

Ductilibility, LLC

Crisis Sentiment Index:

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

March 18, 2010

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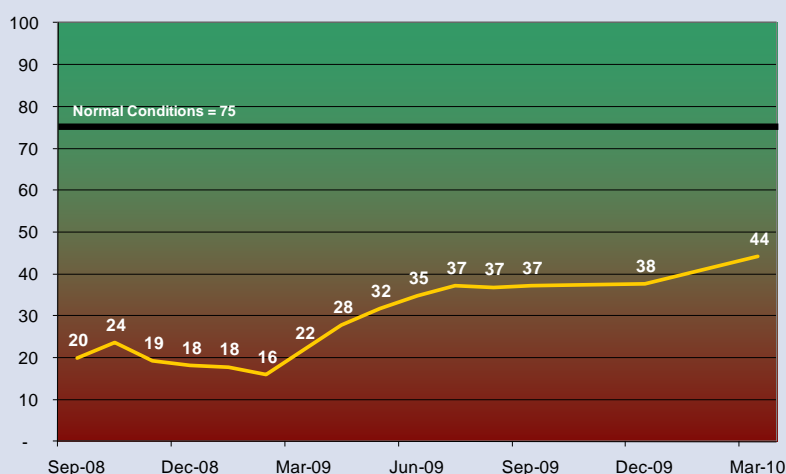
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Executive Summary

The *Crisis Sentiment Index (CSI)* is a regular assessment of the status of the current financial 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.

The Crisis Sentiment Index (CSI) for March 2010 was 44, the highest reading since we began taking the survey and the first improvement in the index in nearly eight months. Still more than 30 points away from 'normal' conditions, the improvement reflects a change in sentiment as twice as many respondents believe that crisis is over or nearly over as those who chose the two most pessimistic options in our core assessment question. Caution still abounds, though, with 62% of respondents saying that while conditions are improving, things could still get worse.

Crisis Sentiment Index (CSI)



Nearly all of the CSI sub-indices registered new highs this quarter. The only one that did not was CSI-Money Markets, which fell back two points to 52 from the December reading of 54, the highest level of the sub-index to that time. While at new highs, all sub-indices are well below 'normal' conditions, but a gradual trend of improvement continues across the board.

In this survey we asked our respondents for their opinion regarding the existence of a Chinese asset bubble. If one exists, we asked their opinion regarding its likelihood of bursting in the coming months and the various regional economic impacts, were such to occur. Full details of respondents' opinions are included in the main body of the report.

Should you have any questions, please don't hesitate to contact me.



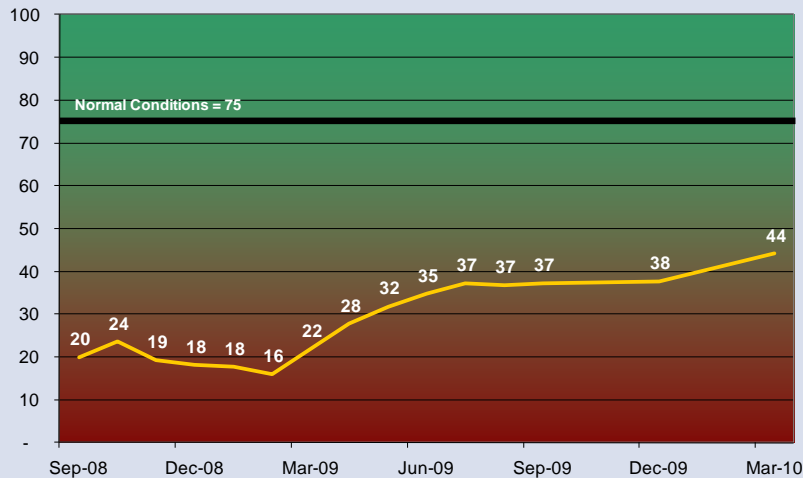
David R. Koening

The survey was conducted between Monday March 8th and Friday March 12th, 2010. Survey participants typically hold the titles of Chief Risk Officer / Heads of Risk Management, Board Director or other C-Level title. Ninety firms are represented in this month's sample 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 17 countries, 60% from the Americas, 33% from EMEA and 7% from the Asia-Pacific region.

