

Ductilibility, LLC

Crisis Sentiment Index:

*An updated assessment of the
current financial crisis by
senior risk executives*

December 20, 2008

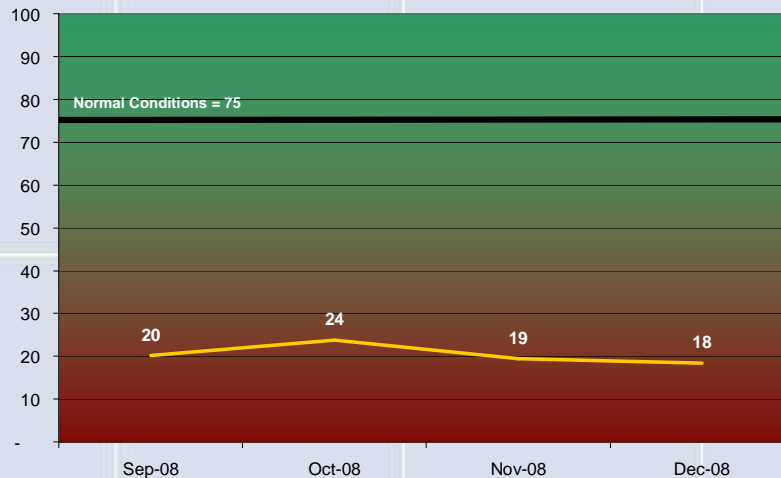
NOT FOR EXTERNAL DISTRIBUTION

Overview

This month we introduce the *Crisis Sentiment Index* as a way to more simply convey the results of our monthly senior-risk-executive-assessment of the status of the credit crisis. The *Crisis Sentiment Index (CSI)* is reported on a scale of 0 to 100, with a reading of approximately 75 indicating normal conditions and lower numbers indicating a more negative risk assessment of the crisis.

The *Crisis Sentiment Index (CSI)* for December 2008 has fallen to 18, reaching a new low for the four months over which we have been taking this pulse. This month's CSI reading is down from 19 in November and down from a reading of 24 two months ago.

Crisis Sentiment Index (CSI)



In this month's report we also introduce new CSI sub-indices focused on industries and specific elements contributing to the crisis. The CSI-Credit sub-index, which focuses on the availability of credit as perceived by lenders and borrowers, suggests that credit is not being held as tightly as before. The CSI-Credit sub-index reading of 25 this month, is up from 19 last month, and is the only sub-index to have increased in December. However, normal credit conditions would be indicated by a reading of approximately 75 on this sub-index, suggesting that credit availability is still very far from normal.

Sub-indices for fear, banking, insurance, hedge funds and money market funds are also reported this month. All indices have been scaled such that a reading of approximately 75 would indicate normal sentiment from senior risk executives towards those specific sectors or factors.

Our survey participants typically hold the titles of Chief Risk Officer / Heads of Risk Management, Board Director or other C-Level title. Approximately 70 firms are represented in this month's sample set and are typically representing the largest 25% of firms in their industries. The sample set is primarily financial service firms, but also includes a number of non-financial companies. Respondents come from a wide geographic range.

The survey was conducted between Thursday December 18th and Saturday December 20th, 2008.

