Approaching Credit Decisions in a Post-crisis Environment

Amanda Duisman
Vice President & Treasurer
Amyris, Inc.

Melina Hadiwono, CFA
Head of Credit Research
SVB Asset Management
Agenda

• Common approaches and challenges faced by corporation and asset managers

• Optimizing diverse information channels and analytical tools

• Avoiding potential conflicts of interest with outside vendors

• Importance of independent corporate cash-focused research

• Creating a corporate cash management-focused credit process

• Identifying suitable issuers and implementing a surveillance process
Any Questions?

Most presentations end asking “Any Questions?” Ours begins with this approach:

You should have a lot of questions as you approach credit decisions.
Pre-2007 Approach

- What do Moody’s and Standard and Poor’s say about credit risk?
- Write a credit policy based on published credit ratings and follow the rule.
Post-2007 Approach

• How should our company conduct an internal credit review?
• How current does the information we rely on have to be?
• How often should we perform credit checks?
• What is the staff time required to adequately assess creditworthiness?
Use of Metrics

- Liquidity ratios
- Working capital as a percentage of sales
- Cash as a percentage of short term debt
- Quick ratios
- Current ratios
Recent News – Warning Signs

- Late filings of financial statements
- Lenders renegotiating terms
- Delisting threats
- Executives resigning
Check Credit Every Sale or Purchase

- Check credit each time rather than relying upon a once-a-year check
- Review credit more rigorously if payment terms are extended or purchase of a security is of a longer tenor
- For investment purchases, ask for the prospectus and then read it
Sample of Credit Vendors

- Dun and Bradstreet
- Investortools, Inc.
- Credit Risk Monitor
- Credit and Management Systems, Inc.
- Experian
Identifying a Philosophy

Know where you’re going via:
- Direct access to a buy-side-only credit team
- Direct access to a true portfolio manager
- High transparency on risk, compliance and credit

Communicate with boards, committees and peers via:
- Demonstrated oversight
- Clear understanding of the fundamental risks of each investment type
- Digestible ways of communicating risk

Raise your value by:
- Eliminating the “Don’t know what you don’t know” phenomenon
- Abolishing the need to “trust” managers to do the right thing
- Being able to drive more return per unit of risk
Know the Key Factors Affecting Your Portfolio

Fed Funds Outlook

Possible sovereign debt defaults

Credit quality

Tax-rate outlook

Employment data

Other regulatory changes

Money fund rule changes

Mid-term elections

Expiration of unlimited bank account deposit insurance

Earnings announcement

Constituent influences

Trading partner health

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Risk Framework: Policies and Controls

Implement Policies and Controls

Review Compliance with Investment Policy

Monitor the Portfolio

Establish a Platform
Risk Framework: Control Overlays

- Investment Manager
- Control Overlays
  - SAS 70
  - Transparency
  - Independent safekeeping
- Reporting
- Custodian
Risk Framework: Daily Compliance and Credit Quality Verification

Daily investment policy

- Compliance analysis.

Each investment policy parameter tracked against its allowable limits. Keep historical violations on record.
Your Asset Managers’ Credit Platforms – The Importance of an Independent and Dedicated Team

Focus

• Capital preservation, sufficient liquidity
• Credit oversight without divided loyalties
  – Do they have a dedicated corporate cash investor perspective
  – Are their approved issuers ‘the last word’
  – Who decides when to sell?
  – Credit decisions entirely independent from portfolio structuring
• Emphasis of fundamental analysis of a smaller number of asset classes, in the high-grade, highly liquid corporate cash investments universe

Goals

• **Know the answer to the question:** “If committees need to discuss the credit risk of individual investments, should my manager be making such investments?”
• Avoid default risk & liquidity traps
• Minimize downgrade risk & headline risk
• Cash investment risk has small upside, tremendous downside.
• Never lose sight that shareholders and boards want firms to focus on business risk.
Demand Direct Access and Timely Support

Ensure communication and service level agreements by having managers:

- Provide direct access to credit for audit support and portfolio reviews
- Commit to ‘real time’ communication of rating downgrades, focusing on rating updates, analysis and recommendations
- Provide credit write-ups upon request
Credit Process: Disciplined and Methodical

1. Identify suitable issuers and then ensure fit with clients’ investment policy
2. Thorough in-depth research and rigorous decision-making process
3. Established controls within systems and processes
4. Ongoing surveillance of issuers and their industries and *when to sell* procedures
Continual Surveillance and Proactive Action: Crucial When there is a Relevant Market Event

Team Expertise

Meticulously screened list of credit issuers deemed highly credit-worthy

Investment Committee
Regular review of sector selection, asset class allocation, maturity profiles and issuer concentration

Daily Surveillance
Continuous daily review of issuer news and financial data

Sell-side Research

Credit Services

Industry Reviews

Quantitative and Qualitative Analysis

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Surveillance, Research and Analysis

- Securities and Exchange Commission (SEC)
- Federal Reserve
- Treasury Department
- Federal Deposit Insurance Corp (FDIC)
- House Committee on Financial Services
- International Monetary Fund
- Senate Committee on Banking, Housing, and Urban Affairs
- European Central Bank
- Federal Housing Finance Agency
Identify Issuers – Key Criteria for Approved Issuers

