional prudential and risk-return indicators. This needs to be revisited, as the large European banking groups in the post-pandemic age have become hybrids of private-sector institutions with quasi-public roles and priorities. This characteristic is holding true during the growing energy and inflation crisis in Europe.

Europe's banks have entered a new age since the pandemic, in which they are more closely aligned with the social and economic priorities of the areas in which they operate – unlike the former "markets and profits first" era. But of course they are not directly State-controlled or constrained like they were in the post-war decades before the sector was privatised and deregulated.

In this new context and from a different perspective, TBTF (Too Big to Fail) should be replaced with TBTBR (Too Big to Be Reckless). The daredevil instincts that defined too many banks' strategies in the past are mostly gone.

With few exceptions, large bank CEOs are now the adults in the room, visibly different from their predecessors' risk-taking adventurism. Even transactions suggested by supervisors, like cross-border M&A, are being shunned as not making economic sense (which in most cases it doesn't).

The limits of the shareholder value-creation approach

The primary concern of investors and analysts is how comfortably the banks they follow meet prudential requirements, mainly capital. Once that is put to bed, the focus is on how the mix of revenues, risks and costs impacts the bottom line. Aside from helping valuation, a bank with a high ROE will be better positioned to raise fresh equity compared with a bank with a lower ROE. And raising new equity can become necessary if a bank is faced with a major hit that can endanger its prudential capital levels. Or if it wishes to pursue a major acquisition which requires new funds.

But this has not been the case among the large banking groups in recent years. On balance, the sector remains well capitalised, with a CET1 ratio of 15% in Q1 2022 according to the EBA. Also, the earnings trajectory in a rising rate environment is improving, which should aid stability despite a likely rise in loan-loss provisions. Banks that have issued equity in recent years like Deutsche Bank (2017), those that are about to issue (Monte dei Paschi di Siena) or which are reportedly considering issuing (like Credit Suisse), are outliers experiencing weakness. Banks displaying high financial strength, low risks, and satisfactory ROE are the least likely to consider issuing new equity. And financing a new major acquisition with new equity cannot be made in the current environment.

Last, but not least, a tightly regulated and de-risked banking sector may suggest a true cost of equity lower than the low double digits generally assumed (without any clear analysis substantiating it). This should challenge the market view that banks in general are unable to earn their cost of capital.

So how do banks create value for more than shareholders?

The needle is moving in the direction of banks as hybrids of shareholder-based companies with quasi-public roles and priorities. But does the market accept that? And how do investment decisions reflect the value created by banks? Which leads to where exactly is the value created by banks and how should it be reflected in the market's view.

I anchor the answers to these questions in four realities:

1 Government will continue to prop up market economies

Banks have ceased operating in open market economies since the GFC 15 years ago. The post-GFC decade saw central banks steer and calm markets by lowering rates and purchasing securities.

In the pandemic years, central bank actions were doubled up by governments offering financial guarantees, subsidies, moratoriums, and direct credit on an unprecedented scale. Public support schemes were largely operationalised by the commercial banking sector. And now, with the deepening energy crisis and high inflation, central banks are back to their traditional role of fighting inflation, but governments are growing their support for households and businesses.

This evidences the fact that European economies, and implicitly the social contract they underpin, could not function without prompt and massive government and central bank intervention. This will not disappear any time soon and it alters the environment that European banks operate in on a more permanent basis.

Since banks are now able to show reassuring fundamentals and improving profits, it is not entirely surprising that governments tried to co-opt them into supporting economies through windfall taxes – as is the case in Spain, Hungary and the Czech Republic – or through limits on increases in banking fees, like in France.

Such steps may be annoying from a pure shareholder value-creation angle, but they do add value from the broader perspective of the role banks play in supporting economies. Especially when many banks themselves needed public support a decade ago.

2 Regulators are the banks' strongest defender

The market often complains about excessive regulation holding the banks back from making profits. But without a credible regulatory framework in place, banks would simply not exist in their current form. Who would leave their life savings with highly leveraged and sub-optimally transparent entities with no control over how money is being utilised?

Neither depositors or borrowers nor debt or equity investors would be happy if their bank started to take unnecessary risks, arbitrage regulations or engage in or be sloppy on misconduct issues such as money laundering.

A bank which consistently avoids bad financial or conduct surprises reflects stable and dependable value, even if its ROE is average

3 The commoditised nature of financial products and services

All large European banks offer a relatively similar range of products to their retail and business customers, regardless of country. If one bank comes out with an innovative product that gets customer traction, competitors will replicate it in short order. No bank has a unique product factory. In the new era of technology, instant communications and open banking, the product uniqueness argument is fake (even though banks, like any other business, still use it in marketing).

So, in this context how can banks create value? First, through quality of service and relationship with customers. This includes safety, reliability, transparency, consistency, and ease of access. The more the bank identifies with its retail and business customers, the better.

Second, through the cost and speed at which products are offered to customers. It is here where fintechs (and some big techs) are either competing or joining forces with incumbent banks and where the banks are making efforts to fully digitalise their businesses. But investment decisions on banks are only marginally, if at all, based on the perceived or even measured quality of service to customers or on digitalisation gains. Metrics such as comparability indicators exist for banks and customers, but so far they fall beyond the "circle of trust" of most investors, analysts and rating agencies.

High customer satisfaction or advanced digitalisation are not winning arguments in an investment, credit or rating committee if the financials do not support them. Questions regarding these aspects are rarely asked on investor and analyst calls with banks.

4 ESG as a growing valuation factor

Regarding the value a bank adds to its stakeholders, including society at large, emerging ESG norms add a long overdue and welcome dimension to the market assessment process. But this is still very much work in progress and the focus is mostly on climate change-related disclosures. A large area of ESG concerns remains only thinly covered: namely the social aspects of banks' activities.

And, within social considerations, there are areas which are not really considered at all. For example, anchored in the current Ukraine war, should banks continue to carry out activities – even when profitable – in countries with hostile regimes like Russia, where bank loans, investments, and taxes can be used for war and propaganda efforts?

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