

Ductilibility, LLC

Crisis Sentiment Index:

*An updated assessment of the
financial/economic crisis by
senior risk executives and
board members*

December 22, 2010

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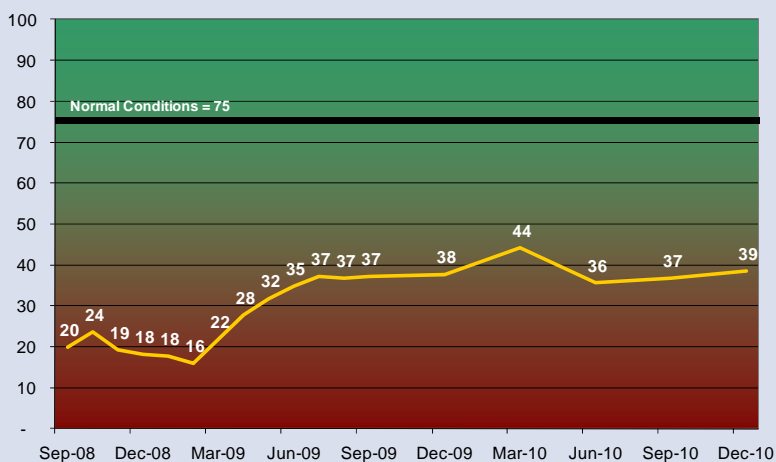
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Executive Summary

The *Crisis Sentiment Index (CSI)* is a regular assessment of the status of the financial/economic crisis around the world by senior executives and board members who are involved in risk management. Reported on a scale of 0 to 100, a reading of 75 indicates “normal conditions”.

During the past quarter, negative sentiment from emerging and accelerating European sovereign risks was offset by modest improvements in credit availability and a reduction in fear, according to our survey respondents. As a result the Crisis Sentiment Index (CSI) for December 2010 rose two points to a reading of 39. At this level, roughly half of the decline in the CSI that followed the start of the Greece sovereign crisis has been recovered. Still, the index remains more than 35 points away from “normal conditions”. Two percent of respondents feel that the crisis has ended, while double that amount chose our most pessimistic survey response. The latter is half the amount who said the same thing last quarter, a time when no respondents indicated a belief that the crisis was over.

Crisis Sentiment Index (CSI)



Industry specific assessments were generally flat, but there was a marked deterioration in the attitudes towards banks with CSI-Banks falling to 36 from a reading of 42 in the previous quarter. The level of fear among the public and professionals improved substantially. Still, only half of the worsening seen following the sovereign issues in Greece last May has been recovered.

In our special question this quarter, we ask whether rising equity prices are telling a predictive story of improvement or if other factors are being reflected by the steady rally. Details on this, each sub-index and specific insights from respondents are contained in the full report. Should you have any questions, please don't hesitate to contact me.

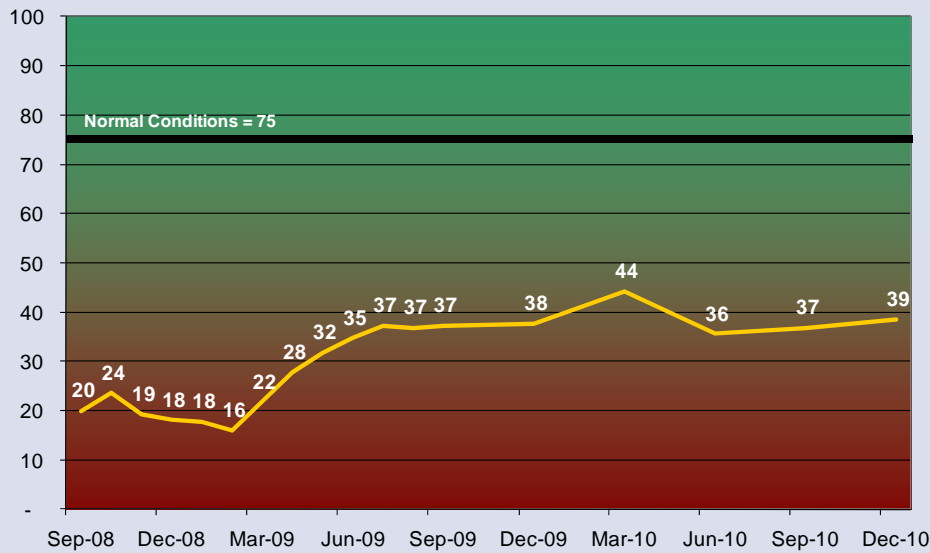

David R. Koenig

The survey was conducted between Monday, December 13, 2010 and Sunday, December 19, 2010. Survey participants typically hold the titles of Chief Risk Officer / Heads of Risk Management, Board Director or other C-Level title. Ninety-three firms are represented in this survey's respondent set and are typically among the largest 25% of firms in their industries. The sample set is primarily financial service firms, but also includes a significant number of non-financial companies. Respondents come from 25 countries, 49% from the Americas, 39% from EMEA and 12% from the Asia-Pacific region.

