

Ductilibility, LLC

*Crisis Sentiment Index:*

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

*May 25, 2009*

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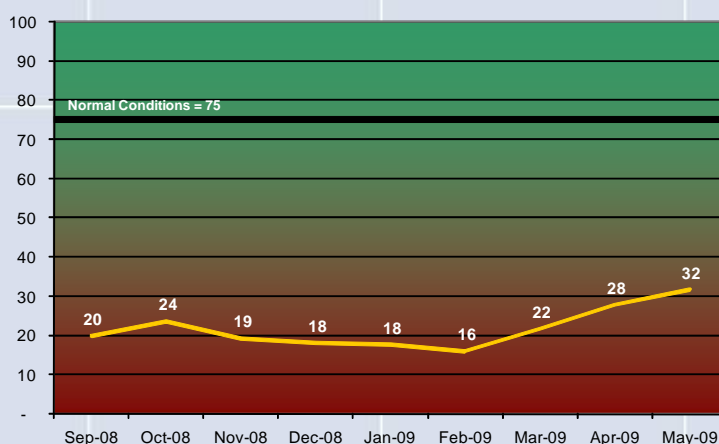
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## Executive Summary

The *Crisis Sentiment Index (CSI)* is a monthly assessment of the status of the current financial crisis by senior risk executives around the world. Reported on a scale of 0 to 100, a reading of 75 indicates normal conditions.

The Crisis Sentiment Index (CSI) for May 2009 has improved to a reading of 32, up from 28 in April, the third straight month of improvement in sentiment. As with recent reports, it must be emphasized that a reading of 32 is still very negative. We find that there is only modest improvement in the availability of credit, despite many suggestions that credit is flowing more easily. Most CSI sub-indices improved this month, while sentiment towards hedge funds retreated slightly. Respondents seem focused on the risk or expectation that a second wave of credit problems will emerge as real economy impacts of the financial crisis drive corporate and consumer defaults.

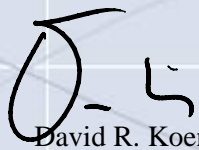
**Crisis Sentiment Index (CSI)**



The CSI-Fear sub-index continued its rapid improvement, increasing to 48 this month from 39 last month. CSI-Credit rose to 37 from a reading of 32 the month prior. CSI-Money Markets increased to 47, its highest reading since the surveys began. Like the overall CSI, all sub-indices remain well below the 75 level which is considered indicative of “normal” conditions.

This month we asked our respondents if their boards and/or Chief Executive Officers had reduced the amount of attention they were giving the crisis. Consistent with the fact that the CSI remains at very negative levels, they indicated no turning away from the crisis.

Full details are included in the body of the main report, which follows. Should you have any questions, please don't hesitate to contact me.

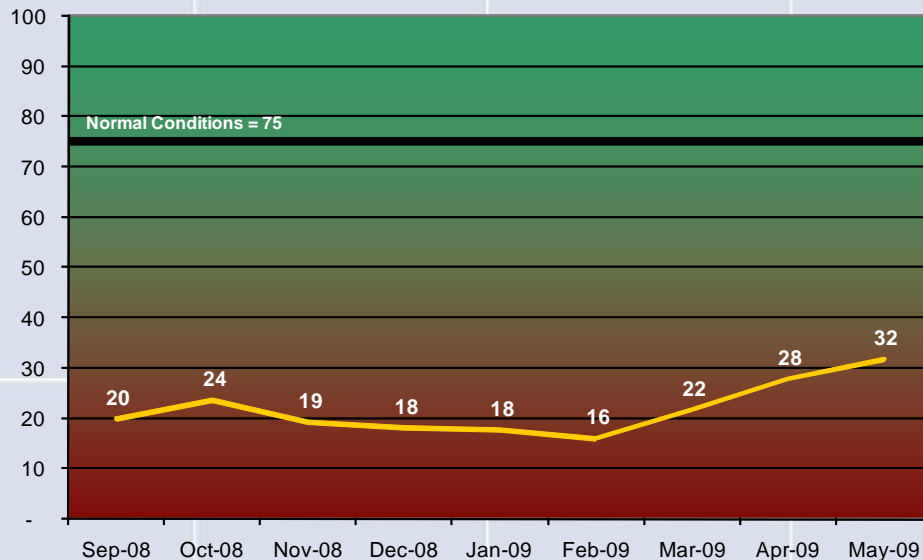
  
David R. Koenig

*The survey was conducted between Tuesday May 17<sup>th</sup> and Thursday May 19<sup>th</sup>, 2009. Survey participants typically hold the titles of Chief Risk Officer / Heads of Risk Management, Board Director or other C-Level title. 101 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 26 countries, 55% from the Americas, 38% 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 month. The core assessment asks respondents to choose whether they feel the crisis 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 get worse.