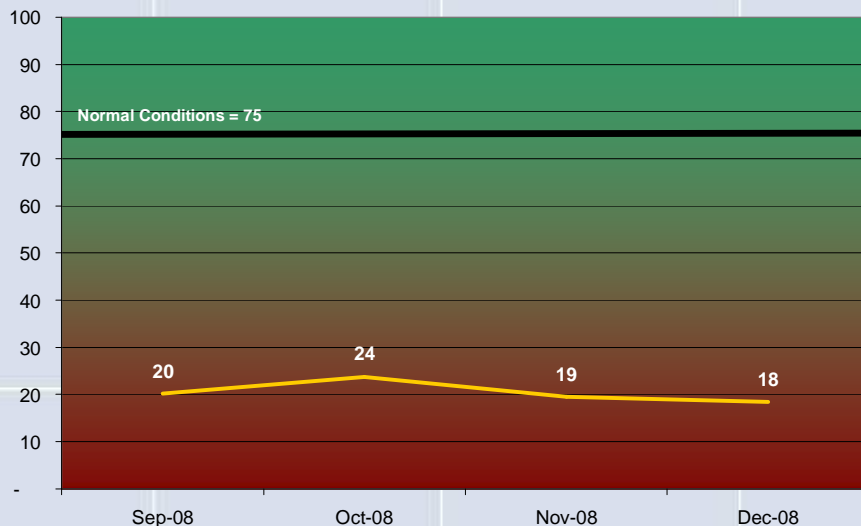
Details of the survey responses follow. Should you have any questions, please don't hesitate to contact me.

David R. Koenig
December 20, 2008

Credit Crisis Status

The Crisis Sentiment Index (CSI) is a weighted average of the results from standard questions being asked each month. The core assessment is of which choice is made between the four answers given to the following question: “As you prepare for your work, which one statement below best characterizes your approach regarding the current credit crisis?”

Crisis Sentiment Index (CSI)



Only one respondent this month chose the most positive assessment “*The actions of the various central banks, governments and regulators are sufficient. I believe the crisis is nearly over*” which is the lowest percentage of respondents to have chosen this option since we began our survey. Nearly 2/3 of respondents chose the two most negative assessments indicating they are planning for a continuation of the crisis for the foreseeable future. This includes 4% who expect quite a bit more downside to the crisis, the most negative assessment option available.

Selected comments:

“*[I expect] a deep recession for all the year 2009 in the US and UK*” - Chief Risk Officer, Europe

“*..[government] actions...have held off Armageddon. However, the fundamental damage to the economy is severe as personal wealth and balance sheets are highly impaired.*” – Chief Risk Officer, North America

“*The aid provided...has done little to alleviate the pressures on the smaller players. Hence, further consolidations seem likely.*” – Head of Operational Risk, Europe

“*The central banks, etc clearly could have done a lot worse. However, they have made some key mistakes.*” - Chief Risk Officer, North America

“*This crisis was triggered by a credit crisis, evolved into a very deep financial crisis and the effects of the crisis are now fed back into the economy. Because of the late reaction of central banks, governments and regulators, the recession will be far deeper than would have been necessary. This in turn will lead to a serious deterioration of other (so far performing) assets on the books of banks. Therefore, a second wave of the financial system shock should be expected within the next three to six months.*” – Chief Executive Officer, North America

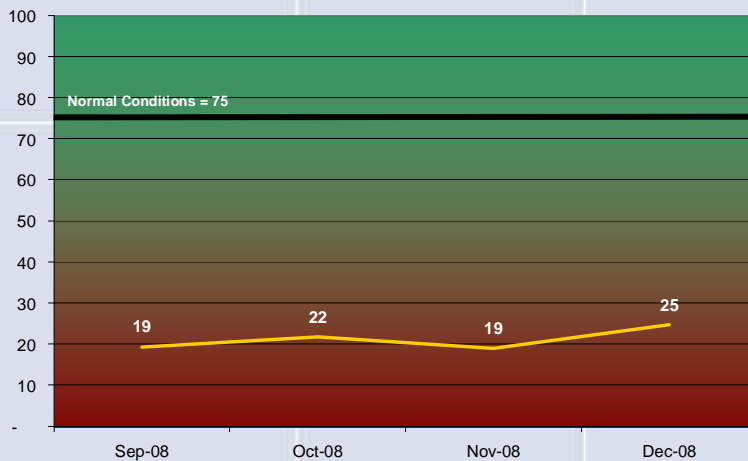
“...only when ‘confidence’ returns back to the market will the crisis start to improve – I certainly cannot see this over the short/medium term.” – Head of Portfolio Risk, Europe

“Despite what is heard in the media, lending activities are ongoing...not to the type of lending at the consumer or commercial level as before...but rather prudent lending as it should be...if it appears that there is no lending activity, that is only on the surface...because it is driven by higher quality activity. – Chief Risk Officer, North America

Availability of Credit

As one commentator above indicated, this crisis began as a credit crisis. Our survey asks both credit providers and demanders of credit to tell us the extent to which they agree that credit has been made more available in the most recent weeks leading up to our survey. There is an improvement in the availability of credit, although the CSI-Credit sub-index reading is still very low.

