Ductilibility, LLC

Crisis Sentiment Index:

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

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e) info@ductilibility.com • t) +1-507-301-3149 • f) +1-480-247-4773 • www.ductilibility.com

Ductilibility, LLC
401 Division Street South
Suite B
Northfield, MN 55057
USA

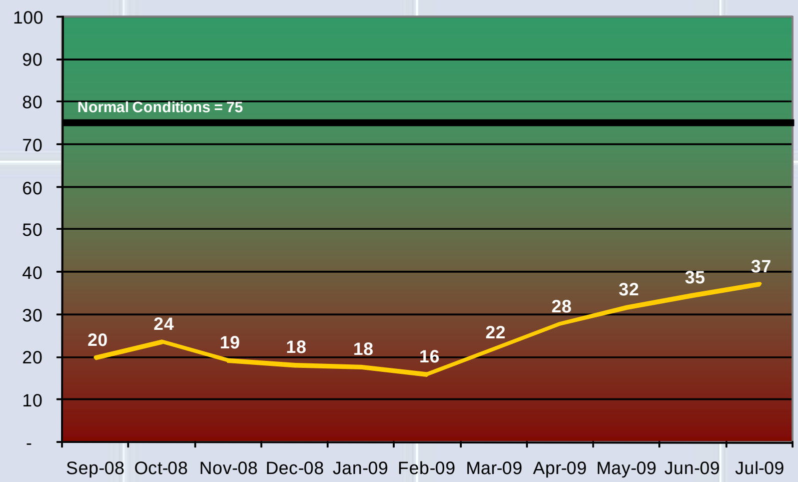
+1-507-301-3149

Executive Summary

The *Crisis Sentiment Index (**CSI**)* is a monthly assessment of the status of the current financial crisis by senior executives and board members around the world 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 July 2009 has improved to a reading of 37, up from 35 in June, the fifth straight month of improvement in sentiment. As with recent reports, it must be emphasized that a reading of 37 is still very negative. While we have seen continuous improvement in sentiment since February of this year, overall, the improvement is not robust. The CSI-Credit sub-index, one of our leading indicators, retreated in July, while the other leading indicator, CSI-Fear, showed healthy improvement by moving to a new high reading for the survey of 53.

Crisis Sentiment Index (CSI)



The decline in CSI-Credit follows a decline in CSI-Fear last month. The robust rebound in CSI-Fear this month is encouraging. With the exception of CSI-Hedge Funds and CSI-Credit, all sub-indexes improved in July. CSI-Money Markets showed strength similar to that of CSI-Fear, moving to a new high reading of 53, fully 33 points above its low of December 2008. There is still quite some distance before the overall CSI approaches normal readings and it is our belief that, given the slow rate at which sub-indices are improving, normal readings will not be seen this year.

This month we asked our respondents for their thoughts on whether the Goldman Sachs buyback of warrants at an apparent profit to US taxpayers was a good sign or an outlier. Details of their responses and full survey data are in the main report.