### Crisis Sentiment Index (CSI)



Nearly 2/3 of all respondents indicated that conditions are improving, with only 6% expecting the crisis to worsen and only 30% planning for a continuation of the crisis for the foreseeable future. The latter figure is half the percentage who expressed the same level of caution two months ago.

We have often mentioned that a reduction in fear/panic was an essential element to recovery and a leading indicator of future improvements in the CSI. Said one Board Member from the Americas, “The crisis of confidence and the fear that the banking system will disappear is over. But the fall-out from the real economy and economic contraction continue.” One EMEA executive suggests that the situation could be addressed successfully with present actions if the crisis were merely one of confidence and liquidity. “It is one of solvency”, he said.

One Chief Risk Officer involved in retail mortgage lending hinted at a sentiment held by others regarding the potential for a second wave of the crisis driven by ‘real economy’ contraction, “Arrears levels in lending beginning to reduce as affordability easing through lower interest rates: however threat of unemployment increasing defaults is a large specter looming.” An Americas Chief Risk Officer focused on commercial lending noted “small signs of stabilization in credit markets.” He continued, “I do not think it is over but maybe hitting a rocky bottom. Companies [are] showing major stress but some signs of hope. [There is] not a trend yet on performance.”

The sentiment regarding the potential for a second wave down is embedded in the survey question choice selected by nearly 60% of respondents “Conditions are improving, but, there is a chance that the crisis will worsen again.” Said one EMEA bank Head of Risk Management, “Though conditions seem to be improving, towards end of FYE 2009 the momentum of losses will drag down investor confidence and I see further liquidity problem in the economic systems.” Another EMEA bank Chief Risk Officer felt “there is too much disregard of the real economy.”

An interesting encapsulation of the situation comes from yet another EMEA bank Chief Risk Officer who noted “Severe crises come in waves, we are expecting the next wave to occur when the real sector gives back (in the form of NPL) what it got from the financial sector (in the form of lack of liquidity).” Take that, banks.

The Financial Times has a somewhat humorous look at the various “shapes” of recovery being discussed in its [Alphabet Recession](#) article. Adding to the mix is the Merrill Lynch Europe outlook for a “square-root” shaped recovery. See a discussion of this analysis, with links to the rationale behind other shapes by [clicking here](#). Very few of our respondents who left comments seem to believe in the “V-shaped” recovery, with just 5% of all respondents claiming victory in the battle against the causes of the crisis.

Additional comments:

*“Despite the positive tone in equity markets and some sentiment based data there is still a considerable amount of bad news coming out of the US and increasingly from Europe. High unemployment and below trend growth may still drag on for some time yet keeping pressure on the banking system. Recent falls in LIBOR are being taken as a sign that credit is thrashing, personally this looks more like a banking system still not wanting to lend, but being forced to put cash from an oversupply of deposits to work somewhere. This is offset to some extent by better news out of China and India, but time will tell.”* – Asia/Pacific Head of Investments

*“There are still substantial parts of the credit markets frozen - eg. Commercial Mortgage Backed Securities. Real estate credit remains very difficult even on cash flowing high quality properties.”* – Americas Board Member

*“I shall be interested to see where so much real estate refinancing will be coming from.”* – EMEA Senior Executive

*“Savings rates are increasing, consumer spending is low and credit card repayment statistics are worsening. Not a mix that is pointing to an improving trend. Banks will continue to suffer from this development.”* – EMEA Chief Risk Officer

*“Interbank lending is improving. On the other hand, problems in the broader economy will lead to further deterioration of bank portfolios.”* – Americas Chief Credit Officer

*“Commercial Real Estate and Commercial Mortgage loans and related structured products are in focus. There is increasing political risk from potential legislation overreactions. Regulatory risk could increase from turf battle distractions and potential loss of industry risk memory as regulatory restructuring accelerates. There are real needs for chief risk officers to be appointed to independently consider and advise the president, the congress and the regulators about the risk and return balances of actions being considered.”* – Americas Head of Investment Risk

*“We have yet to experience the full impact of the automotive industry”* – Americas Chief Audit Executive

