Ductilibility, LLC

Crisis Sentiment Index:

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

August 31, 2009

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

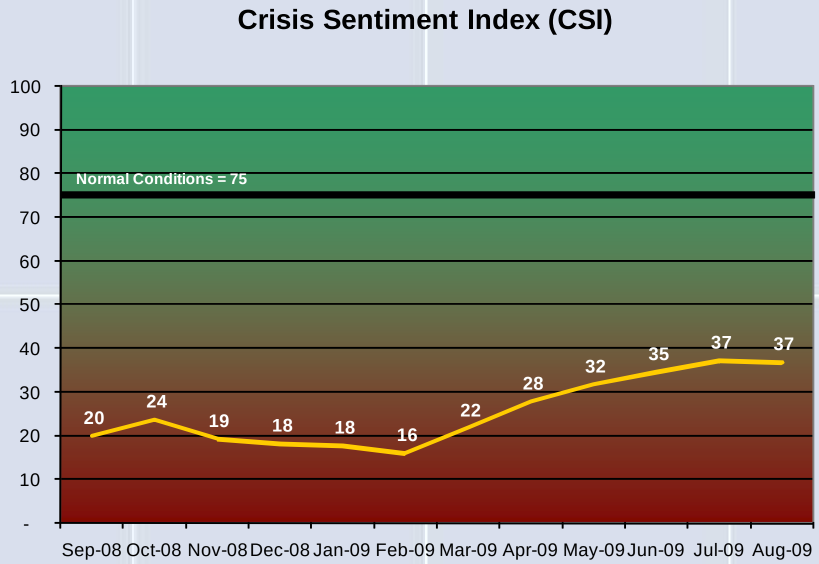
Ductilibility, LLC
401 Division Street South
Suite B
Northfield, MN 55057
USA

+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 August 2009 was 37, unchanged from the July reading, which ends the string of five straight monthly improvements in sentiment. While equity prices in some key markets continue to rise, the general sentiment among survey participants is one of skepticism and caution.



There was a modest retreat seen in participants’ attitudes towards most industries, with the exception of hedge funds, where the CSI-Hedge Funds sub-index improved to a reading of 25, its highest level since the survey started. This reading is still 50 points below “normal”, hence it is not an overall positive expression of sentiment. The availability of credit seems to have improved slightly with CSI-Credit increasing to 41 from last month’s 38. CSI-Fear declined slightly to a reading of 50. We had hoped to see a continued improvement in that sub-index as a forerunner to a general improvement in the CSI.

This month we asked our respondents for their thoughts on whether the re-nomination of Ben Bernanke was justified. 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.

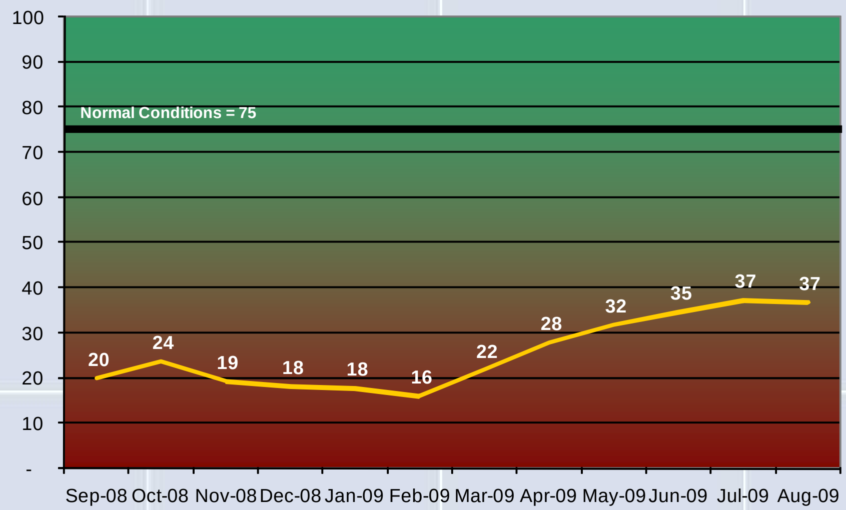
David R. Koenig

The survey was conducted between Wednesday August 26th and Friday August 28th, 2009. Survey participants typically hold the titles of Chief Risk Officer / Heads of Risk Management, Board Director or other C-Level title. Seventy-six 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 18 countries, 58% from the Americas, 37% 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 paused in August. Despite increases in major equity market prices of between 5% and 10% since last month's study, the level of skepticism about the prescience of these markets is keeping views on risk firmly in the camp of caution, leaving the CSI unchanged at a reading of 37. On the positive side, this month only one respondent stated they "expect a worsening of the crisis" and over 80% of respondents indicate their alignment with the two most positive assessments of the status of the credit crisis. It seems that our survey group, though, is still in need of seeing a passing of the threat of a double-dip recession and is keeping watch that recent lessons are not too quickly forgotten.

