

Ductilibility, LLC

Crisis Sentiment Index:

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

June 21, 2010

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Ductilibility, LLC
402 Washington Street
Suite 200
Northfield, MN 55057
USA

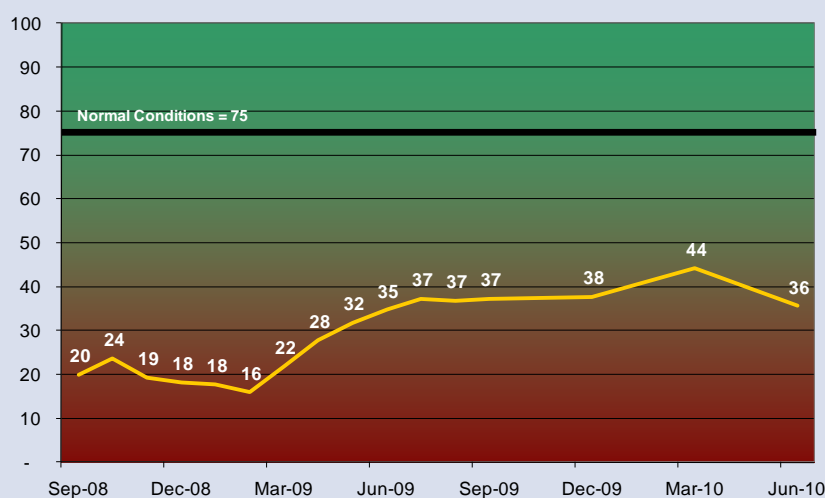
+1-507-301-3149

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.

Fear is on the rise again. As a result, the Crisis Sentiment Index (CSI) for June 2010 fell substantially to a reading of 36, its lowest reading since June of 2009, entirely erasing the gains of the first quarter this year. Nearly 40 points away from 'normal' conditions, the decline has been driven by a major increase in the level of fear among market participants and the public. When asked to name their biggest fears that were likely to occur, respondents ranked sovereign default at non-G-20 countries, pension underfunding and commercial real estate defaults at the top of the list.

Crisis Sentiment Index (CSI)



Nearly all of the CSI sub-indices retreated to levels from several months ago. By far, though, the biggest decline was in the CSI-Fear sub-index, which plummeted from 54 in March to just 34 in June, the lowest level (highest amount of fear) since March of 2009. The next biggest decline was seen in CSI-Hedge Funds, which fell to a reading of just 25, the lowest of all sub-indices.

While most respondents cited a litany of risks and uncertainties contributing to their daily risk management activities, a few positive comments were left by respondents. Still, only one of the 93 respondents to this survey said "the crisis is over".

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

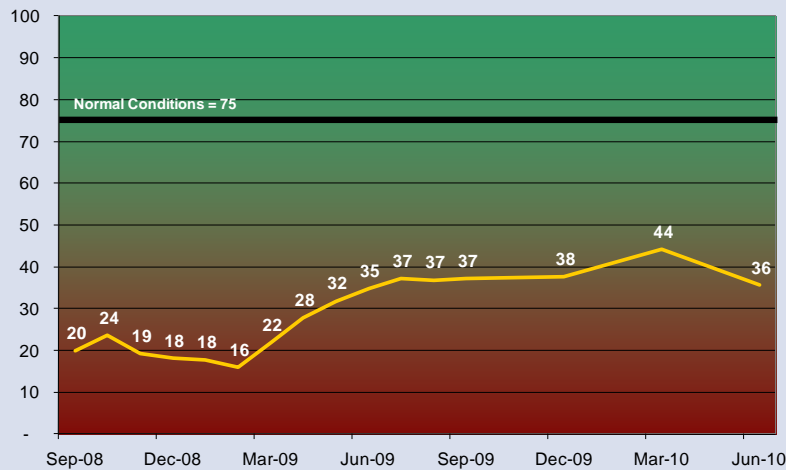

David R. Koenig

The survey was conducted between Wednesday June 16th, 2010 through Friday June 18th, 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 24 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 June was 36, an eight point decline from the reading in March this year and a return to the levels of June 2009. The number of respondents who believe the crisis to be over or nearly over was less than half of that number in March, representing only 13% of respondents. Meanwhile, nearly ¼ of respondents are planning their risk management activities for the crisis to continue for the foreseeable future.

Still, the vast majority of respondents report that conditions are improving. Hence, it is important to note some positive sentiment among respondents. The issue, it seems, is the many sources of vulnerability to those small signs of improvement that give our overall survey response a highly cautious tone.