Keep Every Dollar Safe (KEDS)
1. Understanding of the business
2. Strong franchise value
3. Diversified business lines
4. Strong balance sheet and cash flow generation
5. Strong liquidity profile
6. Robust capital to absorb downturns
7. Management with solid track record
8. Minimal headline risks
9. Quality and timeliness of the disclosure
10. Strong collateral performance and sponsor’s interest alignment for asset-backed securities
11. Knowing when to sell vs. when to stop buying

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Credit Process in Action: Bear Stearns Downgrade

- 3/08: Moody’s downgraded to Baa
- Fitch downgraded to BBB
- S&P downgraded to BBB
- Fitch upgraded to A-
- JP Morgan announced acquisition of Bear Stearns
- S&P upgraded to AA-
- 6/08: Fitch upgraded to AA-
- 7/08: Moody’s upgraded to Aa2
- 10/08: Moody’s downgraded to Aa3
- 12/08: S&P downgraded to A+
- 11/07: S&P downgraded to A
- 11/07: Moody’s downgraded to A2
- 6/07: Removed from approved list
- Moody’s (A1/P 1) S&P (A+/A 1) Fitch (A+/F1)

*Graphs show relative volatility of the 5-year CDS spread (benchmark to gauge credit risk linked to bonds or loans). Source: Bloomberg
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Credit Process in Action: Lehman Brothers Downgrade

LEHMAN BROTHERS

3/2008: Removed from approved list
Moody’s (A1/P-1) S&P (A/A-1)
Fitch(AA/F1+)

Fitch downgraded to A+

Moody’s downgraded to B3
S&P downgraded to D
Fitch downgraded to D

Filed for Chapter 11

Moody’s downgraded to C

*Graphs show relative volatility of the 5-year CDS spread (benchmark to gauge credit risk linked to bonds or loans). Source: Bloomberg

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Credit Process in Action: Fannie Mae and Freddie Mac

Fannie Mae and Freddie Mac stocks as investors have increasingly lost confidence in their ability to weather the ongoing real estate downturn. U.S. Treasury and the Fed announce several actions to support the GSEs.

- SVB Asset Management imposed investment limit for Fannie Mae and Freddie Mac to 5% each due to significant deterioration in financial performance, headline and funding risk concerns.
- Moody's - Fannie Mae (Aaa/P-1) - Freddie Mac (Aaa/P-1)
- S&P - Fannie Mae (AAA/A-1+) - Freddie Mac (AAA/A-1+)

Major sell off of Fannie Mae and Freddie Mac stocks as investors have increasingly lost confidence in their ability to weather the ongoing real estate downturn. U.S. Treasury and the Fed announce several actions to support the GSEs.

- U.S. Treasury placed both Fannie and Freddie under the conservatorship of their regulator, FHFA, established a new lending facility and a senior preferred stock purchase agreement.
- The Fed announced Fannie, Freddie and FHLM direct obligations and MBS purchase program.
- Treasury increased funding commitment to $200 Billion each under preferred stock purchase agreement.
- SVB Asset Management increased investment limit to 15% each.

Fannie and Freddie’s CDS are no longer traded since placed under conservatorship.

*Graph shows relative volatility of the 3-year CDS spread (benchmark to gauge credit risk linked to bonds or banks). Source: Bloomberg.*
Spread History and Market Volatility are Important Liquidity And Credit Considerations

One-Year Spread Between Treasury and Agency

Market disruption created wider spreads

The market has since settled down

Source: Bloomberg, SVB Asset Management
Money Funds Were Not Created Equal, but They Became that Way…

• Money funds are significant credit intermediaries or quasi banks but without:
  • FDIC guaranteed deposits
  • Regulatory and capital rules
  • With homogenous asset concentration
  • With less certainty of liabilities (withdrawals) relative to assets
  • With future exposure to a currently unknown risk (or perceived risk) that affects each one of your peers as well

• *The susceptibility of money funds to investor flight risk have not been addressed by SEC*

• The “Bottleneck Effect”

• *Because of these disadvantages, in addition of understanding a fund’s risk mitigation efforts, these factors matter :*
  1) *The solid integration into a larger financial provider*
  2) *Your ability to gain access to the fund provider*
  3) *The independence of the fund provider from your asset manager*
Surveillance of Money Fund Providers Requires the Same Rigorous Due Diligence

- **Assess**: Proactively assess strength and stability of the funds in changing economic environment

- **Review**: Conduct regular reviews of liquidity profiles, investment exposures, asset allocations, funds risk metrics and fund asset stability

- **Communicate**: Maintain regular communications with fund managers to review strategies and shareholders’ concentration, and assess preparedness in changing economic environment
  - Fact sheet, holdings list
  - SEC letter, ICI website
Conclusion

- Redefine your philosophy based on the possible use of the funds
- Create a comprehensive strategy beginning with a Fed outlook and followed by other major decision points
- PLUG IN - and don’t expect to unplug until your cash is gone
- Constantly re-evaluate both your decisions and the decisions of your investment partners

What you need to do

- Stay on top of your portfolio
- Satisfy auditors
- Present to the board
- Perform due diligence
- Be up to date in the market
- Be aware of your relationships
Questions?
Speaker Contact Information

Amanda Duisman, Vice President & Treasurer, Amyris

E-mail duisman@amyris.com
Phone 510.450.0761 x559
Speaker Contact Information

Melina Hadiwono, CFA, Head of Credit Research, SVB Asset Management

E-mail mhadiwono@svb.com
Phone 415.764.3155
For More Information

SVB Asset Management

- Portfolio Management
- Credit Research
- Reporting and Client Services

- E-mail service@svbassetmanagement.com
- Phone 866.719.9117

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