CSI-Credit



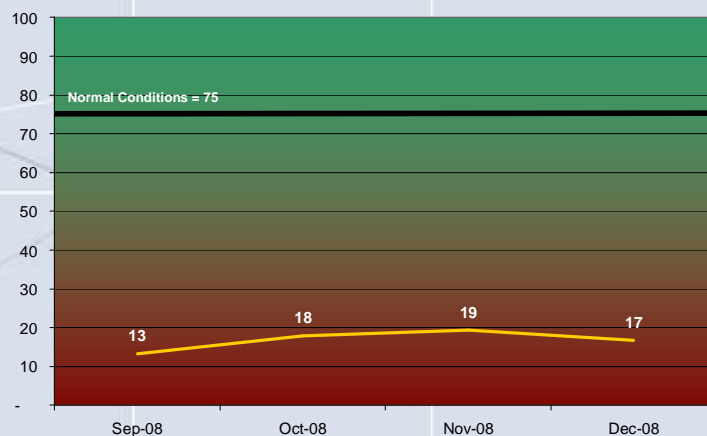
Said one North American Chief Risk Officer, “We are both a credit provider and credit user. We would expand our offerings, but are having a hard time raising capital to do so.” A European Head of Operational Risk said “LIBOR rates have fallen, but the availability of wholesale funding remains a problem.” Both quotes seem to suggest that core funding remains scarce.

Industry-Specific Assessments

The CSI-Banking sub-index is a weighted index of sentiment as expressed via a specific question about the likelihood that at least one major bank will fail or be taken over as a result of the crisis and the primary question of the survey. At 17, this index is higher than the most pessimistic assessment given in September, but remains quite negative.

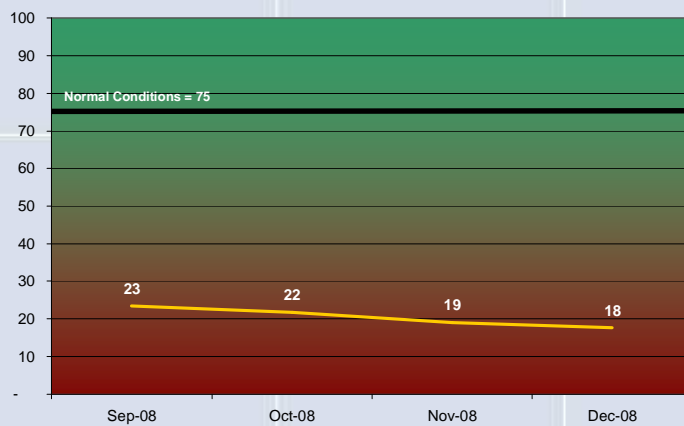
Nearly ¾ of respondents agreed, or strongly agreed with the statement that “at least one more major bank will fail or be taken over as a result of the crisis”. The level to which respondents agree or disagree with this statement accounts for 70% of the CSI-Banking sub-index value.