Credit 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 March was 44, a six point increase from the reading in December of last year and the first significant move higher in the index since the summer of 2009. Now nearly 30 points above the low reading of February 2009, the index reflects the fact that fewer of our survey respondents are very defensive in their positioning. In addition, nearly one in four believe the crisis to be over or nearly over, which is up from less than 10 percent who believed the crisis was nearly over when last asked in December.

Still, nearly 2/3 of respondents see conditions that could lead to a worsening of the crisis and the focus remains on sovereign risk and commercial real estate as potential hot spots, particularly for vulnerable banks. One North American Chief Executive Officer notes “The Venture Capital / Private Equity guys are starting to get back to work.” He continued by balancing this positive indication with the caveat that “the real estate hangover could derail the whole recovery.”

A former North American Chief Risk Officer said “I continue to go into banks in an effort to help clean up balance sheets, establish risk management programs, etc...and I continue to see various serious issues, from liquidity to credit quality, which have not been addressed through ratings or reserves.”

Echoing that assessment, a North American Head of Internal Audit notes his bank has “a fairly high amount of credit risk in the portfolio and is continuing to work through problem assets,” while a North American Chief Credit Officer says “commercial real estate problems are looming.”

Many view high unemployment rates to be a threat to future stability. Softening this risk in the U.S., perhaps, the Federal Reserve just upgraded [its assessment](#) of national labor markets to “stabilizing” from a month ago when it said that labor market deterioration was “abating.” Granted, this is Fedpeak, but it seems consistent with the trend in the CSI overall and respondents’ opinions, at least on the U.S. economy.

On the sovereign front, the problems Greece has experienced, along with [rating agencies' public comment](#) that the AAA rating on U.S. sovereign debt could be in jeopardy if the federal fiscal picture fails to improve, keep respondents reasonably cautious.

Believing that the Greek situation could lead to a contagion effect, one EMEA senior risk officer noted “the political difficulty of cutting government spending (look at basket-case Britain!) means this problem will persist”. One solution, a North American board member suggests, is “for [Washington] to get control of the free spending, wheeling and dealing and demonization...letting the free enterprise system work to restore credibility and good faith in our markets and businesses.”

One EMEA board member notes “a lot of our focus has been directed at what means and methods will be and are being used to reduce the effect of Greek and other similar countries real insolvencies.” He continued, “Will a new reserve currency become reality sooner rather than later and what role will gold have?”

In the Middle East, an EMEA Head of Internal Audit made several comments about the worsening of problems in that region, particularly in Bahrain. “The general sentiment is that we have not seen the bottom in the Bahraini real estate market” citing an article in [Arabian Business](#) which discusses credit rating agency warnings on the impact of regional problem loans. He continued “there is a general perception that the worst is to come.”

Finally, there is the looming concern over an asset bubble in China. We deal with that issue via a special set of questions discussed later in the report.

Additional comments:

“The issues swirling around CCP's and clearing need to be addressed sooner rather than later. We need to avoid regulatory arbitrage between the US and EU.” – North American Chief Risk Officer

“We are still in denial phase; unemployment is still increasing, housing prices declining, corporate profits stalling with here and there a recovery albeit due to cost reductions...I fail to see this as a sustainable recovery at this moment.” – EMEA Head of Compliance

“The global excess of capital (versus tangible or real commercial purpose) continues to be so extreme; the institutional or official capacity to address/alter this imbalance is so far unaltered. Thus a continuation and likely worsening of the credit crisis seems inevitable.” – North American Chief Financial Officer

“The economy is expanding but is in a very precarious position. The real estate markets remain overvalued (although much less so than two years ago) and the unemployment is very high. There is very little room for error in...policy.” – North American Former Head of Risk

“The world economy overall may improve but there are certain national economies where a worsening is likely - such as the UK after the general election.” – EMEA Senior Executive

“What was once a global crisis seems to be localizing in certain areas. Some are recovering, others are flat-lined, some declining.” – EMEA Chief Risk Officer

“The Banking System is not in a position to support economic growth; simultaneously the increased money supply must lead to inflation.” – EMEA Board Member

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 had deteriorated during the last quarter of 2009, but there were some signs of improvement in this current update, albeit only small indications.