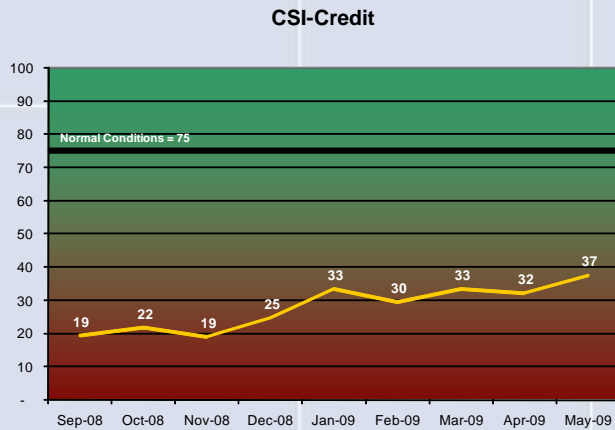
### **Availability of Credit**

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 most recent weeks leading up to our survey. Credit availability seems to be improving, but only begrudgingly so.

It is unmistakable that an improving trend has been reported since November of last year. However, over the six months since that bottom in credit sentiment, the CSI-Credit sub-index has only moved from 19 to 37, less than one-third of the way it needs to travel to reach a level which would be consistent with “normal” lending conditions.

would be consistent with “normal” lending conditions.

Two respondents in our study who represent end investors suggested they are seeing improvements. Said one Americas Head of Investment Risk, “We are an investor in the corporate bond markets and there has been increased issuance and the markets are returning to normal.” The other, a Chief Risk Officer from the Americas, said “We are an asset manager and are broadening our investable list.”



One Asia/Pacific Chief Investment Officer also reports improvements, but some doubt as to whether there is much behind what is being seen, saying “We have seen significant contraction of spreads offered to us by banks on structured products. However their ability to fund remains questionable.”

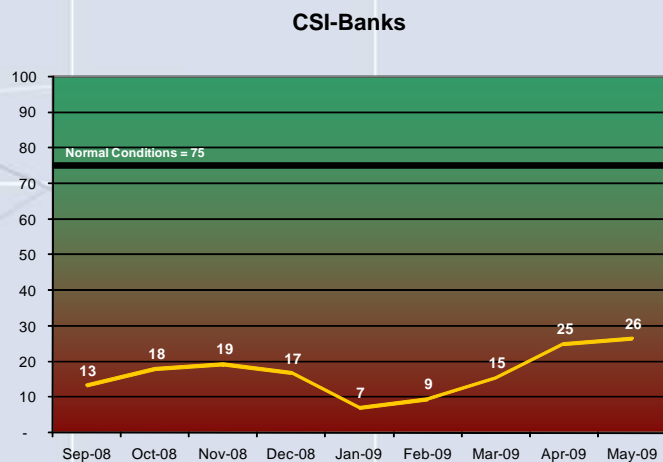
On the more cautious side, an EMEA Chief Risk Officer notes a “modest increase in new lending, from a cautious standpoint and at good margins.” A Chief Credit Officer from the Americas sees “great risk/reward opportunities out there.” Somewhat consistent with these lender perspectives, an EMEA Head of Risk indicates “credit facilities have improved, but the cost of borrowing has increased almost exponentially.” “We are very cautious when evaluating counterparties and very selective while providing the facility,” said an EMEA Head of Risk Management, “There are tight controls on credit quality.”

Still, despite some positive trends, of respondents who indicated they are users of credit, more than 30% disagreed that credit was more available, while less than 20% felt they could access credit more easily now than a few weeks ago. Providers of credit were more evenly split on their opinions regarding the improved availability of credit. Among both groups, however, more than half felt conditions had not changed for better or for worse.

### 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.

The number of respondents who “strongly agreed” that “at least one more major bank will fail or be taken over as a result of the crisis” continues to improve

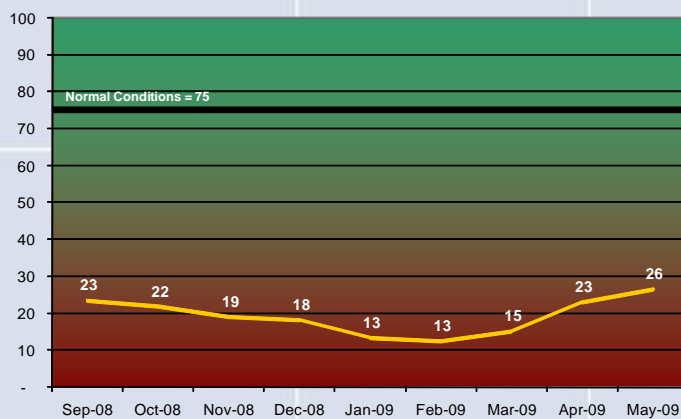


with just 14% choosing this option in May, down from 17% in April. A majority of respondents still feel it more likely that a major bank will fail or be taken over as a result of the crisis, indicating little sense that the banking crisis has been resolved. As a result, the CSI-Banking sub-index rose only 1 point to a reading of 26 in May.