Said one Chief Risk Officer from the EMEA region, “The European sovereign crisis will continue to create volatile conditions for some time (currencies, equities and credit markets)”. He continued, “The crisis may next morph with sovereign defaults or increasing currency, inflation or commodity prices combining to impact leverage consumers, companies or banks holding significant sovereign debt.” An Asia-Pacific Chief Investment Officer offered similar feelings, saying “the financial turmoil in Europe will take some time to settle down and the full effects are yet to be determined.”

One North American board member said “I was more optimistic three months ago than I am now, and here I share the opinion of fellow board members...the political uncertainty in Europe is increasing and the U.S. economy, while picking-up speed, is not strong enough to support a strong and prolonged recovery.”

Uncertainty around regulatory reform was also cited by several respondents as contributing to the fear. A C-level officer in the Asia-Pacific region noted “Regulatory uncertainty, political backlash against financial industry, lack of progress on accounting standards convergence, etc combined with still very high volumes of algorithmic trading strategies all against the worsening fiscal

conditions in Europe and US means there remains significant potential for financial markets to experience future sudden deterioration in confidence and liquidity.”

Some do see conditions improving with a North American President saying “The economy is on the rebound; however it will not occur overnight...better practices will be put into place by those who survive the entire cycle.” One North American Chief Risk Officer noted that “My company has been expanding its credit offerings and is seeing lower delinquency among our borrowers.” While another North American Chief Risk Officer noted “Capital is relatively available for our business. Volatility is relatively mild despite the events in Europe and the equity markets in recent weeks.”

But, an overall positive sentiment is not widely held. One North American Chief Executive Officer put in bluntly “in June our orders stopped. Customers are not refilling their inventories.” A Chief Financial Officer in North America noted “Some of the official policies implemented to address the crisis are likely to cause additional distortions and extend the crisis notwithstanding the good intentions of the policies.” An EMEA Chief Risk Officer said “The increase of fear and jitters in the past month or so are underscoring the very fragile nature of systemic recovery.” He continued, “There are probably more than a few surprises ahead.”

Additional comments:

“Government debt situation has to imply a slower growth profile. European crisis postponed but ever present.” – North American Chief Risk Officer

“There is still no sign of a consumer recovery, the ‘good’ news here and there is very fragile. Hedge Fund performance in general is very low. Downgrading of European countries doesn't help either to gain any confidence. Pension funds are struggling to maintain their coverage ratios. Unemployment is still on the rise. With the governmental stimulus packages fading (cash for clunkers) it is hard to see any potential for recovery.” – EMEA Head of Compliance

“The levels of sovereign debt in Europe as well as other parts of the world suggest economic growth will be dampened (at best) for an extended period of time as countries work to get their debt levels under control. At worst we could see a sharp correction if defaults occur. This together with levels of consumer debt concerns me in terms of a smooth and continued recovery from the recent recession.” – North American Chief Risk Officer

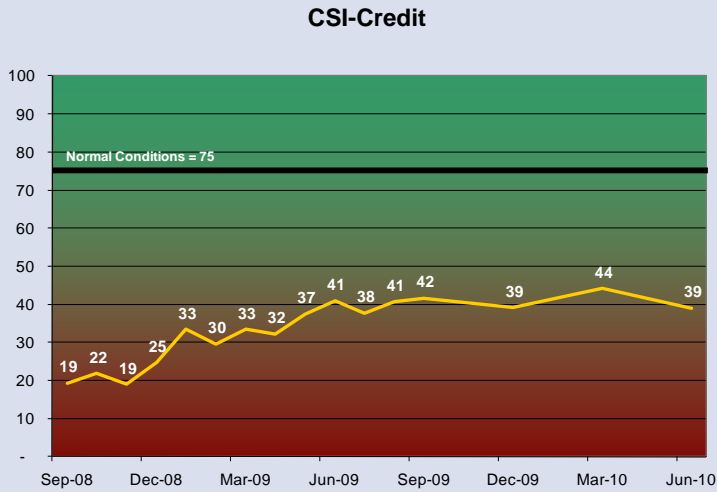
“There are potential issues of concern over the market here and there. If any of them gets materialized, it will be a significant change in market condition that precedent risk management practice would not work. However, we do not know yet as how the market would look like after these changes. Therefore, the only risk mitigant we can take is to diversify and make each investment small enough. Question is how much longer we can keep on this attitude given each institution's earning status.” – Asia-Pacific Chief Risk Officer

“[It] seems that fundamentals may get in the way of our ‘quant’ world. Sovereign sleight of hand - moving pension fund currencies into current government accounts to pay wages and debt, assigning a nebulous timeframe for settlements, and printing out yet more specie to CYA..... tells me we (G20) may be heading for a honey of a roller coaster up ahead.” – EMEA Board Member

“When I look at the world from the bottom-up, things look great: company earnings, cash on hand, etc. When I look from the top-down, I am scared to death.” – North American 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 improved during the first quarter of this year, but all has been given back according to the current assessment.



