

Lending Strategies for the Current Environment

June 2024





Meeting Agenda

- **Why ARC / Why Now**
 - **Interest Rate Outlook**
 - **How To Position ARC In The Current Environment**
 - **How To Explain The Prepay**
- **ARC Strategies to Create And Retain Profitable Relationships**

Current Environment



Inverted Yield Curve, Fed Rate Cuts are Already Priced In





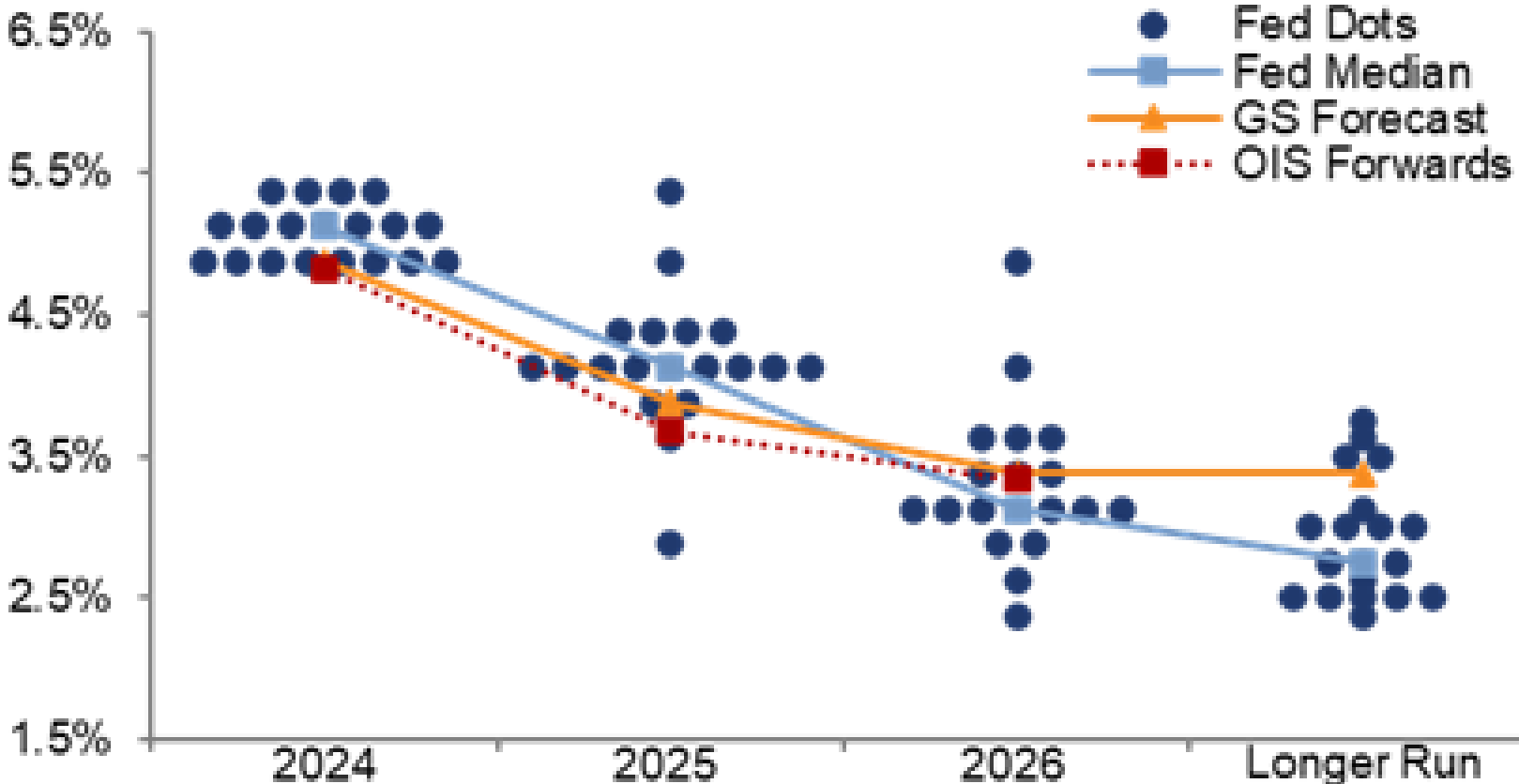
Prime	8.50%
Fed Funds Target Overnight Rate	5.25% - 5.50%
1-month Term SOFR	5.33%

	<u>US Treasury</u>	<u>Swap Rates</u>
3 year	4.50%	4.34%
4 year		4.21%
5 year	4.31%	4.07%
7 Year		4.01%
10 year	4.30%	3.93%
20 year		3.89%



Fed Dot Plot

Markets and the Fed are historically bad at predicting the future





What Will The Fed Do?

