ARC's Credit Exposure

The bank does not guaranty the borrower's performance through ARC. Instead, both bank and ARC share in the real estate collateral through a mortgage or deed of trust. The borrower's underlying pledged real estate secures the bank's interest in the loan and ARC's interest in the hedge.

In The Event Of Borrower Payment Default

The bank agrees to three possible options in the event of borrower payment default (in the case where ARC is no longer receiving its contractual hedge payments). The discussion below assumes that rates are lower, and borrower must pay a hedge unwind fee. If rates are higher and borrower is in default, ARC must pay a hedge unwind fee to the bank instead of the borrower.

- First, the bank may allow ARC to control the loan and the liquidation of the real estate collateral. Any proceeds will first be used to satisfy any swap unwind costs before the bank recovers on the loan obligation. This option is available for accounting purposes to allow the derivative to stay on SouthState's balance sheet. The bank is highly unlikely to exercise this option and will only do so if the value of the underlying real estate collateral is not sufficient to cover any of the loan exposure after payment of the swap unwind costs. ARC cannot exercise this option unless the bank has decided not to exercise either of the next two options listed below.

- Second, the bank may collateralize the market value of the hedge with cash and continue to make the hedge payments to ARC on the borrower's behalf (again assuming rates are lower at time of default). Any payments made by the bank to ARC are recoverable by the bank from the borrower. The bank will likely exercise this option if the borrower is expected to become current on the loan in the near future.

- Third, the bank may pay the unwind cost of the hedge and ARC will assign the right to that unwind cost to the bank. The bank is likely to exercise this option if the borrower is not expected to become current on payments in the near future. Bank and ARC may also agree to transfer the hedge to another acceptable borrower without any economic payment.

Bank's Benefit In Sharing Real Estate Collateral With ARC

First, this unique collateral arrangement with ARC allows the borrower and the bank to hedge interest rate risk without the use of a derivative for the bank. Second, with ARC sharing in the underlying real estate collateral, the bank need not pledge any additional cash or security collateral – after all, the vast majority of loans perform as contracted and ARC's credit exposure is only contingent on interest rates moving lower. Third, the bank's credit exposure with ARC is always superior over using direct swaps. If a borrower defaults, the bank has the ability to unwind the hedge or maintain the hedge (in both ARC and direct swaps). However, through ARC the bank may determine, at its option, that its economic interests are best served by allowing ARC to liquidate the collateral.