Crisis Status

The Crisis Sentiment Index (CSI) is a weighted average of the results from standard questions being asked each time the survey is conducted. The core assessment asks respondents to choose whether they feel the crisis has ended, is nearly over, that there are signs of improvement, that they are planning for a continuation of the crisis for the foreseeable future or that they expect the crisis to worsen.

Crisis Sentiment Index (CSI)



The Crisis Sentiment Index in December 2010 came in at a reading of 39, which is a two point increase from September of this year and is the second highest reading since the survey began in September of 2008. While any gain is encouraging, the index has only recovered half of the decline seen between March and June of this year and it remains more than 35 points away from “normal conditions”. The depressed level of the index is reflective of the generally cautious views shared by respondents in their comments during the survey.

A focus on emerging risks and the follow-on effects in the next year or two of already realized risks was common. Said one senior credit risk executive in the EMEA region, “Though we see some sort of stabilization and consolidation, we feel that crisis is still far from over.” He continued, “2011 will be testing period. [At] financial institutions who have taken large provisions, business units would be under pressure to perform to book profits.”

An EMEA Chief Risk Officer expects an early 2011 Euro-zone shock saying “Spanish debt will be tested by the markets as the European politicians have not created a credible solution for Euro-zone sovereign debt”. Further, he notes “Greece and Ireland CDS spreads still indicate that a restructure is necessary.” Another Chief Risk Officer in the EMEA region feels that while the original crisis may be over, the sovereign phase is only just beginning with “some sovereigns perceived as more risky than some financial institutions.”

A Corporate Secretary in the Americas believes that we are seeing the “third wave” effect of the crisis with “the impact [progressing] down the supply chain to the economic segment that was providing the supplies and services to those companies that have collapsed or have had to

‘restructure’ to recover.” The impact of this is expected to be continued layoffs and reduced incomes at the individual and corporate levels, making any belief that the crisis is over, premature.

Regional differences in economic conditions were highlighted by several respondents, with the obvious negative lead being given to Europe, while positive indications came from respondents in Australia, and other countries linked to China and India’s growth. Said one Asia/Pacific based Board member, “Coming from Australia, there is generally optimism around our markets.” Similarly, a Chief Risk Officer in the Asia/Pacific region noted “Australia had minimal impact from the global financial crisis, except in some areas of property development and merchant banking.” Noting further, “the continued demand for our natural resources from China and India lessened the impacts.” Indicating risk to this optimistic tone, a Chief Risk Officer in the Americas said “I’m most concerned about a lack of clear financial thinking when it comes to China. It’s a train-wreck waiting to happen, not an El Dorado.”

Last quarter, respondents indicated they would need an average of slightly more than one year to pass without incident before they felt the crisis had ended. With the realization of the Irish sovereign crisis, the clock has likely been reset. An EMEA Head of Internal Audit noted “...loans provided to companies in the real estate sector reportedly will fall due in 2011 and 2012. The ability of the borrowers to service their commitments will have a huge impact on the bottom line of commercial banks...” A Chief Risk Officer in the EMEA region suggested “We have potentially another three years through the crisis and there will be continued volatility.”

That same Chief Risk Officer noted, though, that there will be opportunities in the near future and suggested “M&A activity may become a leading indicator.” In fact, more than 70% of respondents see some signs of improvement in the crisis and 15% of respondents believe the crisis is over or nearly over. A senior risk executive in the Americas believes “There are a number of indicators that are moving to positive territory. The contagion from other European impacts is likely to be minor for the US.” He continued, “The fact that credit is opening up and that consumer sentiment is improving probably indicates that it is a matter of time before consumer spending prompts companies to use some of their cash reserves for ramping up inventory.”

For most, it seems, an event-free period would be a gift in the new year.