One EMEA Research Director noted “We're witnessing a period of increasing complacency, buoyed by massive liquidity injections. This leads to a postponement of necessary reforms, which I believe is likely to increase their eventual cost to the taxpayer and the system at large. This sentiment was echoed by an EMEA Chief Risk Officer who feels “bank restructuring is still needed in Europe, especially Germany.”

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**

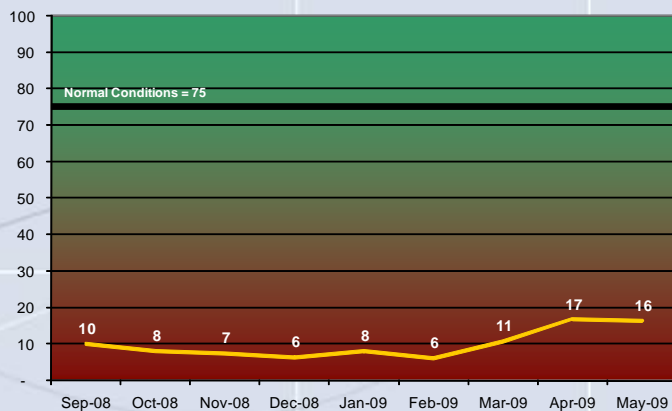


For the third straight month, this sub-index has improved, moving to 26 in May, up from 23 in April and the best assessment of the industry since our first survey in September of 2008. Still, as noted earlier in the report, this is a very low reading and would be considered indicative of highly negative conditions in the industry.

The percentage of respondents who 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” has fallen to just below 50%, whereas it was over 80% in the March assessment. It would seem logical that the use of U.S. TARP money for some U.S. insurers would be seen by some as a positive development.

The percentage of respondents who agree or strongly agree with the

**CSI-Hedge Funds**



The sentiment towards hedge funds has taken a step backwards and that industry continues to receive the most negative assessment of any of the sectors on which we have asked for opinions. Falling back to a reading of 16 from last month’s sentiment reading of 17 is only a minor set-back, but runs counter-trend to all other sub-indices.

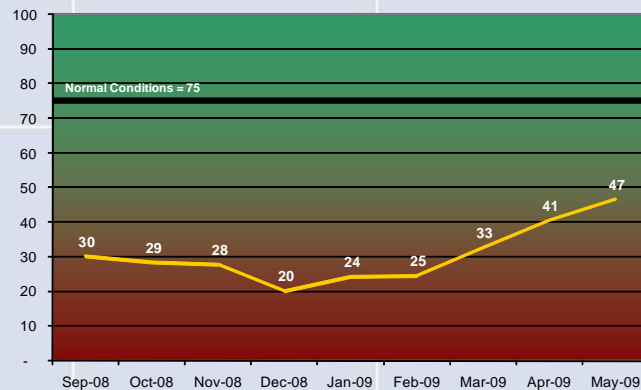
Seventy-five percent of respondents agree or strongly agree that another major hedge fund will close or be taken over as a result of the crisis.

One Americas Head of Risk Management directs us to the [case of Satellite Asset Management](#) calling it “a perfect example of a major hedge fund with a very distinguished track record that

recently closed because of the illiquidity of the positions in the portfolio...it was unable to pay out redemptions lodged by its investors.”

Sentiment regarding the likelihood that another money market fund will “break the buck” has improved for the fifth month in a row. The CSI-Money Markets sub-index rose to a reading of 47 in May. This trend is a positive indication for short-term borrowing, but, as stated last month, we will only begin to take more significant comfort from this sub-index when we see readings in the 60s.