CSI-Banks



Similarly, the CSI-Insurance sub-index is a weighted index of sentiment as expressed via a specific question about the likelihood that at least one major insurance company will fail or be taken over as

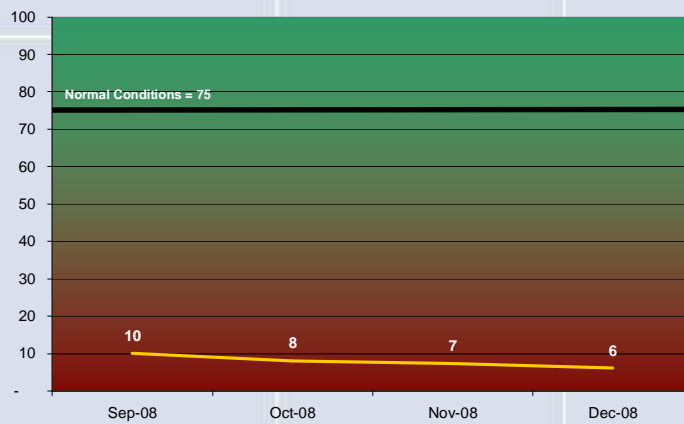
CSI-Insurance



a result of the crisis and the study's primary question. At 18, this index is at its lowest level of the four months in which our survey has been taken.

Sixty-eight percent of respondents now agree or strongly agree with the statement that "at least one major insurance company will fail or be taken over as a result of the crisis." In last month's study, one commentator noted growing fear over insurance products with embedded rate floors and their possible impact.

CSI-Hedge Funds



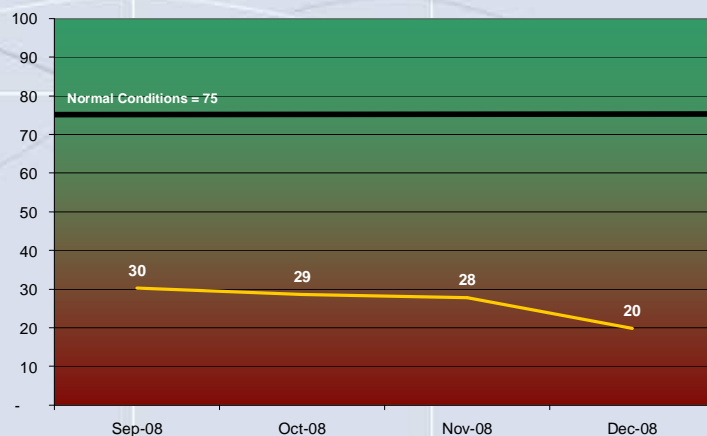
Headlines have not been kind to hedge funds, especially in light of the emerging Madoff story. Sentiment towards hedge funds has been strongly negative during each of our monthly studies, but this month's CSI-Hedge Funds reading is nearly as low as is possible at just 6. Ninety-six percent of respondents expect a major hedge fund to fail as a result of the crisis (69% strongly agreed with this expectation).

A December 18, 2008 story on CNN Money looks at the body count in the "[Hedge Fund Graveyard](#)" and reflects/informs this sentiment reading.

Perhaps the most dramatic deterioration in sentiment during the month was regarding the likelihood that at least one major money market fund would "break the buck". Fifty-nine percent of respondents indicated that they agreed or strongly agreed with the statement that one would. Only 1 in 5 respondents disagreed.

CSI-Money Market Funds

The dramatic lowering of central bank target rates, particularly in the US has created some growing concerns. In this study, we specifically asked for respondent comments on issues that might arise from this development, which are not widely being discussed. We received numerous comments, indicating that this is an area of concern. These



comments are highlighted in a special section below.

Regarding the general likelihood of failures at financial institutions and funds, or forced-acquisitions, comments indicate that there may be some de-sensitization to these events among professionals in the marketplace. One respondent, a Head of Portfolio Risk in Europe, indicated, though, that they felt the public was only “*now starting to understand what the impact of the Bank crisis means to them*”. A further warning was received from a European Chief Risk Officer, “*The new risk is corporate loan defaults. Current provisions in this area will not be sufficient. So, significant new provisions will be required.*” One supposes this will stimulate some further consolidation.

Fear

We again asked whether fear and panic were growing problems. In [other writings](#), the importance of psychology and risk has been highlighted, particularly the under-appreciated amplification of risk events that comes through social channels.