Additional comments:

“A lot of the credit issues have not been resolved and will reveal themselves in the near future (1-2 years) as it becomes obvious that QE efforts are misplaced and stoking inflation.” – EMEA Chief Risk Officer

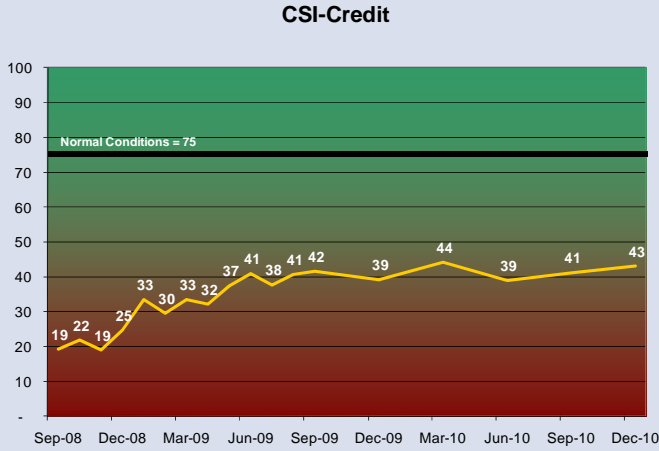
“Due the strength of Asia and our mining industry this is providing stability in our markets. In some respect there is a 2 speed economy is progress resources and non-resources.” – Asia/Pacific Board Member

“The ultra-low interest rate risk environment is likely to persist and turn out to be a source of problems over time rather than a cure. Interest rates should rise markedly in emerging economies and probably will not rise enough - or will come with capital controls.” – Asia/Pacific Board Member

“Our government, economic and financial experts have no short term solutions because the tricks we have used in the past to break the cycle are ineffective. We need more substantial overhauls of our system.” – Americas Chief Risk Officer

Availability of Credit

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 period between the last and the current assessment.



Credit availability seems to continue to improve. For December, CSI-Credit moved up to a reading of 43, just one point below the high of 44 seen in March of this year.

There was a more balanced report of those indicating credit was more available than less available compared to last quarter, but the net impact was still positive on the sub-index.

An Americas-based Board member at a non-financial company said “Credit has eased. Though we tend to see a drop in revenue during the winter [Northern Hemisphere] it is appearing to be less than projected.” An EMEA Head of Audit said “some of our project companies have had difficulty in raising funds for their projects, but only those in the real estate sector.”

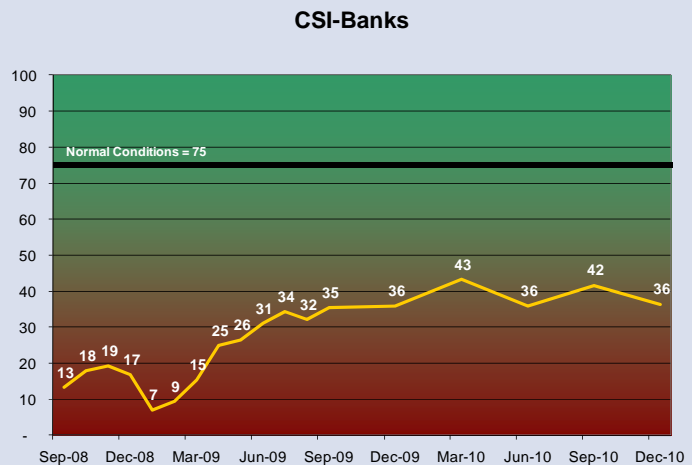
Reflecting the sense that good quality customers are still hard to find for lenders, one Board member from the Americas said “The lack of credit demand for the traditionally good borrowers continues in SMEs in the Northeastern US. Now, this trend has continued for at least six months and banks may potentially have to reduce credit underwriting standards.”

An Asia/Pacific-based Board member at a fund management firm noted “We have had strong inflows in fixed income portfolios over the last two years,” which could be a source of easier credit going forward.

Industry-Specific Assessments

The CSI-Banks sub-index is a weighted index of sentiment as expressed via the primary question of the survey and a specific question about the likelihood that at least one major bank will fail or be taken over as a result of the crisis.

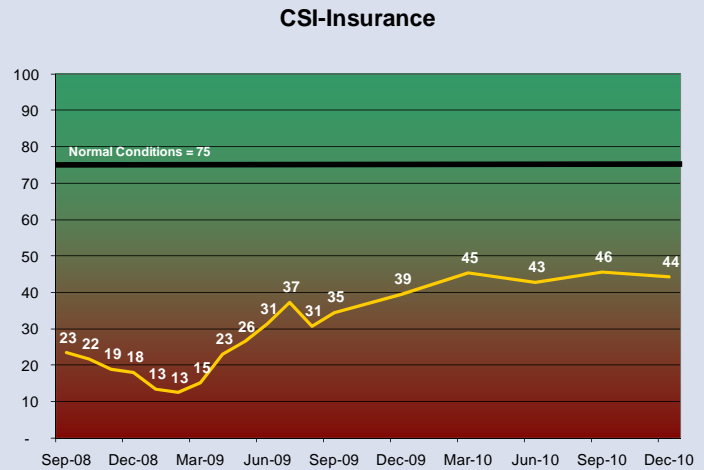
Reflecting a renewed concern over asset quality and follow-on effects of risks that have already been realized, the CSI-Banks sub-index fell sharply to a reading of 36 in December, making it the second worst of the sub-indices, slightly above the sentiment expressed towards Hedge Funds.



