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INVESTMENT NOTE **26 FEBRUARY 2014**

Bail-in or bust: risks to watch amid new bank rescue laws according to Senior Credit Analyst Filippo Alloatti

Coming bail-in laws will impose losses on bondholders in future European banking crises. Which risks has the market priced in, and what has it missed?

Road to reform: In two years bail-ins will be the default way of strengthening troubled banks. In preparation for this, the region's central bank is investigating the balance sheets of large lenders. Stress tests by its banking authority will follow. Institutions that fail will be given six months to build a capital buffer equalling 5.5% of risk-weighted assets.

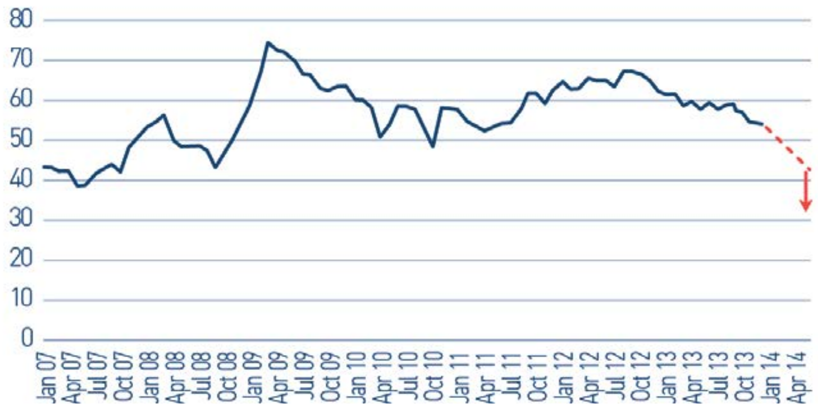
Probability of default: Market consensus is that an 8% stack of liabilities and equity will protect senior unsecured debt in a bail-in. We disagree: most banks, particularly medium-sized lenders, will struggle to afford issuing expensive subordinated debt to protect senior unsecured bondholders.

Loss severity: The sound performance of senior bonds in recent months may be misleading. Investors have focused on the declining probability of default, but the risk that deposits greater than €100,000 could be ranked above senior debt is more potent – and currently mispriced. If this happens, the severity of losses in a default would be amplified. By knowing the regulator's track record, senior bondholders should anticipate its preferences and consider how much they could lose if all deposits climbed the capital spectrum.

Expected Loss = Probability of Default x Loss Severity We believe that the expected loss is unchanged. Its balance, however, has: the probability of default has declined as loss severity has increased, reversing the trend of recent years.

Opportunities: In our view, senior spreads don't provide enough compensation for potentially lower recovery rates. Securities further down the capital structure have idiosyncratic risks that are more rewarding. Legacy KBC tier 1, and USD Lloyds and RBS SPV tier 1 bonds, offer funding characteristics that are similar to senior debt. They were issued at high costs, too, and are consequently uneconomical. At some point, we expect them to be redeemed at a premium for bondholders.

The relationship between so-called old style subordinated and senior debt has changed due to regulation and should lead to more spread compression (%)



Source: Bloomberg
The Hermes Global High Yield Bond Fund returned a net annualised 8.47% compared to its benchmark's 5.76% in the one-year period ending 31 January 2014, and 9.93% against 9.58% since its May 2010 inception. Returns are in euros.

Past performance is not a reliable guide to future performance. Performance is the Hermes Global High Yield Bond Fund F share class in euros net of all costs as at 31 January 2014

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Notes to Editors:

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- Our **Multi-Boutique Structure** gives institutional and pension fund clients globally the benefit of access to a broad range of specialist, high conviction investment teams operating within an established and robust operating platform.

- Our **Investment Office** is a crucial function, acting as a performance risk 'radar' for all boutiques' investment activity and is central to our mission to deliver Sustainable Risk-Adjusted Alpha to all our clients.

- Our commitment to behaving as a **Responsible Asset Manager**, not merely by being a 'Responsible Investor' in quoted companies but also by applying these principles across all asset classes and by behaving as a 'good fiduciary' on behalf of our clients.

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- **Equities**: Global, Emerging Markets, Small & Mid Cap, Europe, Japan

Hermes manages assets on behalf of more than 170 clients* across these investment areas with £26.3 billion* assets under management. Additionally, we support pension funds and other global institutional investors worldwide in meeting their ESG responsibilities through our market leading Hermes Equity Ownership Services, which takes on a stewardship role engaging globally on more than £98 billion* of assets.

*Please note the total AuM figure includes £3.4bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 December 2013.