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

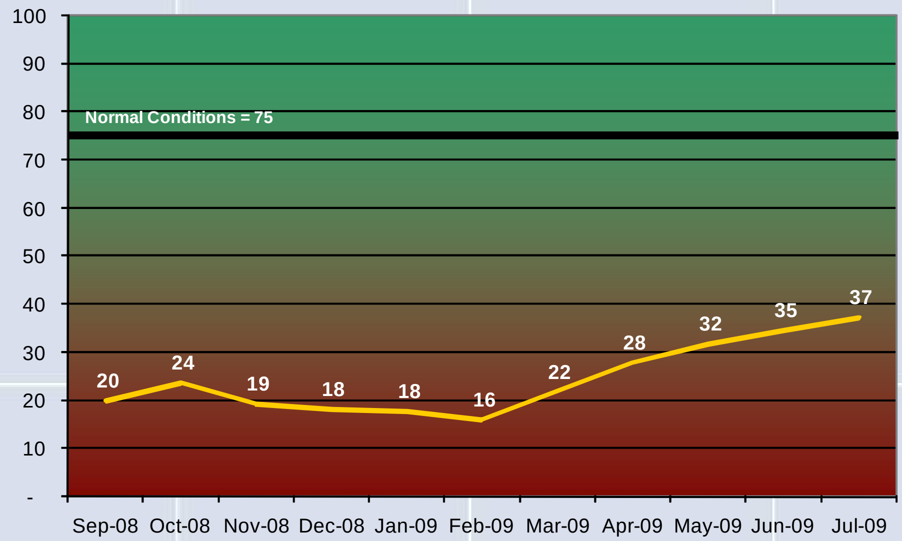
David R. Koenig

The survey was conducted between Wednesday July 22nd and Monday July 27th, 2009. 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 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 21 countries, 59% from the Americas, 35% from EMEA and 5% 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)



The slow and steady climb in the CSI from the lows of February this year continues. Now, slightly more than ¾ of respondents indicate their alignment with the two most positive assessments of the status of the credit crisis and more than 1 in 10 now believe the crisis is nearly over. A reading of 37 is still very negative and is reflective of both negative assessments of specific industries as well as a general caution regarding economic effects that have yet to fully materialize.

An EMEA Chief Risk Officer said, “We do see conditions gradually improving.” He continued by noting, “credit rating agencies have trimmed their expectations for the default rates from upward of 16% (last seen in 1933) to around 13%.” Most would suggest that this level of corporate defaults would still be disruptive and the uncertainty regarding coming months was noted by a Chief Risk Officer from the Americas who said that we “still have to see what will occur with commercial real estate, small business loans and credit card portfolios.”

Surprise problems, or at least those that seem to have caught some analysts off-guard were noted by two respondents. The first, a Head of Internal Audit from the EMEA region said “The Gosaibi-Saad saga (read article from The Economist) is enough to keep us on tenterhooks.” He continued by saying “talk of a “big name” going bad in Kuwait adds to the negative sentiment.” One North American Board Member suggests that if CIT does not survive, one sign of the status of the recovery will be “how aggressively competitors seek out the CIT customers.”

An EMEA Chief Risk Officer expressed worries, as well, about commercial lending, saying “we are certainly expecting the level of default in this sector to continue to deteriorate for the foreseeable future.” A Board Member from a bank in the Americas noted “most of our portfolio is real estate, commercial development and some commercial & industrial loans. There are signs of weakening, particularly among residential developments that have weathered the crisis thus far and now are showing weakness due to lower prices on troubled properties that are saturating to the market.” He continued, “With commercial and industrial and commercial real estate, there have also been signs of some weakening, but as far as we can see, these are loan specific factors that are the likely causes."

The lagged effect of rising unemployment was noted by several survey participants. Said one Chief Investment Officer from the Asia/Pacific region, "while [unemployment] keeps rising, you have to question the sustainability of any recovery." Seeing the crisis as one that comes in waves, an EMEA-based Head of Risk Management described the stages as "1st wave- large corporate, biggest real estate projects, financial institutions, hedge funds, 2nd wave- small and medium sized enterprises, micros, municipalities, 3rd wave- private individuals (employees of [those impacted in the first two waves]), small entrepreneurs and professionals." He stated his belief "in Europe it appears that the 1st wave is almost over and the 2nd wave is coming [with] impacts [that] will be less deep than in the 1st wave, but rather with wider range."

A general reading of the tone of comments left by respondents, as well as a look at how sentiment responses have been migrating over the past months, suggests that in absence of surprise disruptions to the markets, sentiment will gradually improve through the year, but will not reach "normal" levels anytime during 2009.

A Chief Risk Officer from the EMEA region believes the "crisis impact has been addressed in a proper way. Now, we need to prepare for an exit strategy which envisages a gradual mopping up of liquidity." A Board Member from the Americas said "we sense an easing of the crisis both in the markets and in business in general." She continued, "There will be no return to pre-crisis profit numbers, however, for a considerable time for the majority of businesses. There is where we see a slow build back that might take five years or more."