A Board Member in the Americas stated “It is a growing concern how potentially higher rates will impact our lending base and our core profit generation. Exiting from the crisis will be challenging.”

The CSI-Insurance sub-index is a weighted index of the study's primary question and sentiment as expressed via a specific question about the likelihood that at least one major insurance company will fail or be taken over as a result of the crisis.

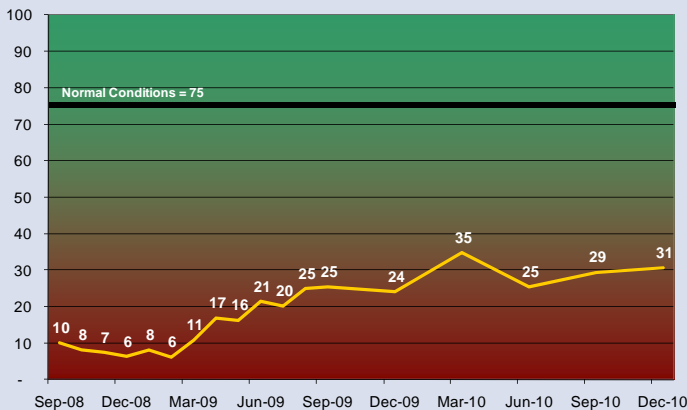
CSI-Insurance had been the leader in terms of industry assessments, but dropped back from its high last quarter to a reading of 44 in this quarter's assessment.



Again, noting regional differences in sentiment, a Chief Risk Officer in the Asia/Pacific region said

“it is unlikely that an Australian bank or insurance company will fail, but likely that this will occur in either the US or Europe.”

CSI-Hedge Funds

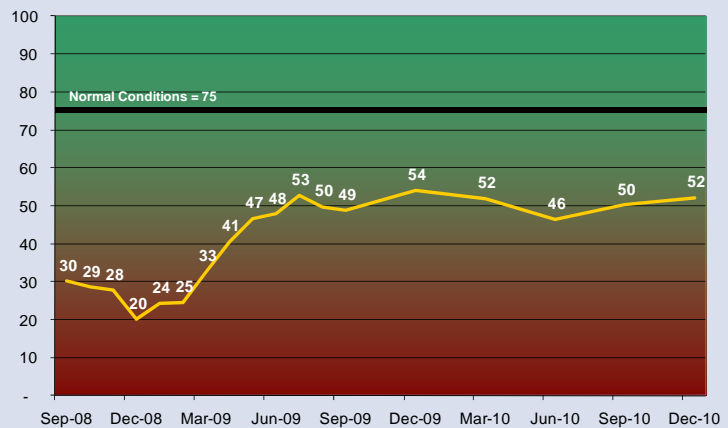


CSI-Hedge Funds remains the laggard among sub-indices, but has improved for the second month in a row, coming in at a reading of 31 in December, nearly forty-five points from “normal”. The industry has experienced growing positive inflows of investment capital, but, returns have not reached pre-crisis levels, generally, and positive sentiment towards the industry may only follow returns that improve

Sentiment regarding the likelihood that another money market fund will “break the buck” improved again in December with that sub-index moving to 52, up two points from the reading in September, and just two points below the high seen one year ago.

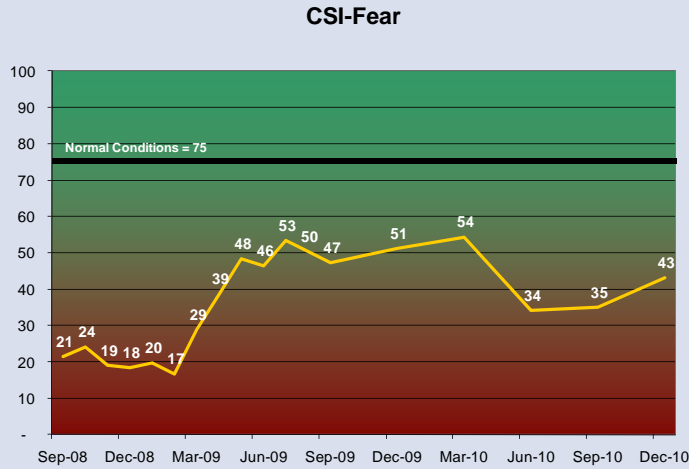
Only one percent of respondents felt it was very likely that another money market fund would suffer problems requiring a capital infusion, while more than half of respondents disagreed that there would be another problem caused by the crisis.

