AMERICA'S MUTUAL BANKS
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British Building Societies Strive to Fashion a Marketable CET1 instrument

While mutual banks in the United States ponder the implications of the agencies' proposed Basel III regulations for the long term survival of mutuals, mutuals in Great Britain and the EU are working hard to develop a capital instrument suitable for a mutually owned bank. While the one size fits all approach of the Federal Reserve Board offers little hope that mutual banks in the U.S. will be able to raise capital to meet increasing requirements other than through the accumulation of earnings, the Fed's lack of creativity may become more apparent as exceptions and precedents are developed in other countries. This in turn may give the Fed more flexibility or political courage to qualify as CET1 certain instruments designed to be compatible with mutuality.

The European Commission's capital requirement directive IV published in July offers a degree of flexibility not yet demonstrated by U.S. bank regulators. This has encouraged central bankers and regulators in the EU to make an effort to accommodate mutual banks with capital requirements for mutuals that will meet Basel III, with efforts underway in Germany, France and Spain (whose cajas have been particularly hard hit by government mandated real estate lending) to structure compatible CET1 instruments.

Perhaps the most far along are the British Building Societies which have historically relied on an instrument termed "permanent interest bearing shares" or PIBS for tier 1 capital under Basel II. PIBS are a hybrid instrument not a bond and not capital stock. They are junior to all savings accounts as well as all debt, ranking on liquidation at the lowest level similar to common stock. As their name implies they are permanent with no maturity date although they carry a stated call date which is optional with the issuer. What the typical practice has been is the issuer would honor the call date funding the redemption of the PIBS with a subsequent issue. They also carry interest which can be reduced in the event the issuing bank becomes troubled.

Notwithstanding these features and the relative high risk of the PIBS, these securities were listed on the London exchange and traded regularly. This feature allowed the holders to have liquidity despite the lack of maturity of the instrument. Nationwide Building Society, Britain's largest, has outstanding 1.5 billion pounds sterling in PIBS with an interest rate of 6.97% which at current market price is discounted to yield 7.36%. The size of the trading spread fluctuates with the size of the amount of PIBS outstanding with smaller issues carrying wider spreads between bid and asked.

PIBS would of course be a very attractive means to raise capital for U.S. mutual banks but the feature of paying a fixed coupon will disqualify them as CET1 under Basel III. In the long run, this may cause a capital crunch for British Building Societies, which must seek ways to replace PIBS during the 10 year Basel III phase out of formerly qualified instruments in order to maintain their traditional high capital and preserve their mutuality.

The proposal which has emerged from the need to find an alternative to the PIBS is the for the issuance of "core capital deferred shares" or CCDS. As is often the case, Nationwide Building Society, has pioneered the way last May, obtaining the approval in principle by the Britain's Financial Services Authority of the CCDS as a CET 1 instrument.

The terms of the CCDS differ in a number of ways from the PIBS. With CCDS there are no fixed coupons but discretionary payments which are linked to earnings levels similar to the MIC. However, the bank could make payments similar to dividends at a rate commensurate with its earnings in good years offering investors an attractive expectation. Unlike the PIBS there is no stated call date. Presently Nationwide has said it will use the authority as a backup as it like mutuals in the U.S. it already enjoys a high capital ratio—12.5% in its case. The CCDS are not insured by the Financial Services Compensation Scheme (FSCS). Most importantly, what is different in Britain than in the U.S., is that investors and brokers have already accepted the high yields on PIBS as attractive investments. This has sustained their marketability even though a few troubled societies such as Bristol and West have reduced payment to 60% of face value. The precedent of an active market for PIBS has caused Nationwide (presumably with the advice of its investment bankers) to believe that there will be similar interest in the CCDS. Already, investment articles are appearing which have cautioned as to the risks but seem to suggest CCDS's issued by Britain's strongest Societies the are attractive. What is needed is greater interest by U.S. underwriters who specialize in bank securities. One would hope now that the conversion market has practically dried up compared to pre-crisis levels they will be searching for new fee opportunities