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# Market Update

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## Market update post collapse of Lehman Brothers

### Summary of recent events:

- **Lehman Brothers**, one of the largest US investment banks, has filed for bankruptcy
- **Bank of America Corporation** has announced that it has agreed to acquire Merrill Lynch in a \$50 billion all stock transaction, valuing the company at a significant premium to its Friday closing price. The deal, which is subject to shareholder approval, will create the largest brokerage in the world
- **American Insurance Group** is seeking to raise equity from buy-out investors to shore up its balance sheet. AIG has also applied to be allowed to borrow from the Federal Reserve's discount window
- **Group of Banks back liquidity fund.** Bank of America, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan Chase, Merrill Lynch, Morgan Stanley and UBS have pledged \$70 billion to a liquidity fund and stated that they will assist an "orderly resolution" of Lehman's derivative exposure.
- **The Federal Reserve** has ease the terms under which it lends to primary dealers, allowing them to pledge a wide range of assets as collateral

The list of casualties of the credit crisis worsened over the weekend, as both Lehman Brothers and Merrill Lynch joined the growing number of financial institutions that have not been able to survive the deepening credit crunch. The sheer scale of these failures has sent shock waves throughout the financial markets, and the fact that the Federal Reserve and US government refrained from intervening to save Lehman Brothers has removed the perceived safety net that such major institutions are "too big to fail".

Lehman was forced into bankruptcy yesterday as Barclays and Bank of America abandoned takeover talks, leading to the collapse of the fourth largest US investment Bank. This represents the biggest bankruptcy filing in history, with Lehman Brothers listing more than \$613 billion of debt, dwarfing the collapse of WorldCom Inc. in 2002 and Drexel Burnham Lambert's failure in 1990. In addition to this, another one of

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America's oldest financial institutions succumbed to the pressures of the credit crunch, as Bank of America agreed to acquire Merrill Lynch.

In addition to these two seismic events, American Insurance Group (AIG) has been trying to gain access to the US Federal Reserve's discount window in what would be a move that is unprecedented for an insurer.

Following these events, the Fed has set up another set of emergency funding measures, notably allowing other assets (equities) as collateral for loans. In addition, ten of the largest global banks have pooled assets in a \$70bn liquidity fund to mitigate risks of the failure of Lehman Brothers.

Predictably, the news of further turmoil in the financial sector has caused extreme weakness to a number of financial markets, with equity markets (particularly financials), and credit markets weakening, whilst investors have flocked to the safety of lower risk assets such as sovereign bonds. European equity markets fell by 5% in morning trading, and credit default swaps widened across the board, with the itraxx Crossover index reaching new highs (over 600). Concern quickly grew over the outlook for the US economy as a whole, and consequently the market quickly discounted interest rate cuts in the US and elsewhere, causing a significant rally in government bond prices, and a fall in US 10 year treasury yields towards 3.5%. The short term concern is both the potential direct effect on Lehman Brothers counterparties, but also the effect that a forced sale of Lehman's assets could have on a number of asset classes, potentially triggering further write-downs across the sector.

Whilst we are in the immediate aftermath of this major event, speculation is quickly building towards which institutions are next to fail, and the potentially devastating effects that this could have on the economic outlook. The effects of the fall out from Lehman Brothers, and reliable estimates for the likelihood of another major bank collapse are largely unquantifiable. What is clear, however, is that markets are increasingly concerned about the stability of the financial system, and that the lack of a centralised bail out this time has had, and will have a material effect on confidence, and mean that volatility in risk assets is likely to remain high for the foreseeable future.

We have been mindful of the risks to the fundamental economic backdrop during the year, and how these are being exacerbated by the deepening credit crisis. Our quantitative models also signalled caution on the outlook for equities, and a more constructive view on bonds, and hence we reduced our equity positioning, and went underweight in June.

Going forward, however, the outlook remains extremely difficult to call. Over the next twenty four hours we may have further significant events from policy makers with aggressive US interest rate cuts now being priced in by markets, starting from tomorrow's FOMC meeting. The market has moved to a near certainty

that rates will be cut. If this is the case, it is likely that the Bank of England and the ECB will follow, in part to avoid currency overvaluation and even bigger internal economic problems.