CSI-Credit increased to 44 in March, its highest level since the CSI survey began in September of 2008.

One fear among lenders is that a need to strengthen capital ratios could curtail overall bank lending. On the flip side, a North American board member reports “we are

increasingly unable to find creditable borrowers with capacity.”

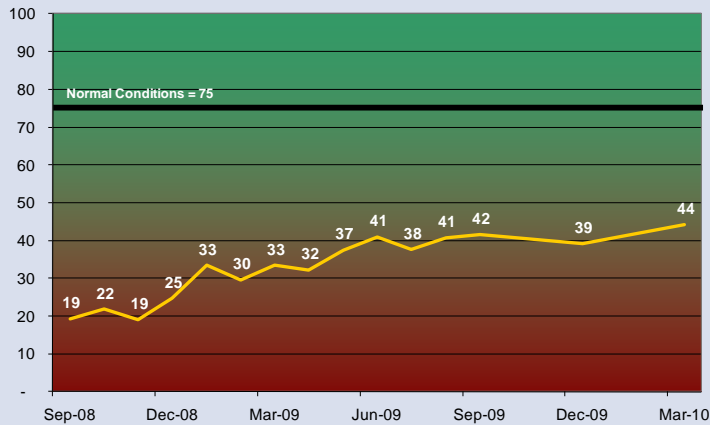
The more sanguine sentiment among bankers is reflected in the narrow difference between respondents who are lenders and indicated that they had improved credit availability during the last quarter (22%) as reported a contraction in lending (17%). However, the ratio of credit demanders who reported more favorable credit terms in the last quarter (35%) versus worsening terms (18%) is easily the most positive assessment of this condition since the survey started and is the main contributor to the increase in CSI-Credit. Therein lays some hope, so long as it does not fuel a return to over-leverage and too much debt. An EMEA Senior Executive believes, however, that this is exactly what is happening saying “the credit crisis is over...we are back to normal of living on debt and credit at the corporate level.”

Industry-Specific Assessments

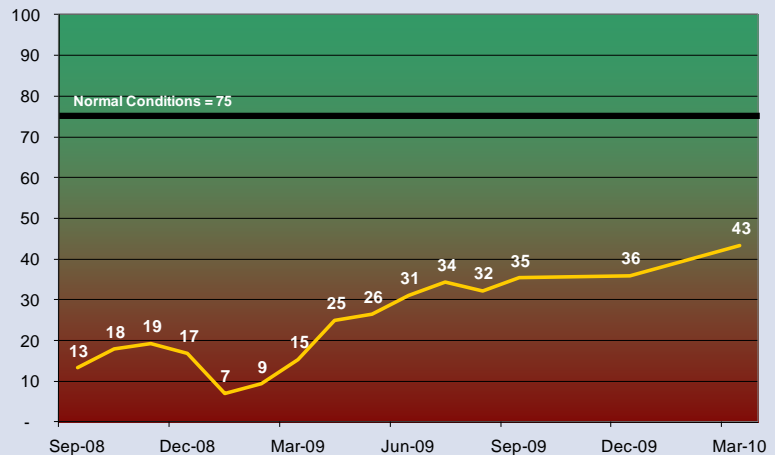
The CSI-Banks sub-index is a weighted index of sentiment as expressed via the primary question of the survey and a specific question about the likelihood that at least one major bank will fail or be taken over as a result of the crisis.

There was a noticeable improvement in the sentiment towards banks during the last quarter, with CSI-Banks increasing to a new high of 43, up from the previous high of 36 seen in December and dramatically above the bottom of 7 in January 2009, just fourteen short months ago.