Additional comments:

"There are two perspectives here. On a more micro level, businesses seem to have adjusted to the crisis, and are patiently waiting out the change in demand. On a more macro level, the combination of low interest rates and deflation increases real risk premia, and the expectation of potentially higher interest rates in the coming years may erode any signs of optimism." – Americas Board Member

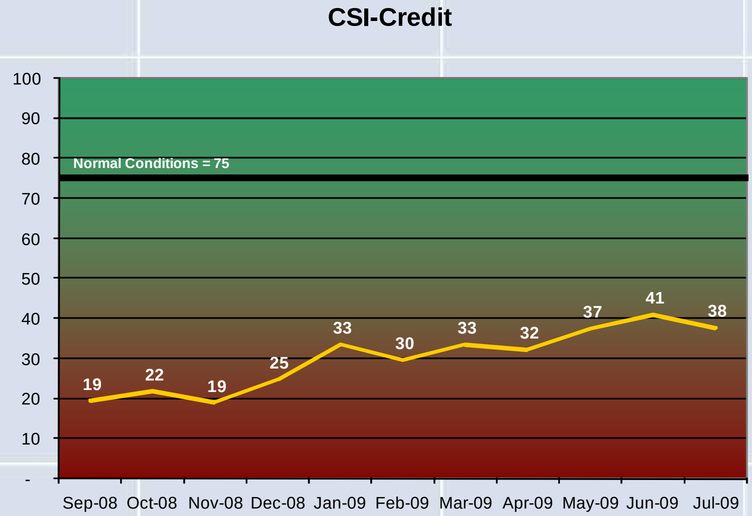
"The data is mixed so it is difficult to see through the haze. Many, including the gov't, are so focused on highlighting the good bits and 'hiding' the bad bits that the system is not being allowed to deal with issues in an efficient, market driven manner. Senior creditors (ie banks) are extending terms to keep insolvent firms in business so they can avoid writing down loans which ultimately makes the recovery worse, especially for the jr lenders. This type of behavior will not improve credit markets and, therefore, will exacerbate the crisis." – Americas Chief Operating Officer

"Most of it is behind us in terms of credit crisis. This crisis was about showing that the world economic balance has shifted to the East." – EMEA Head of Investments

"I think it's early yet to talk about the crisis being over, after all banks still have the toxic assets on their balance sheets. The only dynamic that has changed is that most governments and Central Banks have exhausted their fiscal and monetary "firepower" to properly clean bank balance sheets. Add to this the growing unemployment (which several economists have indicated will not go away soon even with modest recovery), low consumer confidence and new found "saving culture" that is emerging in the US and other parts of the world will not help either." – EMEA Head of Risk Management

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 have deteriorated slightly this past month, with the CSI-Credit sub-index falling back towards the range seen since the beginning of the year.



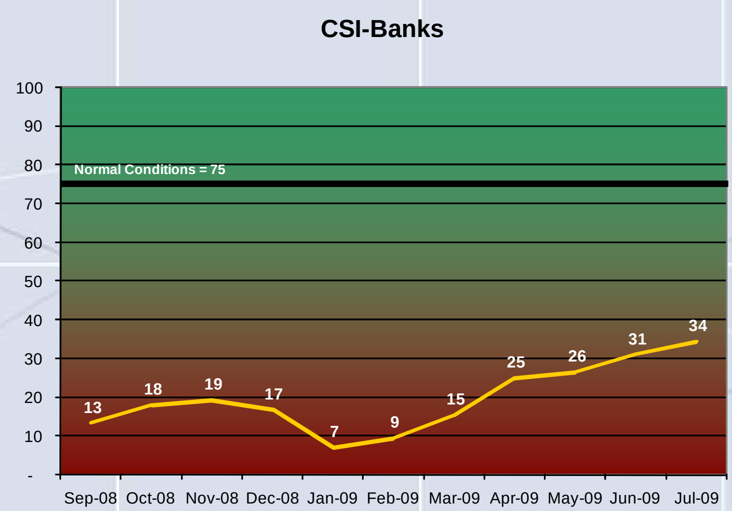
Coming in at a reading of 38 in July, the CSI-Credit had risen for two straight months before the decline in July. While users of credit seemed to report better availability of credit in the past month, more providers of credit said that they had tightened conditions than had loosened them.

Almost 30% of credit users felt that conditions in terms of the availability of credit had improved, with slightly more than 20% saying they had deteriorated. A Chief Risk Officer from the EMEA region said "[it] depends upon what part of the world you are working in…in some areas like South America we are expanding and in other areas like Asia we are consolidating/liquidating portfolios."