Said one Chief Risk Officer in the Americas "I personally believe the worst is over, but preparation for a reversal is in place since this recession is unlike any others." Similarly, a board member from the Americas said "We see the light at the end of the tunnel." But cautioned, "The question is whether what we see is the credit crisis train in reverse or we are close to the end…we are strongly motivated to keep our guard up."

Keeping up a guard remains a common theme among survey respondents. An EMEA Head of Risk notes that they have adopted a defensive posture in their portfolios, despite believing that the worst is behind us, saying "[we are] awaiting the traditional September swoon in the equity markets."

One board member from the Americas expressed concern that the apparent improvement in conditions would weaken the political will for important reforms, suggesting that August was "a good month economically, but politically, reform seems to be fading."

Some respondents worried that new asset bubble had grown out of the crisis and government responses to it. One EMEA Head of Risk Management pointed to China as evidence of one bubble and another asked "did someone forget to remind the Asian markets that their economies are not as vibrant as they once were?" A Chief Risk Officer in the Americas said it "seems like we're inflating another financial market bubble - and yet a lot of uncertainty still exists relating to federal deficits, inflation and the dollar."

Surprise inflation risks also were noted. A Chief Risk Officer in the Americas worries about a spike in the velocity of the money supply in the US, saying "the Fed needs to start raising rates to head off incipient inflation."

Either equity prices are climbing a "wall of worry" or the inconsistencies and risks seen by those in our study will present a challenge to continued asset price increases.

Additional comments:

"Supporting availability of credit is not a sustainable strategy and some financial impacts have yet to work their way through properly." – EMEA Head of Risk Management

"The systemic risks have reduced all indicators are improving (VIX, TED Spreads and LIBOR), the economy in some countries is improving but there remains risks to the recovery in all countries." – EMEA Head of Risk Management

"Even though the there are some positive signs such as better collection results, improved payment capacity from the clients and improved deposit balance, we are preparing for a possible shock that may hit us in the last quarter." – EMEA Board Member

"I continue to believe that there are significant losses to be posted and that such assets as CRE and credit card are only showing their tip of the iceberg. Additionally, there will be an increase in bank failures especially in the Thrift category here in the U.S. - those heavily exposed to residential mortgage lending as mandated by their charter." – Americas Chief Risk Officer

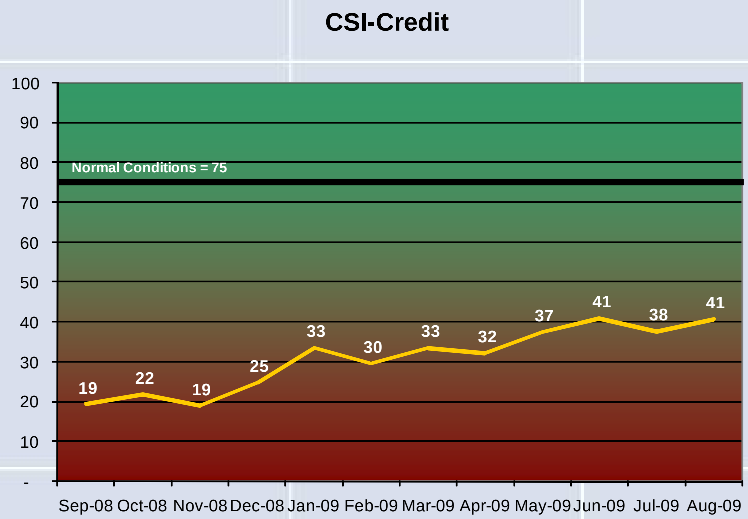
"There remains a risk of a W shaped recovery, consumers are sitting on their hands. Systemic risks appear to be behind us. Many in the US / UK are debt burdened and credit remains a problem for companies and individuals. We still appear to be at the start of the recovery phase which will take a long period to return to pre crisis levels." – EMEA Head of Risk Management