CSI-Credit



CSI-Banks

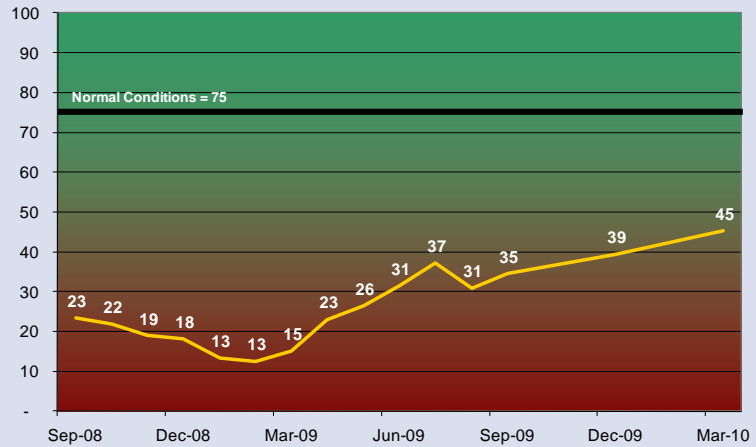


A North American Chief Credit Officer said “many more banks will fail, but they will be smaller banks. Conditions are improving but that only means the survivors are being sorted from those that will not survive. Problems will persist for a period of time.”

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.

Like the CSI-Banking sub-index, CSI-Insurance reached a new high for the period over which our surveys have been conducted.

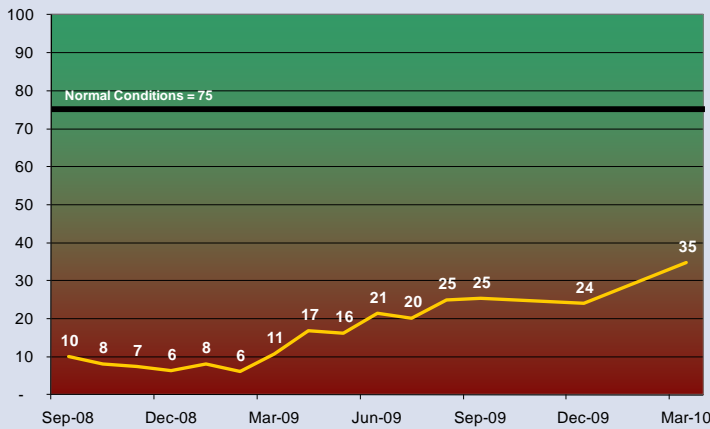
CSI-Insurance



Having bottomed in February 2009,

there has been a consistent improvement in the attitudes our respondents have towards the insurance sector. CSI-Insurance jumped from 39 to 45 over the past quarter. Although it is still quite a ways from ‘normal’, the trend of growth continues to be good.

CSI-Hedge Funds



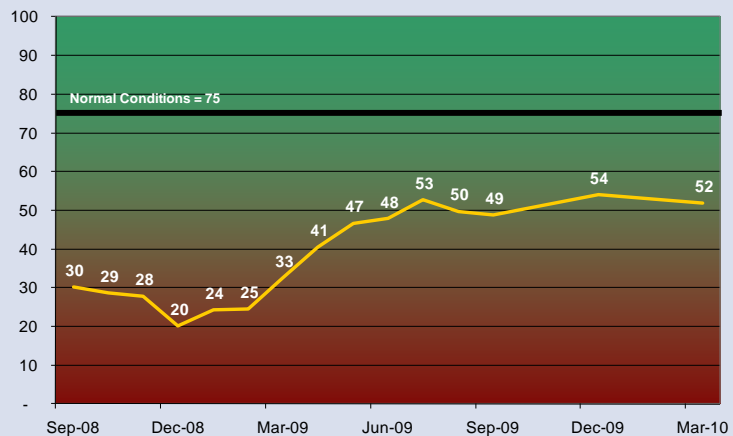
The CSI-Hedge Funds sub-index showed the largest improvement of any sub-index during the last quarter, reaching a new high of 35, up 11 points from December 2009, and 10 points above its former high. This index has consistently

been the most negative of all in our survey.

More signs point to [a return of money to the sector](#) in 2010, with [punishment by investors](#) of those who turned these investments into highly illiquid instruments during the crisis.