More than ¼ of credit providers reported a tightening of credit availability, which is up from 17% last month. This is a fairly modest deterioration, and there were some positive comments left about credit availability, including an Americas Board Member who said "small business commercial and industrial lending is still very active at the community-bank level."

It may well be that the decline in this sub-index is reflective of last month's deterioration in the CSI-Fear sub-index reading of anxiety in the public and among professionals. As noted later in this report, that sub-index rebounded sharply this month. So, perhaps credit availability will also improve next month

Industry-Specific Assessments

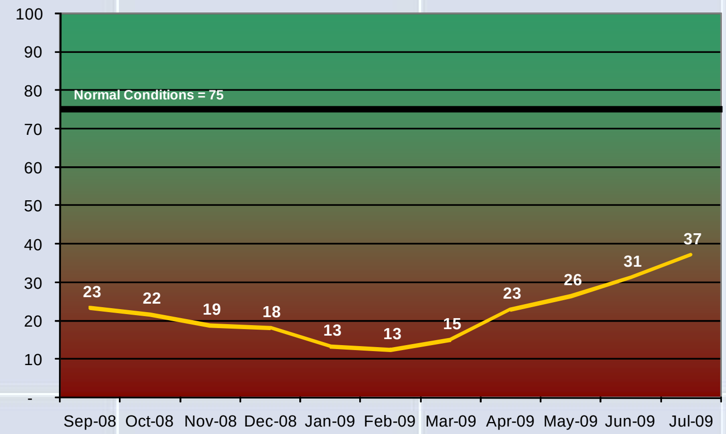


The CSI-Banks sub-index is a weighted index of sentiment as expressed via a specific question about the likelihood that at least one major bank will fail or be taken over as a result of the crisis and the primary question of the survey.

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 7% choosing this option in July, down from 11% in June. Four in ten respondents now disagree that another major bank will fail as a result of the crisis, leading to an increase in the sub-index value to 34. This marks the sixth month in a row that the CSI-Banks sub-index has improved, albeit to a level which is still very negative.

Said one Chief Credit Officer from the Americas, "there are large regional banks that are still at significant risk." Meanwhile, a Board Member from the Americas feels "commercial real estate will drag down at least one more large bank."

CSI-Insurance



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.

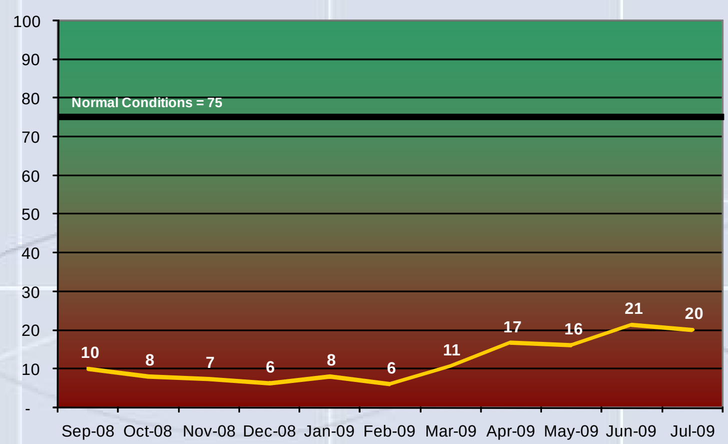
For the fifth straight month, this sub-index has improved, moving to 37 in July, up from 31 in June and the best assessment of the industry since our first survey in September of 2008.

Both CSI-Banking and CSI-Insurance are well below 'normal' readings and their slow ascent, to levels less negative than early in this year, reflect sentiment that is still negative in absolute terms.

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 less than 35%, whereas it was over 80% in the March assessment.

Sentiment towards hedge funds deteriorated slightly, registering a reading of 20 on the CSI-Hedge Funds sub-index. At 55 points below normal, this industry continues to receive the most negative assessment by our respondents of any.