Eighty-three percent of respondents feel that fear is growing among the public and more than 60% gave the same assessment to the level of fear among market professionals. The result is that the CSI-Fear sub-index fell to a level of 18, indicating that fear is still spreading at a high rate.

Only 1 in 4 disagree that fear is growing among market professionals and just 1 in 8 disagree that it is growing among the public. One might expect this sub-index to be one of the earliest indicators of changing sentiment as removal or reduction in fear will be required to stimulate risk-taking among core private-sector liquidity providers.

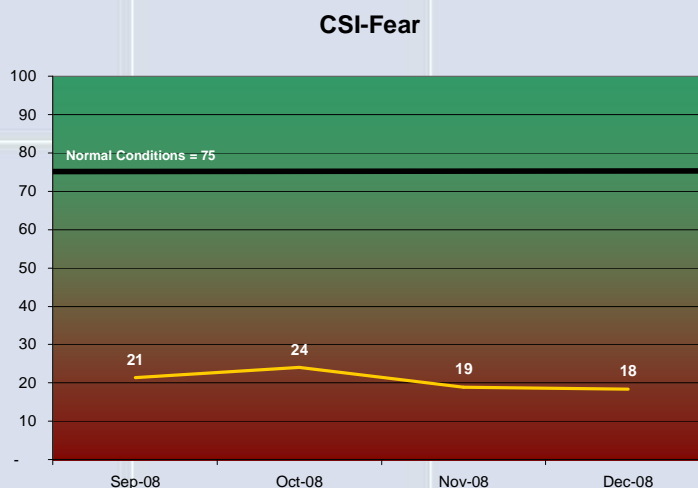
As with the industry-specific sub-indices, a reading of approximately 75 on the CSI-Fear sub-index would indicate normal conditions in the market.

Unanticipated Consequences from Low Interest Rates

Risk managers are generally thoughtful about emerging risk issues and the participants in this survey are exposed to a breadth and depth of information from their work roles. We hoped that some thought had been put into the unanticipated consequences from near-zero funds rates now being pursued in the US and in other countries and asked our audience for their concerns. Nearly half of respondents left comments, indicating that this is indeed an issue receiving their attention.

One European Chief Risk Officer is worried about potential redemptions and the long-term viability of what he described as “*this grey banking segment*”.

Several indicated potential consequences in foreign exchange markets, especially those who have currencies pegged to the dollar. Said one North American Board Member, “*there is concern that*



this action will force sovereigns with linked currencies to take similar actions or risk trade imbalances.” A European Head of Investment Risk said that “currency crises are likely in 2009”.

Members of the LinkedIn Directors and Chief Risk Officers Group may recall an article highlighted to them back in mid-November called “[The Doomed Dollar](#)” in which the author cited reasons why the dollar could collapse from its level at that time. Since this prescient article, published on the day of the most recent high in the dollar index, the dollar has fallen by more than 10% and concerns among survey respondents indicate further downside risk. One respondent worries about the impact this will have on foreign capital investments in the US.

Some of the other comments left include concerns about whether the US Fed will have any tools remaining to assist in battling the crisis. One European Chief Risk Officer suggested that the correlation between the fed funds rate and interbank lending rates was not so evident just now. A North American Chief Risk Officer expressed unease saying “*I’m a little concerned that it gives us no where else to go if the crisis worsens.*” Another North American Chief Risk Officer suggested that the decline in rates was mainly symbolic and that other non-conventional measures are needed in a liquidity crisis. This seems to follow the thinking of Fed Chairman Bernanke when he speaks of his planned approach. This Chief Risk Officer further stated, though, “*There exists a large degree of uncertainty about the effects of ‘non-conventional’ measures*”, potentially undermining short-term effects of such Federal Reserve actions.

One potential benefit of near-zero rates is that they may stimulate risk taking in pursuit of non-zero returns, or perhaps better stated as above zero returns. One North American Chief Actuary wonders how long this will take to happen. A Latin American Chief Risk Officer noted that individuals are losing the incentive to save money and that there is still no consumer credit.