Sentiment regarding the likelihood that another money market fund will “break the buck” declined slightly in March. This sub-index has been mired in the high-40’s to mid-50’s since May of 2009, reflective of the overall caution shown by respondents.

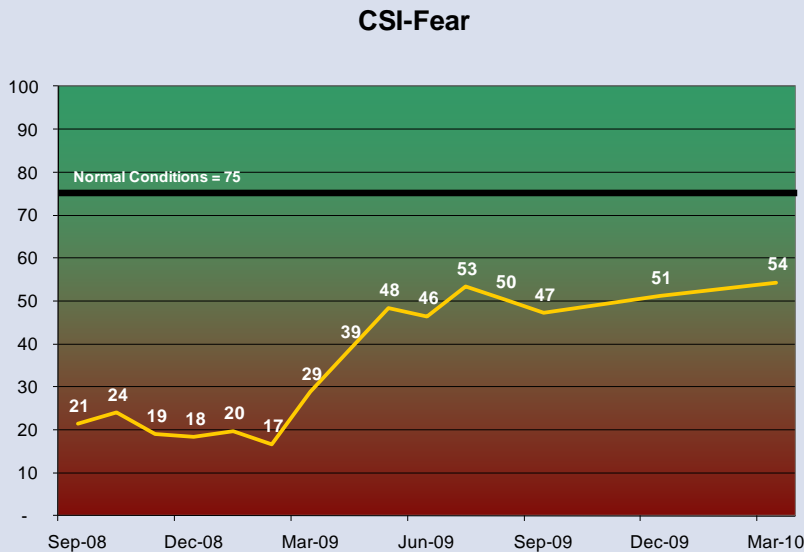
CSI-Money Market Funds



There are no clear reasons for this decline, save the possible influence of sovereign debt risk expressed elsewhere in the survey, including that related to the U.S., U.K. and other major economies that project growing future deficits in their budgets.

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.



CSI-Fear reached a new high for the survey coming in at 54 in March, up from a reading of 51 in December, and just above the previous high of 53 seen in July of 2009.

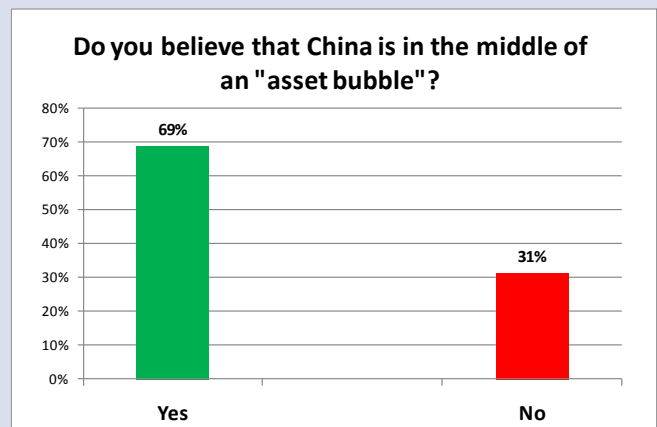
Several respondents left comments regarding the impact of the media on “fear”. Said one North American Chief Executive Officer, “The public doesn’t have enough knowledge to create fear. They follow the latest news

story.” A North American Chief Financial Officer showed skepticism regarding the media and the need for current capacity in these sectors, saying, “I am leery of media coverage, negative or positive, on what the market professionals or the public is feeling regarding the financial order. Everyone has a publisher, and everyone has an angle in order to ‘sell their own book’; but I do believe that much of the capacity in banking, insurance, investors/hedge funds, and money market funds is redundant and significantly unnecessary.”