CSI-Money Market Funds



Fear

Each survey period we ask whether fear is growing among market professionals and the public. We believe this to be one of the key leading indicators of the direction the crisis will take, especially as it relates to credit availability.



Fear remains a problem, but nearly half of the increase in fear seen as a result of the Greece crisis in May has been recovered with CSI-Fear moving to a reading of 43 in December.

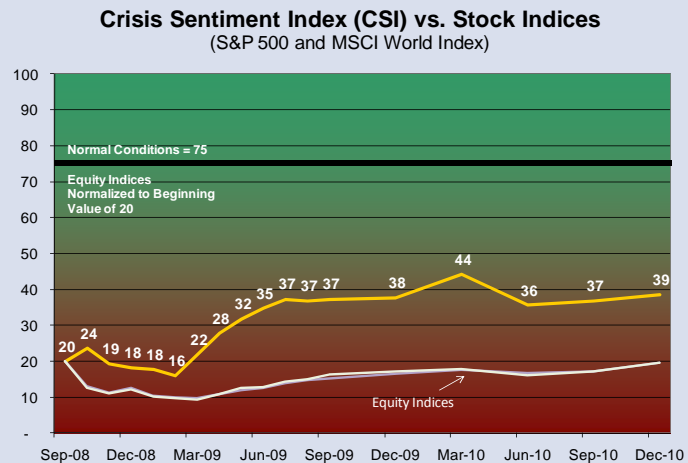
Less than one-quarter of respondents believe that fear is growing among market professionals and slightly more than one in three believe it is worsening among the public.

Said one Board member in the Americas, “I think frustration is a better word than fear. The length of the down cycle is depressing and depresses economic activity.” An EMEA Board member suggested “The longer the economic slowdown, the more fear that there will be from all sectors as to when the crisis will end. Most consumers and businesses have never experienced anything like this before.”

An Asia/Pacific-based Board member said, “The public here are not as concerned, but would be if there is a down turn in China and/or India.”

The CSI and Equity Prices

Despite the continued gloom, equity prices globally have moved higher during the past quarter, with gains in the US in excess of ten percent and many other regions similarly showing growth. Equity prices have often been thought of as leading indicators of economic conditions. So, one should ask if the increase in equity prices is predictive of better times ahead. Or, as we all know, asset values are also impacted by assessments of future risks. We should, therefore, ask whether the increase in equity prices is merely a reflection of risks that had already been discounted, but, were never realized.



According to survey respondents, more than seventy percent believe the case to be the latter and that increased equity prices are not predictive, this time, of improving economic conditions.

The chart above shows both US and Global equity indices normalized using the same scale that is used to calculate the CSI. From this chart, it would seem that equity prices have lagged the

improvement in sentiment amongs our respondents. Perhaps the equity markets are even more cautious than those of us who focus on risk in our careers.

Note that the calculation of the CSI is not linear and this chart does not imply that equity prices would be more than three and one-half times higher than their September 2008 levels should the CSI return to “normal conditions”.

Conclusion

While a large majority of respondents see signs of improvement, the general sentiment reflects the fact that there are many issues that must be worked out in the coming years. Regional differences in risk and expectations are clear, with the most negative sentiment shared about Europe and the most positive sentiment shared about countries that are benefitting from the growth in India and China.

The strength of the banking sectors seems to have been called into question again in this quarter’s survey, but the reduction in fear, absent any more major risk events, should continue. That latter element is a leading indicator of future sentiment. So, we will pay close attention to risk-taking sentiments as we move forward.

Our next assessment will take place in March 2011. In the event of a major disruption in the markets before then, we will conduct an interim assessment. In the meantime, we encourage you to discuss this report and your localized experiences online in the [LinkedIn Directors and Chief Risk Officers Group](#).

We wish you a very happy and prosperous new year!

Appendix

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 crisis is over.
- I believe the crisis is nearly over
- Conditions are improving, but, there is a chance that the crisis will worsen again.
- I am planning our risk management activities for a continuation of the credit crisis for the foreseeable future.
- I am expecting a worsening of 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 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 quarter (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)

6. In the three months since our last survey, US stock prices have risen by more than 10% and stocks worldwide have generally advanced. Are these stock price movements leading indicators of positive change in the global economic environment or just a reflection of discounted/anticipated risks that did not materialize? (More likely to be leading indicators, More likely reflecting risks that did not materialize)

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A private initiative to advance the practices of corporate governance and risk management at complex organizations.

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