Liquidity is being pumped into the financial system but, like similar previous occasions this and last year, it's not enough – risk and borrowing aversion remains at high levels, as evidenced by spreads between base and lending/borrowing rates. In the short term, it is likely that risk assets will continue to suffer while safe haven bonds will benefit.

From a fundamental perspective, the credit crunch has now moved into a phase where financial consolidation (and failure) has begun. This potentially has some way (and time) to run. Looking at history as a guide, we will likely eventually see state backed guarantees for depositors being extended and more government intervention, such as the establishment of entities to work out loans and support asset values.

In summary we believe that the short term will be tough for equities and credits and there is a good chance of further downside in prices in coming days. Lehman Brothers has proven that the bar for those 'too big to fail' has just been raised.

Paul Niven

Head of Asset Allocation

15 September 2008

## Lehman Brothers Rating Actions:

### **Moody's:**

Moody's downgraded the senior ratings of Lehman Brothers Holdings Inc. ("LBHI"), and those of certain guaranteed subsidiaries, to B3 from A2. The firm's subordinated debt was downgraded to Caa2 from A3, and its preferred stock to Ca from Baa1.

The senior long-term rating of Lehman Brothers Inc. was lowered to B1 from A1 and subordinated debt to B3 from A2. The short-term ratings for all rated Lehman entities were lowered to Not-Prime from Prime-1. All long-term ratings were placed on review for possible further downgrade.

*"Today's rating action follows the collapse in market confidence in the firm, and Lehman's announcement that it was filing for Chapter 11 bankruptcy protection after its failure to reach a merger agreement with a stronger strategic partner. According to Lehman, none of the firm's broker-dealer subsidiaries or other subsidiaries of LBHI will be included in the Chapter 11 filing".*

### **S&P:**

S&P lowered its long-term counterparty credit rating on Lehman Brothers Holdings Inc. to 'SD' (selective default, meaning payments may not be made on some financial obligations), from 'A'.

S&P also removed the rating from CreditWatch, where it had been placed with developing implications on Sept. 12, 2008.

*"The downgrade followed our lowering of Lehman's preferred stock issues to 'D' from 'BBB+'. At the same time, we lowered Lehman's senior unsecured debt issues to 'CCC-' from 'A', and its subordinated debt issues to 'C' from 'A-'.*

*The issue ratings remain on CreditWatch where they were placed on Sept. 12, 2008, but we have changed the implications to negative from developing. Meanwhile, we lowered the long-term counterparty credit and issue ratings on most of Lehman's other subsidiaries to 'BB-' (see list below). These ratings remain on CreditWatch with developing implications, which means that we could raise, affirm, or lower the ratings."*

### **Fitch:**

Fitch Ratings has downgraded the long- and short-term Issuer Default Ratings (IDRs) and outstanding debt ratings of Lehman Brothers Holdings Inc, (LBHI), parent of Lehman Brothers Inc and other subsidiaries as follows:

- Long-term IDR to 'D' from 'A+';
- Short-term IDR to 'D' from 'F1';
- Senior debt to 'CCC' from 'A+';
- Subordinated debt to 'C' from 'A';
- Preferred stock to 'C' from 'A'.

Fitch has also removed LBHI's long- and short-term ratings from Rating Watch Negative, where they were originally placed on Sept. 9. Today's rating action follows LBHI's declaration of bankruptcy. The ratings of the subsidiaries will remain on Rating Watch Negative and will likely be downgraded as additional information becomes available.

## Potential recovery value

At this very early juncture recovery values are unclear. For example, Creditsights has suggested 60-80% for senior unsecured bonds but notes that the bottom end of the range is more likely. Moody's stated that Lehman's rating implies a recovery of 90% plus, but the rating remains on review for downgrade so is subject to revision. Lehman bonds currently trade at 30-35 cents bid highlighting the uncertainty faced at the moment and the difficulty involved in trying to calculate a robust recovery value at the moment. We will be refining our analysis as more information becomes available.