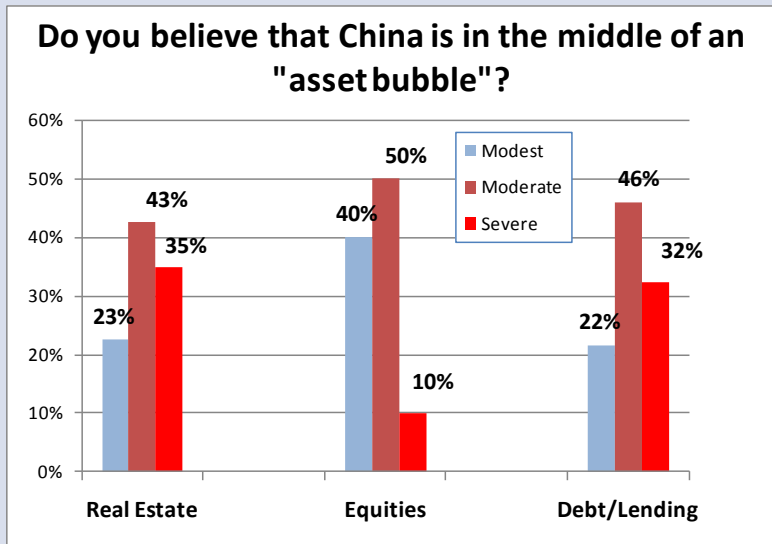
Is China in the Middle of an Asset Bubble?

In addition to fears over sovereign debt, country-specific risk has been identified by many as it relates to the potential or actual existence of [an asset bubble in China](#). We asked our survey respondents for their sentiment regarding the existence of an asset bubble, how likely it was to burst in the coming months and the impact of a bursting on various regional economies.

As shown in the chart on the right, seven in ten respondents agreed that China is experiencing an asset bubble. When asked for their opinion of the severity of the bubble, nearly 80% felt the real estate bubble in China was “moderate to severe”, with a similar percentage applying the same assessment to the bubble in debt/lending. Clearly the two are related.



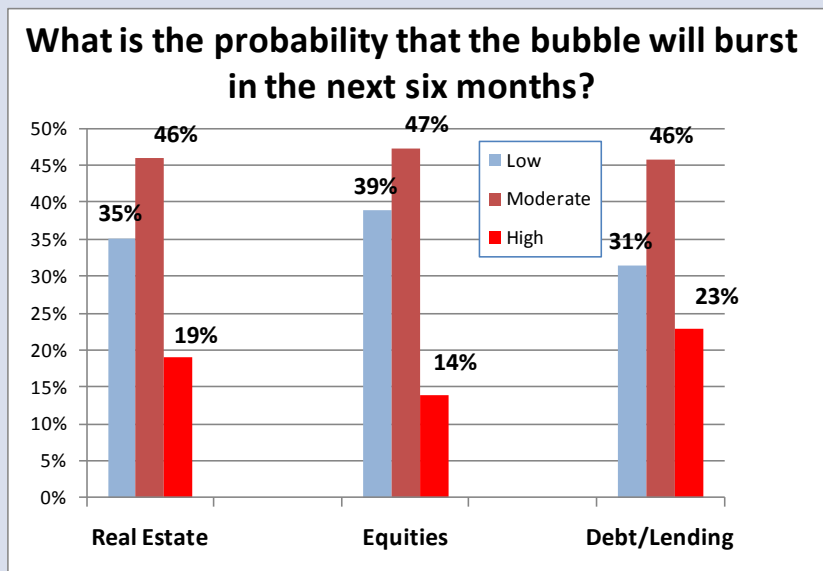
The assessment of the degree to which there has been an [equity price bubble](#) in China was less certain, with 60% feeling such was “moderate to severe” and 40% opining that it was only a “modest” bubble.



The size of the bubble has been generating significant commentary in the press and, as the report in the link above indicates, among entities like the World Bank. Inevitably, all bubbles burst, but the timing and impact of such are never known in advance. Clearly the impact of a bursting of the Chinese bubble just as other economies are emerging from the financial crisis could be significant, especially given the Chinese