CME FEDWATCH TOOL - CONDITIONAL MEETING PROBABILITIES									
MEETING DATE	325-350	350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550
7/31/2024				0.0%	0.0%	0.0%	0.0%	8.3%	91.7%
9/18/2024	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	4.8%	56.7%	38.5%
11/7/2024	0.0%	0.0%	0.0%	0.0%	0.0%	1.7%	23.4%	50.2%	24.7%
12/18/2024	0.0%	0.0%	0.0%	0.0%	1.2%	17.1%	42.4%	32.1%	7.1%
1/29/2025	0.0%	0.0%	0.0%	0.6%	9.5%	30.3%	37.0%	19.1%	3.4%
3/19/2025	0.0%	0.0%	0.4%	6.2%	22.5%	34.5%	25.8%	9.3%	1.3%
4/30/2025	0.0%	0.2%	3.0%	13.4%	27.8%	30.6%	18.5%	5.7%	0.7%
6/18/2025	0.1%	1.9%	9.4%	22.3%	29.6%	23.2%	10.7%	2.7%	0.3%
7/30/2025	0.9%	5.0%	14.8%	25.3%	26.9%	18.0%	7.3%	1.7%	0.2%

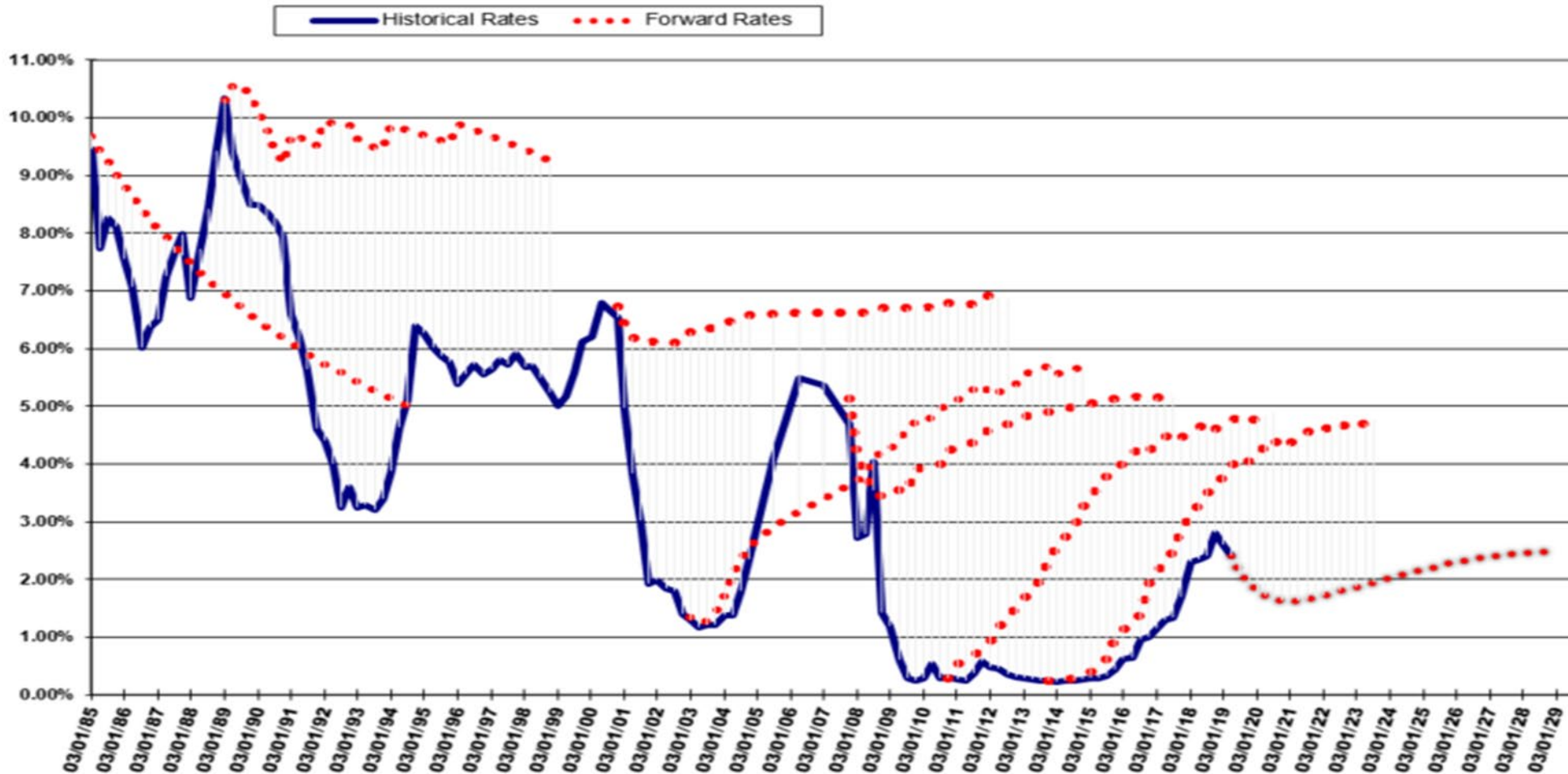
	<u>Swap Rates</u>	<u>Discount</u>
3 year	4.34%	-0.99%
4 year	4.21%	-1.12%
5 year	4.07%	-1.26%
7 Year	4.01%	-1.32%
10 year	3.93%	-1.40%
20 year	3.91%	-1.42%