CSI-Hedge Funds

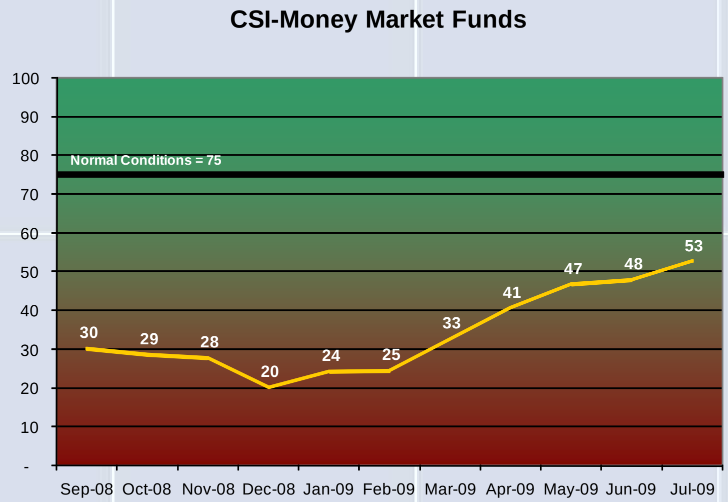


"Hedge funds have become more prudent in their use of leverage, some of them by [necessity] as the cost of borrowing from prime brokers makes it prohibitive to employ leverage and others by choice," noted a Chief Risk Officer in the EMEA region.

Five times as many respondents agree that it is likely another major hedge fund will close as a result of the crisis as disagree.

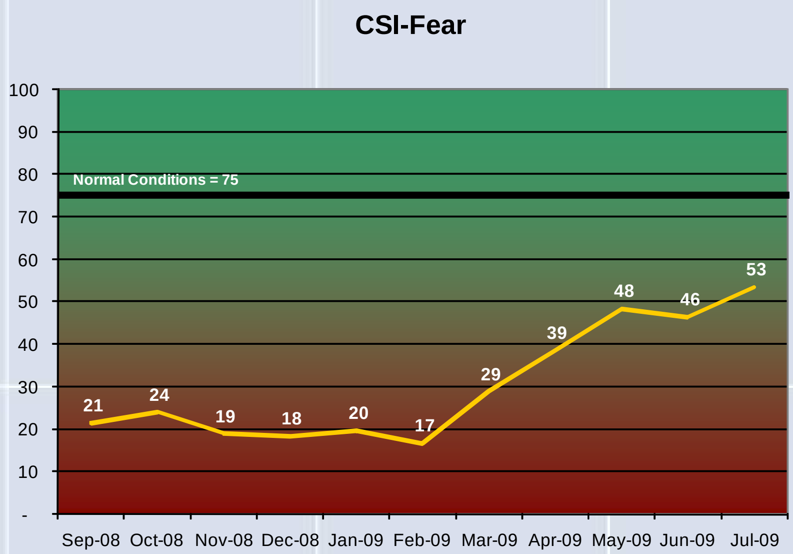
Sentiment regarding the likelihood that another money market fund will "break the buck" has improved for the seventh month in a row. The CSI-Money Markets sub-index rose to a reading of 53 in June. We look for a reading in the 60's on this index to be one of our first signs of a return to normalcy.

Nearly 60% of respondents disagreed that another major money market fund will "break the buck" as a result of the crisis, while 14% still believe it likely that one will.



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.



While during Jun there was a slight deterioration in the sentiment regarding the growth of fear among both professionals and the public, a sharp improvement in sentiment regarding fear was reported during July.

The CSI-Fear sub-index rose to its highest level since we started this survey, reaching a reading of 53.

With the sentiment towards Money Market funds improving, if we see a return to movement away from tightening credit, we expect CSI-Fear to be the first of our sub-indices to reach a reading above 60. While 75 is considered to be a reading indicative of "normal" levels of fear, any reading above 60, especially given the events of the past year, will make fear a non-factor in our study.

A Chief Credit Officer in the Americas believes "the critical issue right now is how long households' saving propensity will continue. Once people start spending again, the crisis will start waning." There is some belief among respondents that equity markets may have gotten ahead of themselves in recent weeks. A Chief Investment Officer from the Asia/Pacific region believes this is the case and says "it seems unlikely that they can sustain this lead unless the real numbers start turning positive rather than simply declining less." It would seem likely that any substantial sell-off in equities worldwide, or in major economies, would put a damper on the ascent in the CSI-Fear sub-index.