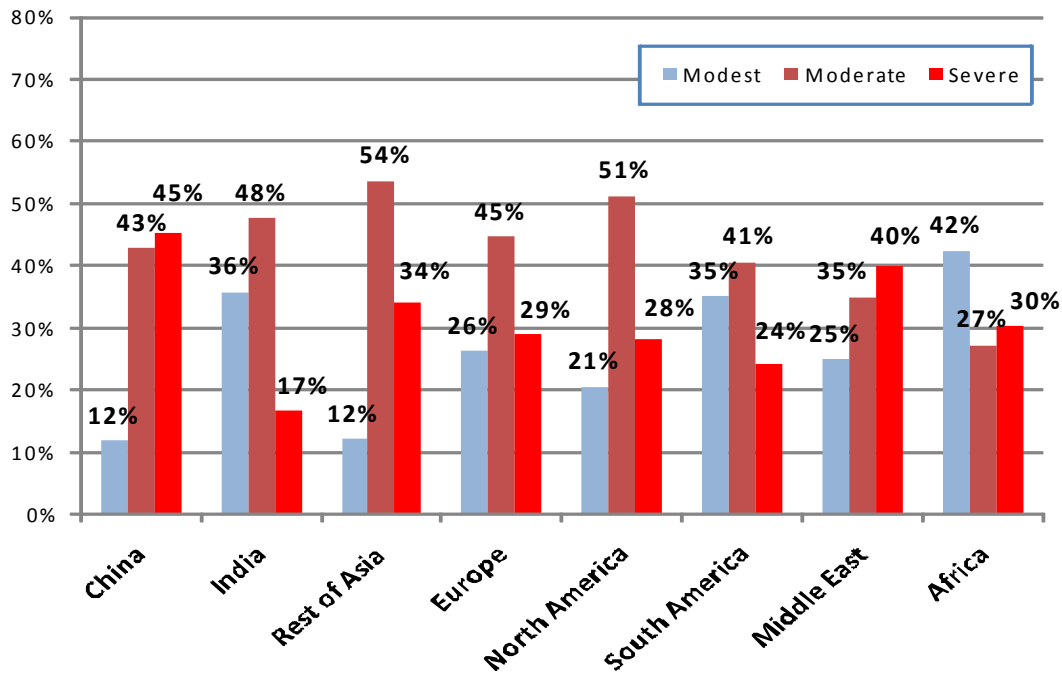
appetite for investing in the sovereign debt of countries like the U.S. So, preparedness, if one had a sense of an imminent bursting, would seem to be in order.

Of those who expressed an opinion regarding the likelihood that the bubble might burst in the next six months, there was a similar assessment across the three choices, with roughly 60% to 70% suggesting there is a “moderate to high” probability that the bubble will burst in the next six months, but only 15% choosing “high” probability for equity prices, while roughly 1/3 assigned a “low” probability of disruption in any markets.



Should the bubble burst, we asked respondents about the likely impact on various regional economies. Not surprisingly, the largest impact is expected to be within China, on China’s neighbors, on North America and in the Middle East, where one assumes the expected impact would be on oil demand from a stumble in the Chinese economy.

What is the expected severity of impact should the bubble burst?



Respondents noted significant skepticism towards official data coming from China, making it difficult to know if the problems have already started, or if they start, when they will be officially acknowledged.

Conclusion

A modest increase in the Crisis Sentiment Index during the first quarter of 2010 is one of the first positive signs from our survey group in several months. While a greater percentage than any time since the survey started believe that the crisis is over or nearly over, the vast majority of respondents remain cautious, citing risks to real estate, particularly commercial, that could impact banks and growing attention to, and realization of, sovereign risks a focus of concern. The possibility of a Chinese asset bubble bursting is just one more reason why the CSI remains thirty points below 'normal' conditions. Still, it is encouraging to see upward movement since December, and for most sub-indices to be reaching new highs.

Our next assessment will take place in June. 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](#).

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)

5. Do you believe that China is in the middle of an "asset bubble" (Yes, No, Don't Know)?

6. To what extent is there a bubble in the following sectors (Modest, Moderate, Severe and Real Estate, Equity Prices, Debt/Lending)?

7. What is the likelihood that a bubble will burst in the next six months (Low, Moderate, High and Real Estate, Equity Prices, Debt/Lending)?

8. If there is a bursting of the bubble, what is the likely impact on the economies of the following regions (Modest, Moderate, Severe and China, India, Rest of Asia, Europe, North America, South America, Middle East, Africa)?

Ductibility, LLC

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

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