"My primary concern is managing market and investment strategy once investors realise that the private sector may not be in a position to lead growth once government stimulus declines. A continuation of the easy fix may increase actual inflation pressures in the medium term just when asset markets may be approaching cyclical highs again." – EMEA Chief Risk Officer

"We are very positive in that we believe we've reached the wall on the other side of the trough. Unfortunately, I don't believe the far wall is steep but rather a very slight incline that may persist for the next 9-12 months (slow but sure growth hopefully)." – 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 most recent weeks leading up to our survey. Credit availability seems to have improved again, slightly.



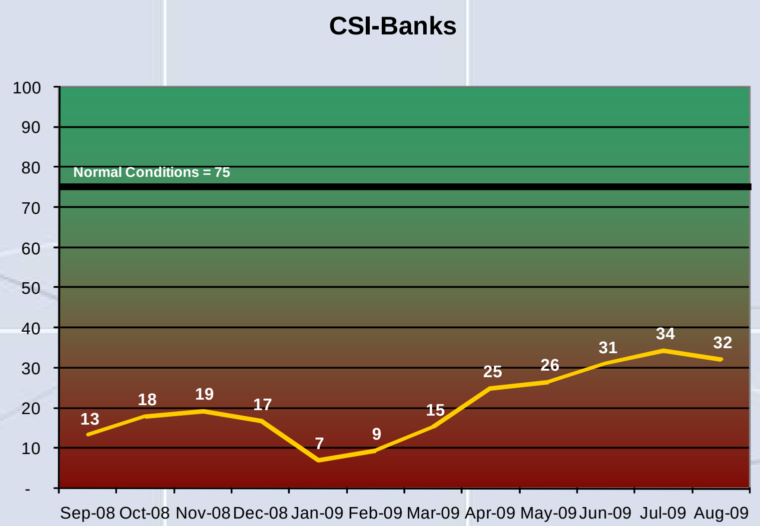
Coming in at a reading of 41 in August, CSI-Credit is at its highest level since our survey began, equal to where it was two months ago. Over 30% of credit providers report making credit more available in the past month, while just over 21% report a reduction in the availability of credit.

In roughly equal proportion, nearly 25% of users of credit report seeing an improvement in the availability of credit, while just 16% report that credit conditions are more restrictive.

“As a result of our government's efforts in the autumn of last year, we are now well and truly hyper-liquid, like many of the best banks in our country,” reports an EMEA Chief Risk Officer. An Americas Chief Financial Officer reports a change in terms on their line of credit, but no demand to use it, “We have a line of credit that was based on receivables. The collateral has since transitioned from receivables to real estate to have a more stable base. Regardless, the line of credit remains unused.”

Industry-Specific Assessments

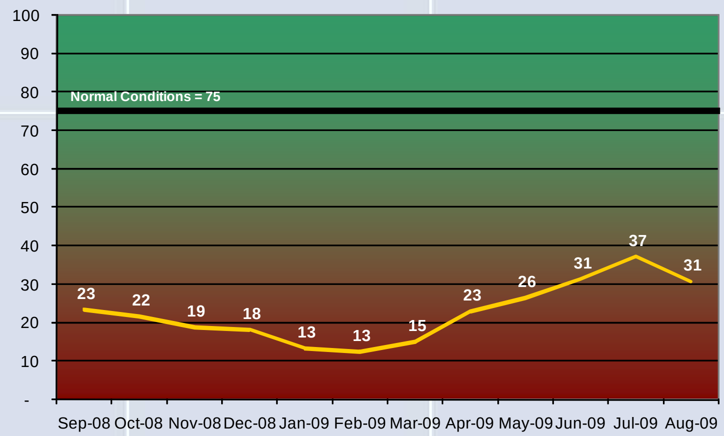
The CSI-Banks sub-index is a weighted index of sentiment as expressed via the primary question of the survey and a specific question about the likelihood that at least one major bank will fail or be taken over as a result of the crisis.



More than half of this month’s respondents feel that another major bank will fail or be taken over as a result of the crisis. Last month, the percentage was roughly the same, but this month, more respondents “strongly agreed” that such would be the case. As a result, the CSI-Banks sub-index has fallen to a reading of just 32 in August.

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.