**CSI-Money Market Funds**

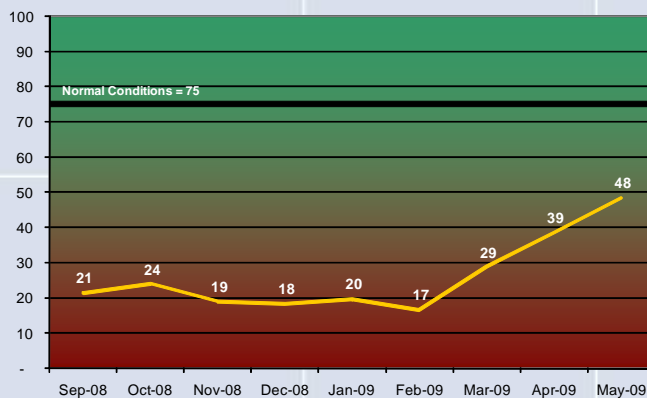


An EMEA Chief Risk Officer notes a “general optimism in the markets and financial crisis is receding (reduction in TED spreads and LIBOR)”. These trends in spreads are also being cited in the financial press as an indication of better credit conditions and perhaps less fear of instability in money funds follows such.

## Fear

Each month 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. In May, the CSI-Fear sub-index jumped to a new high for our survey, reaching a level of 48, the highest reading of any sub-index.

**CSI-Fear**



On a relative basis, there is a near-absence of belief that fear is growing among market professionals with just 11% agreeing or strongly agreeing that fear is on the rise among members of this group. More than 70% of respondents disagreed that panic was on the rise.

An even greater improvement was seen among respondents regarding the notion that fear among the public was still increasing. While there is a general sense that fear is growing more among the public than among professionals, only 20% agreed or strongly agreed that it was, while nearly 2/3 of respondents disagreed or strongly disagreed.

An executive at a non-financial corporation in the Americas said “in talking to others in the market, they are very cautious about the future situation and are taking a rather guarded look that matters will improve.” A Chief Risk Officer from the Americas said “whether justified or not, the general mood appears to be one of moderating fear and lower volatility and risk taking. The risk premium in the market has been reduced due to many factors that are yet to define themselves fully. “ Concluding, a Chief Risk Officer from Asia/Pacific region believes “we have now moved from fear to uncertainty.”

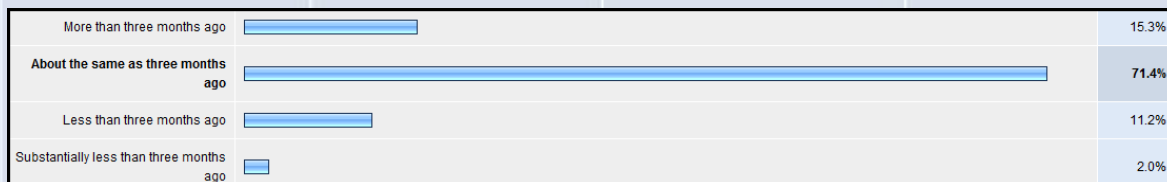
## Are We Staying Focused?

With equity markets on the mend and substantial rallies soothing the pain of many an investor, private and commercial, we wondered if that meant our senior governing officials might be turning their attention elsewhere. We are somewhat encouraged to find that boards and Chief Executive Officers, save one with a valid excuse, seem still be generally tuned into the potential ramifications of the current crisis.

Asked if their Board of Directors were paying attention today to the crisis relative to the attention it was given three months ago, our respondents reported that 85% of boards were paying the same or more attention to the crisis. Only 2% report substantially less attention being paid.



Similarly, Chief Executive Officers appear to be keeping their focus.



An EMEA Chief Compliance Officer notes “the phrase ‘business as usual’ starts to spread around trying to keep positive and motivation ongoing, but in reality this is still far from usual conditions.” A Board Member from the Americas reports “not much change on attention level, but focal change to understand stimulus and regulation direction and implementation.” One EMEA Chief Risk Officer reports at the board and CEO level the crisis is receiving “sustained maximum attention.”

As for the one CEO with an excuse for not paying attention....he’s retiring August 30<sup>th</sup>. Ah, temptation.

## Conclusion

Sentiment continues to improve, albeit slowly. We fear the availability of credit is not keeping up with the reduction in “fear” and rallies in equity prices. Both measures may retreat some if expectations regarding credit availability are not fulfilled and if any signs develop of a second leg down in the economic cycle.

We will update our assessment again in one month. In the meantime, you can discuss this report 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:

- 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 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)

5. What level of attention is the financial crisis receiving from your board? (More than three months ago, About the same as three months ago, Less than three months ago, Substantially less than three months ago)

6. What level of attention is the financial crisis receiving from your CEO? (More than three months ago, About the same as three months ago, Less than three months ago, Substantially less than three months ago)



# Ductibility, LLC

*A private research initiative serving the governance needs of Boards of Directors and senior executives.*

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