CSI-Credit fell back to a reading of 39, its lowest since July of 2009, and equal to the reading of December 2009.

Only 28% of respondents reported that they had made credit more available during the past quarter with a similar amount of borrowers reporting the receipt of more favorable terms and conditions. Still a nearly equal number of borrowers reported that terms and conditions of availability for credit had

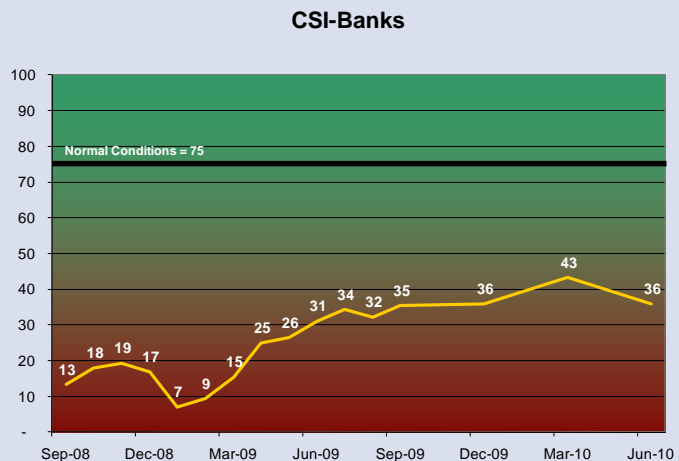
deteriorated during the quarter with slightly less than ¼ of lenders in the survey reporting that they had restricted credit further.

One North American board member said that they continue to find it difficult to locate creditable borrowers. He said “marginal borrowers are easy to find and they are much stronger than they were a year or eighteen months ago.” He worried, though, that the lack of demand from strong credits “may be a problem down the line.”

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.

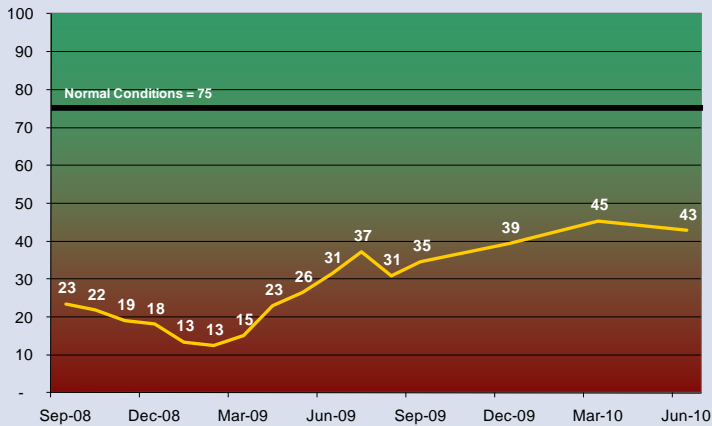
Like other sub-indices, the CSI-Banks sub-index retreated during June to a level of 36, its lowest reading since September of 2009. There seems to be some worry regarding contagion to banks, especially if there is a major sovereign default. Regarding the condition of banks in Spain, one Chief Risk Officer from the EMEA region suggested that “Caja banks in Spain and banks in some other countries may need to consolidate in order to survive the future.”



A North American Chief Risk Officer stated “I do not expect a major bank to fail, but expect to see mid-size banks in the U.S. (with commercial real estate and mortgage concentrations) and Europe (state banks with large sovereign debt holdings) [to fail]”

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

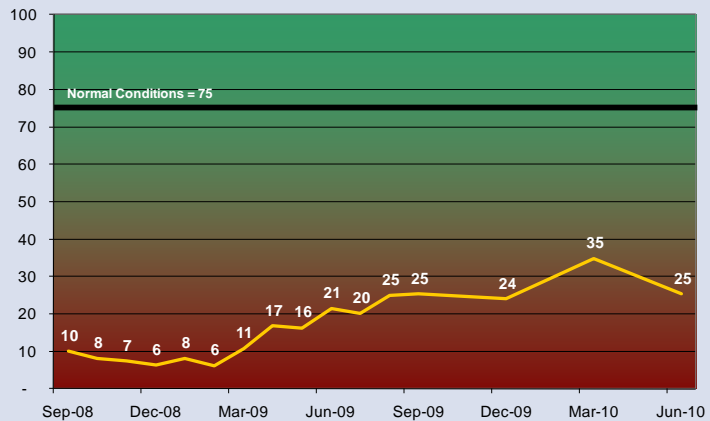


CSI-Insurance seems to have held in better than all other sub-indices, dropping only two points to a reading of 43, the second highest reading since the survey began. There were no clear indications as to why this industry might not suffer as much of a set-back as others from recent market conditions, but at a reading of 43, the sub-index remains

more than 30 points away from ‘normal’ conditions.