Worries about the implications for money market funds, as noted above, contributed to some of the deterioration in the CSI-Money Markets sub-index. A Board Member in Asia says “*[near zero rates are] bad news for money market funds and also any investment vehicle where capital protection is implied or expected.*” The Chief Risk Officer at a European firm expects to “*see a consolidation in money market funds.*” He continued, “*Some firms will actively consider closing funds, others may waive fees and want to outlive the crisis.*” One North American Chief Risk Officer notes a structural issue, “*it’s hard to offer a negative yield on a Treasury money market fund. The machinery does not exist.*”

Another North American Chief Risk Officer notes that banks will be forced to find more non-interest fee income. A couple of respondents noted similar concerns for insurance companies.

Finally, some more general thoughts about expectations from these rate changes were left by our respondents. Said one North American Head of Enterprise Risk Management, “*I think policy makers are doing most anything to get the economy back on the SAME track again... we need to accept that we need to be on a different track in order to truly restore a great economy.*” Continuing, this risk officer said “*...we should view this as a period of permanent adjustment and not a period where policy tweaks can put things back the way they were.*”

The comment above seems to suggest that one of the risks is that we simply continue to defer the problems until they get bigger. One North American Chief Executive Officer believes “*the crisis is structural, not cyclical. Interest rates will only gain traction in a cyclical downturn.*” He continues by expressing concerns that “*this low interest rate environment does not reflect the risk/reward relationship of holding U.S. Treasuries. Every day the risk of a U.S. default grows and every day the return on U.S. Treasuries drops.*”

Conclusion

Risk executives who participated in this survey continue to express highly negative sentiment about the status of the credit crisis. Deterioration in sentiment was nearly across-the-board, pushing our measure of senior risk executive sentiment, the Crisis Sentiment Index (CSI) to a new low.

One wonders what tools are left among governments and central banks to change attitudes. Perhaps it is only a matter of seeing time pass without the fulfillment of expectations or fears. We hope that such an emergence, if it is to be, will be revealed early through our sampling.

We will update our assessment again in one month's time. In the meantime, you can discuss this report online in the [LinkedIn Directors and Chief Risk Officers Group](#).

Notes

Questions in the Survey include the following:

1. As you prepare for your work, which one statement below best characterizes your approach regarding the current credit crisis:

- The actions of the various central banks, governments and regulators are sufficient. I believe the crisis is nearly over
- The actions of the various central banks, governments and regulators have helped. But, I believe that there is a great risk that this is just a pause in the crisis.
- I am planning our risk management activities for a continuation of the credit crisis for the foreseeable future.
- The actions of the various central banks, governments and regulators will wind up making this crisis worse. We are expecting quite a bit more downside to the crisis.

2. Please tell us your agreement or disagreement with the following statements about the next stages of the current credit crisis (Strongly Agree, Agree, No Opinion, Disagree, Strongly Disagree):

- At least one more major bank will fail or be taken over
- At least one more major investment bank or broker/dealer will fail or be taken over
- At least one more major insurance company will fail or be taken over
- A major hedge fund will close
- Another major money market fund will "break the buck"
- Fear among market professionals is growing
- Fear among the public is growing

3. My company is a credit provider and we have been expanding our offering of credit to customers over the last few weeks (Strongly Agree, Agree, Neutral, Disagree, Strongly Disagree)

4. My company is a user of credit and we have experienced an improvement in the availability of credit to us over the last few weeks (Strongly Agree, Agree, Neutral, Disagree, Strongly Disagree)

Ductibility, LLC

A private research and advisory network serving the governance needs of Boards of Directors and senior executives.

Contact:

David R. Koenig
Principal

email) david.koenig@ductibility.com

telephone) +1-507-301-3149

fax) +1-480-247-4773

videoconference) <http://199.199.129.246>

web) <http://www.ductibility.com>

NOT FOR EXTERNAL DISTRIBUTION