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Market Update

For immediate release

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“US Senate approves rescue plan, as more doubts emerge about its efficacy.”

Summary of latest events:

- **US Senate** votes in favour of the revised **Troubled Asset Relief Program** but more doubts emerge about the efficiency of the plan.
- Debate around **accounting changes** heats up, as politicians search for miracle solutions to banks' balanced sheets.

Commentary:

The Troubled Asset Relief Program, or the Emergency Economic Stability Bill to give the proposed legislation its full legislative title, was put to vote for the second time this week, this time to the US Senate. The rescue plan was passed by 74 to 25 votes in favour yesterday. There were several additions to the initial legislation, including a rise in the government's guarantee on savings from \$100,000 to \$250,000, in a bid to ease the passage of the Bill through both Senate and Congress.

It had been widely expected that Senate would pass the Bill as the senators do not face the same pressure from the electorate as members of Congress who face the polls in November (only a third of the Senate is up for election). The House of Representatives will meet today and may vote on the Bill again either this evening or, more likely, on Friday. It remains a moot point whether the amendments made to the original Bill will be sufficient to ensure that it is passed given that some of the opposition to it is based on ideological principle rather than the details. We would caution against assuming that passage of the Bill is a 'done deal', even though it has now passed through Senate, as the strategy seems to have been to target incremental Republican votes through additions on some of the tax issues. Any offsetting impact on Democrat voting intentions is unclear. The process has been speedy and rushed, given the pressures, but there is still

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a clear risk that the Bill again stalls. This is not the consensus view and it would be an extremely negative market development but must nevertheless be considered.

Regardless of whether Congress backs the 'Tarp', there remain serious doubts over its ultimate efficacy. Markets seemed to have viewed the initial plans as something of a panacea but the longer that they have had to consider the broad detail of what is being proposed, the less impressed investors seem to be becoming in terms of whether this is really the solution that had been hoped for. There is little doubt that elements of the plan are to be welcomed and, in theory, the removal of toxic waste from banks' balance sheets should reduce counterparty risks, stimulate lending, and encourage recapitalisation. But there are huge operational complexities. The transfer process from bank to Treasury of bad assets is far from clear, nor is the mechanism for valuing these assets. Overpaying for the assets is unattractive politically but would enable capital injections from the state. Underpaying will force further writedowns and further undermine the financial system. The Plan continues to provide an inadequate solution, in terms of recapitalisation, for the banking sector. A more attractive option would be direct capital injections into the banking sector in return for ownership stakes, with warrants being frequently suggested as an attractive element within such a structure, such that taxpayers can share in any potential upside. Hard decisions would have to be made over which banks to save but the market has been doing a good job of weeding out the weak players rapidly. For the unlucky losers, the State should take failed companies' assets and ensure an orderly unwind, as the Resolution Trust Corporation did in the early 1990s. The need to be expedient in legislature means that a root and branch review of the Bill will not happen – unless it fails again. Longer term, this may be a lost opportunity as it is capital which the banks desperately need.

In addition to the Tarp, there is a growing groundswell of opinion that suspension of mark to market, in terms of valuing assets on bank balance sheets, will alleviate the current crisis. The view seems to be that current illiquid market conditions are forcing banks to recognise losses which are unwarranted and are not expected to materialise and that this practice is exacerbating the downturn. The rules are relevant for Bank's 'Level 3' assets which are 'hard to value'. The 'fair value' rules force firms to price assets at their worth on the open market. In recent days, the SEC and FASB are encouraging firms to use their own judgements to value assets, which are not trading, using metrics such as expected cash flows. Politicians such as UK Conservative Party leader David Cameron, France's President Sarkozy, as well as a number of those who voted on the Bill, have backed more flexibility in the rules.

Suspending mark to market accounting will mean a suspension of current market prices and current reality. Level 3 assets, which are 'hard to value', should be valued using 'fair value principles'. In an example of the world pre FASB 157, such as the Enron fraud, the auditor was crucified (Arthur Anderson) along with the corporate fraudsters. Prudence, in accounting terms will continue to drive a move to price hard-to-value credit assets at liquidation values and hence, even a change in the accounting guidelines may not prevent the auditors from playing it safe. If mark to market rules are suspended this may not lead to an improvement of valuations on balance sheets if auditors are unwilling to take the risk of signing off management assumptions and hence transparency may fall, rather than rise. This is clearly not a quick fix solution. In addition, are we really expected to believe that upward revised estimates to bank balance sheets, at this stage when trust has evaporated, really represent a 'true and fair view'? Such action comes too late and politicians looking for a miracle solution through accounting changes are misguided.

Paul Niven

Head of Asset Allocation

2 October 2008

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Notes to Editors

F&C Investments

- F&C Asset Management (F&C) is a London Stock Exchange listed asset management group which traces its origins back to 1868 with the launch of the Foreign & Colonial Investment Trust, the first ever publicly listed investment fund. Foreign & Colonial Investment Trust remains a client of F&C.
- F&C is an active fund manager with a multi-specialist investment model where individual teams have strong accountability for their products and processes. The group is also an active shareholder with a leading franchise in governance and sustainable investment.
- F&C now manages £96.5 billion (€121.9 billion) of assets* for a diverse range of institutional, insurance and retail clients across all major asset classes – equities, bonds, cash and property – as well as alternative and specialist product classes such as Socially Responsible Investment funds, hedge funds, funds of hedge funds, private equity funds, Global Tactical Asset Allocation products, enhanced alpha funds and Liability Driven Investments. F&C invests globally and has been a longstanding investor in emerging markets.
- F&C manages assets principally from three investment centres: London, Amsterdam and Edinburgh. The group has an office network spanning ten countries: China (Hong Kong), France (Paris), Germany (Frankfurt), Ireland (Dublin), The Netherlands (Amsterdam), Portugal (Lisbon), Sweden (Stockholm), Switzerland (Geneva), UK (London, Edinburgh, Dorking) and the United States (Boston).

* As at 30 June 2008.

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