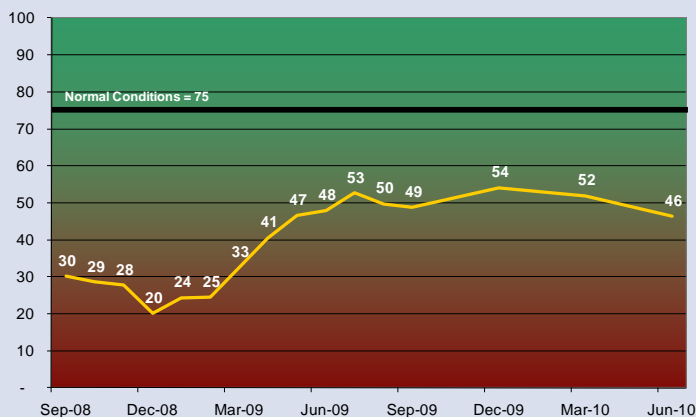
On the flip-side of the CSI-Insurance assessment, the CSI-Hedge Funds sub-index fell dramatically from 35 to 25. This index has consistently been the most negative of all in our survey and the [report that nine of the ten strategies tracked by Credit Suisse / Tremont lost money in May](#) (with average losses of nearly 3% for the month) may have our respondents looking for some additional fall-out in the industry, just as investors seemed to be returning.

CSI-Hedge Funds



Sentiment regarding the likelihood that another money market fund will “break the buck” declined for the second quarter in a row with CSI-Money Markets dropping to a reading of 46, its lowest reading since April of 2009.

CSI-Money Market Funds



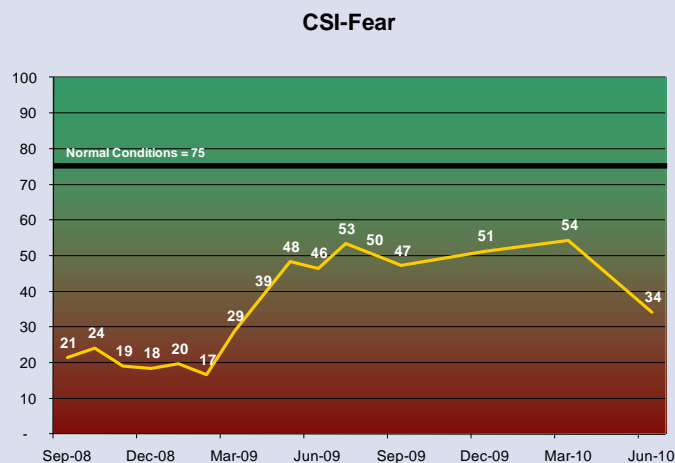
It would seem that the combination of increased sovereign default risk, combined with potential contagion effects makes it more likely that a single large loss could occur in one fund, necessitating an inflow of

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capital from its manager to support the NAV at \$1.

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 collapsed during the June reading, falling 20 points from 54 in March to 34 in June, its lowest level (highest amount of fear) since March of 2009.

Said one former senior risk executive in North America “Market professionals and the law makers globally are confused as to the

near/long term future and so is the public. Uncertainty generates fear and cascading negative impact and irrational behavior.” Added a North American board member, “the big question is the European mess (Greece, Spain, Hungary, etc), and the realization that public finances in the U.S. are in a much worse shape than people think. We should expect to see more public borrowing and raised tax burden, both on the local and federal level. How this will affect the long-term stability of the financial and capital markets is too early to tell, but there are few ‘good’ [stories].”

Fear tends to impact risk-taking decisions in the relatively near term. As was cited earlier, uncertainty around financial reform seems to be also contributing to growing fear. Said a North American Chief Risk Officer, “Fear among market professionals may now be primarily driven by uncertainty in financial reform and global bank capital requirements.”

A North American Chief Financial Officer stated “Fear and the potential for institutional failures are driven by competence and financial risk literacy - which we see as most extremely impaired among the major banks and market professionals caught in the severe challenges of systemic change.”

Which risks are likely and most feared?