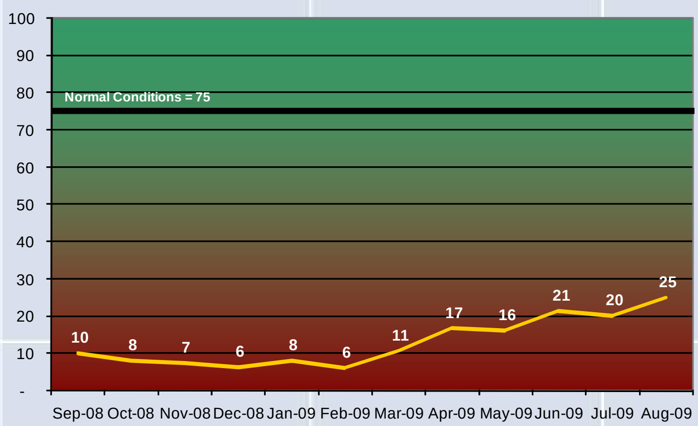
CSI-Insurance



All of the gains in the sub-index seen in July were erased in August. There was no clear indication among respondents as to why there was such a sharp reversal, but the sub-index has fallen to a reading of just 31, almost 45 points from what would be considered "normal" conditions for Insurance companies.

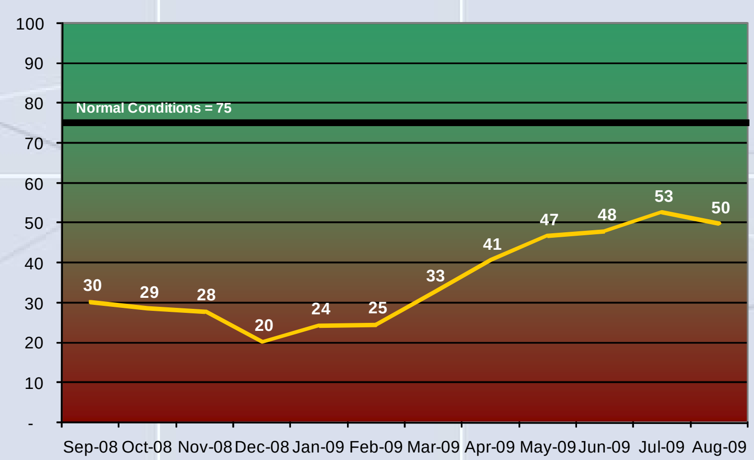
The percentage of respondents who agree or strongly agree with the statement that "*at least one major insurance company will fail or be taken over as a result of the crisis*" rose back above 50% this month. It had dropped to 35% last month. Just 30% of respondents disagreed that there will be some kind of failure or consolidation among major insurers and only one respondent was confident enough in the industry to "strongly disagree" that such would occur as a result of the crisis.

CSI-Hedge Funds



With more news appearing that seemed to suggest assets were flowing back into Alternative Investments, sentiment towards hedge funds improved, bringing the CSI-Hedge Funds sub-index to its highest level since our surveys began. The reading of 25 in August, though, did nothing to change the assessment of this industry as the direst among those we review.

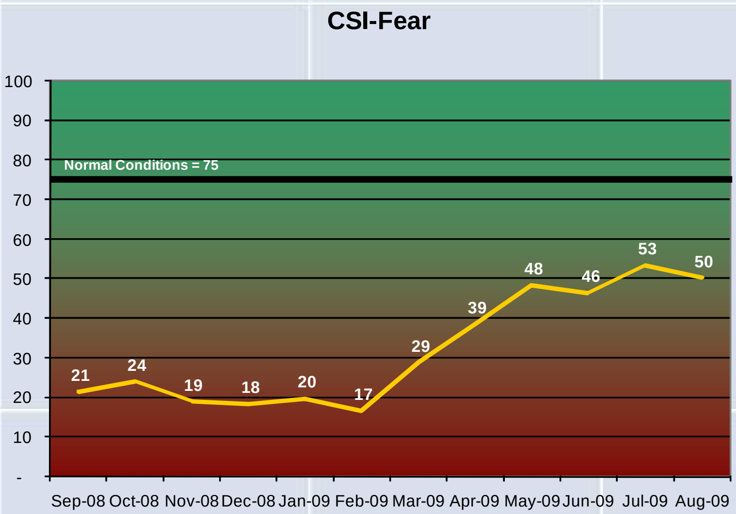
CSI-Money Market Funds



Sentiment regarding the likelihood that another money market fund will "break the buck" has declined in August. The CSI-Money Markets sub-index fell back 3 points to a reading of 50. We had been looking at the possibility of this being the first sub-index to return to levels above 60, but such was not to be the case. Only 20% believe it likely that a money market fund will "break the buck" as a result of the crisis, but this is up from 14% last month.