Was the Goldman Sachs buyback of warrants from the US Treasury an outlier or positive indication of things to come?

As was widely reported in the press, Goldman Sachs seems to have rid itself of the stigma and restrictions of the US TARP program by buying back the warrants it issued to the US government as part of the program. This action by Goldman, seen by many as the one firm that has distinguished itself from the crowd on Wall Street during this crisis, was viewed by a majority of respondents as being an outlier event.

The majority view in this case was not overwhelming, however, with just 55% believing the buyback to be something unique to Goldman Sachs and 45% indicating it likely to be a sign of positive things to come.

A Board Member from the Americas noted "Goldman is an outlier and although Morgan Stanley is following suit in repaying TARP, they are left behind even further. The last six months have cemented Goldman Sachs as the undisputed player on the field.' He continued, "But, the question is when will the distorted level of risk appetite equalize, so that Goldman Sachs' willingness to buy risk cheaply is replaced with a marketplace that more soberly prices risk."

The Head of Internal Audit from an EMEA-based firm says that while it is a positive sign "one or two swallows do not make a summer." While a Chief Financial Officer from the Americas thinks that the "repayment…is seen as a measure of more financial stability for the player. Thus [because of competition] others will be driven to do the same."

A Board Member from the Americas believes "there will be significant gain from additional buybacks, but Treasury will reap rewards [in]adequate for the risks it assumed." Similarly, an EMEA Board Member is "confident that [Goldman Sachs] have made more profit off of this government money than the government has made."

Other comments from participants in the survey include:

"Goldman Sachs was the 10th or 11th bank to repurchase the TARP warrants. They were the first to show an increase in share-price at the time of the repurchase (pay a profit to the Treasury). I believe this is a positive sign that the repurchase was not an outlier and that banks continue to improve shareholder value and capital." – Americas Board Member

"There are two groups of companies that received government support - strong companies like Goldman that needed short-term help and are or will be paying the money back soon and weak companies that will need a long time to pay back the money." – Americas Head of Risk Management

"'A sign of good things to come' is inappropriate phrasing. Given the tremendously supportive environment (fiscal, monetary, accounting, political), the only banks unable to generate outsized profits given a negligible cost of funds are those with heavily geared legacy balance sheets. The direct government support for banks at far below market rates was an arbitrage of sorts, so a repayment of a mispriced liability does not really warrant further comment." - EMEA Chief Risk Officer

"A positive sign, some banks now have or are generating surplus capital which may mean a round of consolidation may occur for small to medium sized banks, so some banks may be taken over in a

positive manner. Goldman remains ahead of the curve when compared with its competitors.” – EMEA Head of Risk Management

“Outlier. Goldman is a unique case and the buyback was a move to allow them to get back into a competitive executive compensation range.” – Americas Board Member

“This is one of the signs that the crisis has not yet changed the governance within investment banks” – EMEA Head of Risk Management

Conclusion

The slow and steady improvement in sentiment towards the crisis continues. Taken as an absolute reading, the CSI is still in highly negative territory, dragged down primarily by continued negative sentiment towards much of the financial sector and fears of additional waves of problems caused by commercial real estate, ongoing unemployment and the potential for additional, surprise shocks to the system.

The bright spots are a substantial reduction in fear among the public and market professionals, as well as some belief that stability has returned to short-term money market funds. If we see the next few months pass without major incidents in the markets, we should expect to see fear become a non-factor in terms of its impact on business and credit decisions.

Expectations are, however, that the CSI will not approach levels anywhere near those reflective of “normal” conditions during 2009.

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. Is the Goldman Sachs buyback of warrants from the Treasury (at an apparent profit to Treasury) a sign of good things to come from others who received government support or is it more likely to be an outlier? Please share your thoughts.

Ductilibility, LLC

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

Contact:

David R. Koenig
Principal

email) david.koenig@ductilibility.com
telephone) +1-507-301-3149
fax) +1-480-247-4773
videoconference) http://199.199.129.246

web) http://www.ductilibility.com