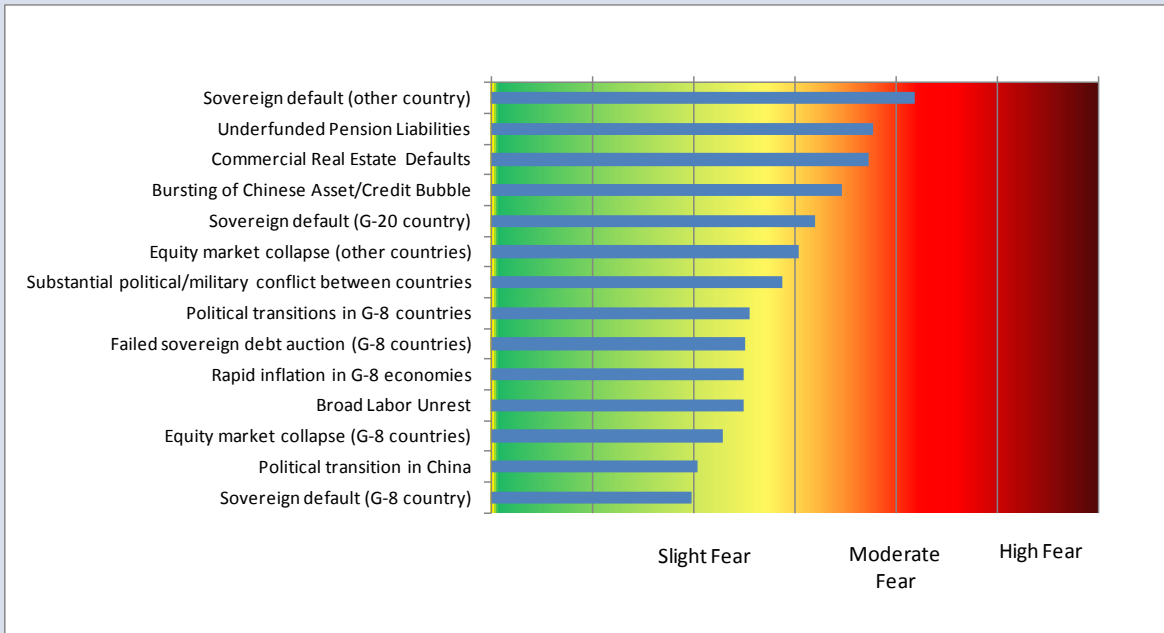
Given the plethora of potential negative catalysts and the realization of multiple risks during the month of May, we wondered which of these risks were believed likely to be realized, and to what extent their realization would have a major impact on the financial/economic crisis.

The top five ‘likely’ risks, of which our respondents indicated they have, on average, moderate fear of their impact include: Sovereign Default at a non-G-20 country, the impact of Underfunded Pension Liabilities, Commercial Real Estate Defaults, the Bursting of the Chinese Asset/Credit Bubble (see [last quarter’s survey](#) for more details on respondents assessments of this possibility) and Sovereign Default by a G-20 (non-G-8) country.

Nearly 30% of respondents assigned a ‘high’ level of fear that there would be a sovereign default in a non-G-20 country and just over 27% expressed a ‘high’ level of fear regarding underfunded pension liabilities.

Nearly 80% of respondents assign a ‘moderate’ to ‘high’ level of fear to the non-G-20 sovereign default risk, an extraordinarily high number who seem to feel such is likely to occur. Over 2/3 of respondents expressed similar fears about underfunded pensions, and ¾ expressed ‘moderate’ to ‘high’ fear around commercial real estate defaults.

The average assessments of each named risk are shown in the chart below. We note only slight fear around a G-8 sovereign default, the bottom in our list.



Conclusion

All that was gained in the first quarter of this year was given back in the second. Fear is on the rise, and the focus remains on sovereign and commercial real estate default risk, with underfunded pension liabilities surging to the forefront of survey respondent concerns.

No doubt there is substantial contagion risk, but with some positive anecdotal reports from a few respondents, perhaps there is a chance that this is just a pause and not the start of a second dip in economic activity.

Our next assessment will take place in September. 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. Which of the following risks do you fear will have a major impact on the status of the financial/economic crisis and feel may be likely to occur (Sovereign default (G-8 country), Sovereign default (G-20 country), Sovereign default (other country), Underfunded Pension Liabilities, Commercial Real Estate Defaults, Bursting of Chinese Asset/Credit Bubble, Equity market collapse (G-8 countries), Equity market collapse (other countries), Political transitions in G-8 countries, Political transition in China, Broad Labor Unrest, Rapid inflation in G-8 economies, Failed sovereign debt auction (G-8 countries), Substantial political/military conflict between countries)?

Ductibility, LLC

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

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>