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.



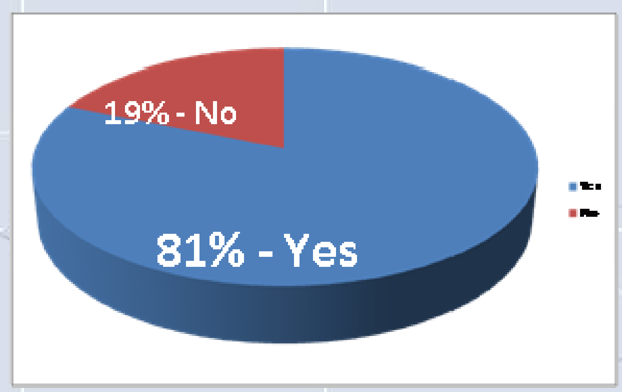
Despite the rally in equity prices, the CSI-Fear sub-index fell back to a reading of 50 in August. Like CSI-Money Markets, we expected CSI-Fear to be one of the first indicators to cross back above 60, removing "fear" as a major element standing in the way of more robust investment and spending, as well as more available credit.

Recent news about the expected size of US federal budget deficits reaching $9 trillion+ in the next ten years may be one contributing factor. "In the U.S. I think there's a growing concern with government debt and budget deficits," noted one senior executive in the Americas. Similarly, a board member in the Americas stated "The fears in the market are increasingly focused on the deficit and the impact on the US dollar long term." Continuing, "Today, there is too much uncertainty to resolve these fears."

A Chief Credit Officer in the Americas believes "The reorganization of financial institutions is far from over and should lead to continuing layoffs, inducing fear among professionals."

If it was your decision, would you re-appoint Ben Bernanke as Chair of the Federal Reserve Board of Governors?

"Helicopter Ben has done a commendable job," states an EMEA Head of Risk Management. Others in our survey group seem to agree. When asked about the decision to re-appoint Ben Bernanke as Chair of the US Federal Reserve Board of Governors, more than 80% of respondents who expressed an opinion said that they would.



But, the numbers may be a bit deceiving in terms of their endorsement of the man, versus a reflection of the situation in which the man finds himself.

Respondents don't give the Chairman a pass on culpability for the cause of the crisis. In fact, several argued that he played a role in its start and/or in its worsening. It seems that the fear of the impact of a change in leadership at this point in time plays more of a role in their bias towards re-appointment than does his performance in battling its impact. “It is bluntly wrong to re-appoint someone that failed totally in foreseeing or taking measures or any other pro-active reaction towards the crisis,” said an EMEA Chief Compliance Officer, “the problem is that it is very difficult to find another central banker, so there is no choice than re-appointment.” Similarly, a Chief Operating Officer from the EMEA region asked “Is there a credible alternative?” Continuing, he said Bernanke had “steady hands once the crisis erupted, but was complicit pre-crisis (2007 and earlier) of stoking the bubble.”

One respondent, a Chief Credit Officer in the Americas, was more ebullient, saying “Bernanke has saved the US (world?) economy from a repeat of the Great Depression.” But, perhaps capturing group sentiment best, an EMEA board member simply said “in for a penny…in for a Pound.”

Conclusion

Taken as an absolute reading, the CSI remains in highly negative territory. Respondents see ample opportunities for a stumble in the recovery, or perhaps even an expectation of a 2nd leg down in a “w-shaped” cycle.

With CSI-Fear and CSI-Credit seeming unable to break-out of their recent ranges, there seems to have been a stalling in the improvement of sentiment among board directors, chief risk officers and other c-level executives in our study.

It is our expectation that we will need to see the balance of this year go without major incident for the ascent in the CSI to anything close to “normal” levels. The question is whether equity markets have it right, or if they have been inflated by false expectations or other unsustainable factors.

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. If it was your decision, would you re-appoint Ben Bernanke as Chair of the Federal Reserve Board of Governors?

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

web) http://www.ductilibility.com