<https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html?redirect=/trading/interest-rates/countdown-to-fomc.html>



Market Expectations vs. Actual

Markets are historically bad at predicting the future

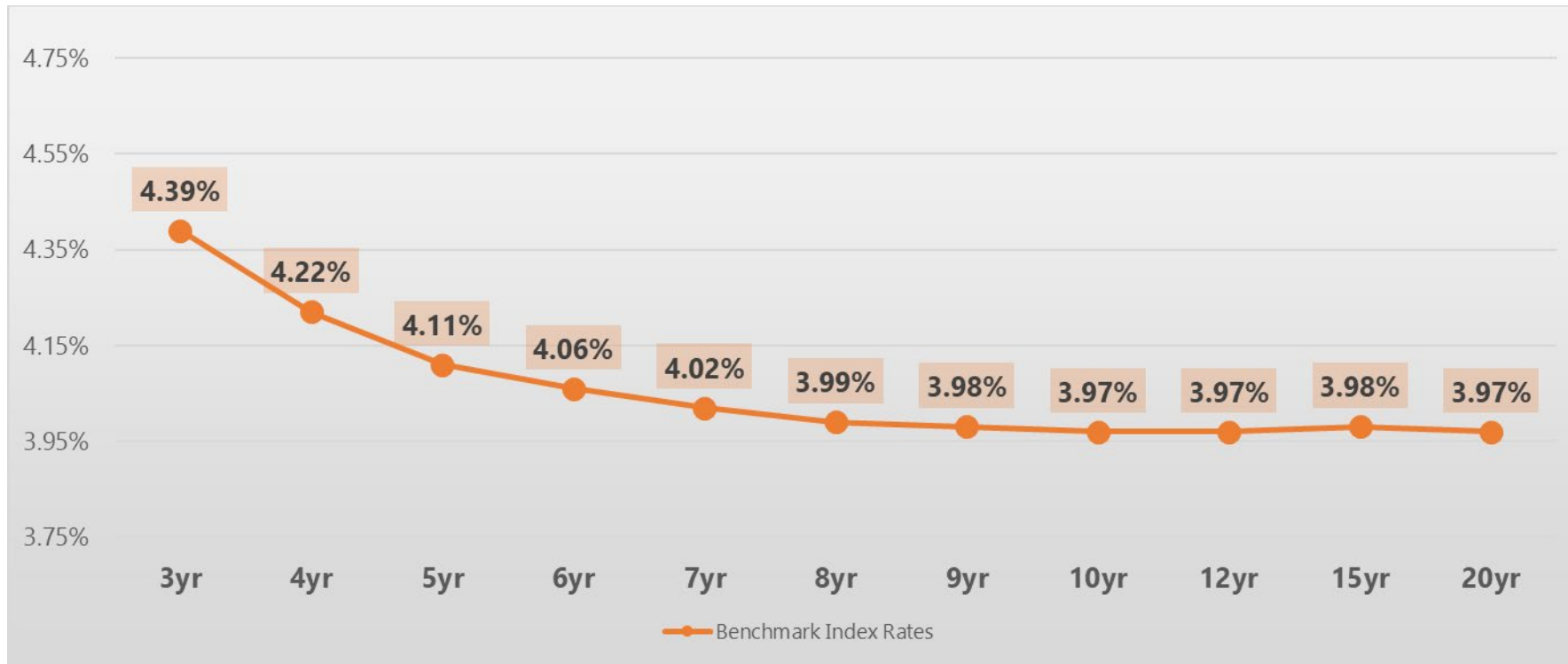




Shape Of Today's Yield Curve

Benchmark Hedge Index Rates

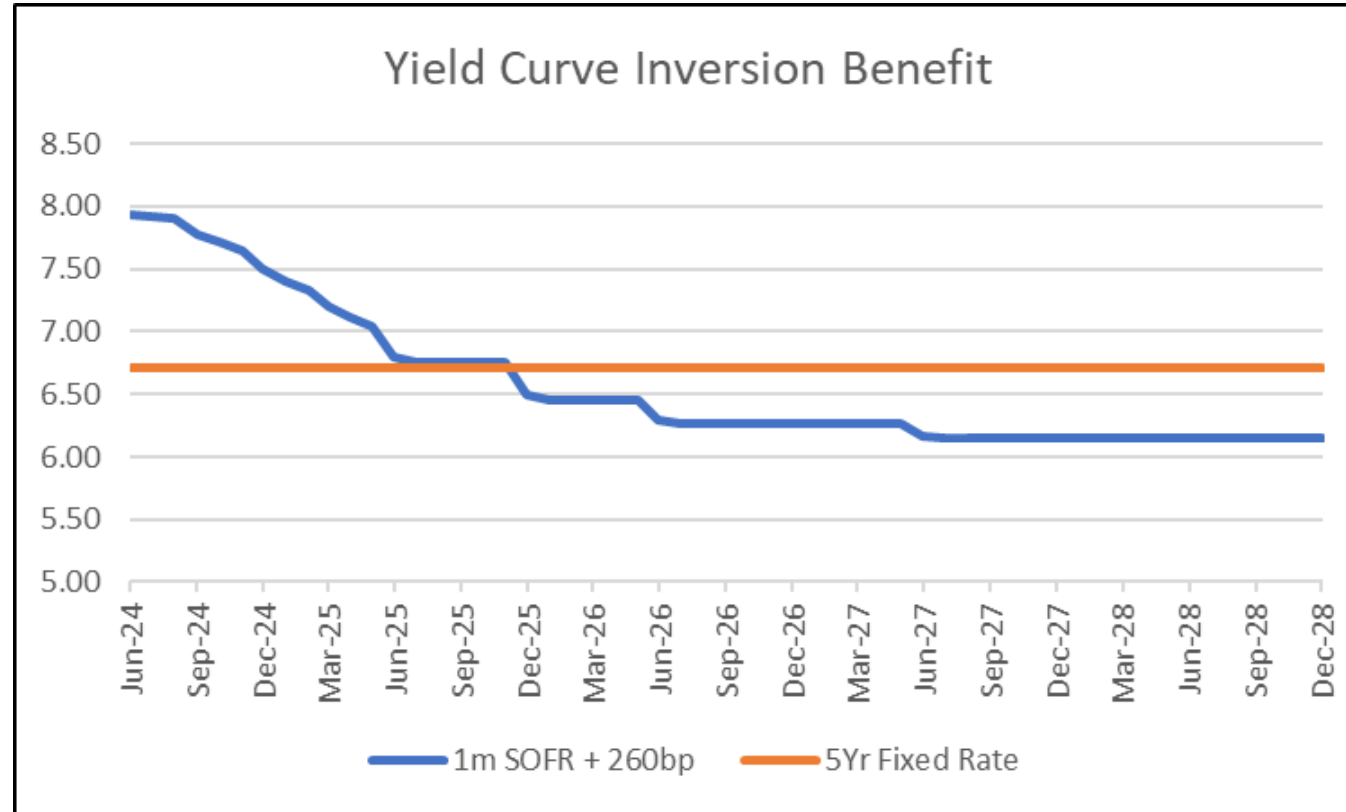
SOFR =
5.33%



Indicative fixed rates as of 6/12/24



Yield Curve Inversion



Bank's Variable Rate Will Be Greater Than Borrower Fixed Rate At Origination

6? 5? 3? 2 Cuts? Or None?

While the Fed is fighting inflation the yield curve is expected to remain inverted. In other words, rate cuts are already priced in.

As of 06/12/24

How To Position ARC In The Current Environment



How Hedging can Help You Benefit From an Inverted Yield Curve





Traditional Fixed vs. Hedged Alternative

Traditional Fixed Rate

Target: Prime Less 0.75%

UST + 3.50%

Fixed Rate For 1 to 5 Years

Fixed Rate To Borrower: **circa 7.75%**

Yield To Bank: circa 7.75%

No Additional Income Above Origination

If DSC is 1.25x then.....

ARC Fixed Rate

Target: SOFR + 2.60%

Plus 25bp Hedge Fee

Fixed Rate For 1 to 20+ Years

5Y Fixed Rate To Borrower: **6.96%**

Yield To Bank: circa 8% (Yr 1)

Hedge Fee: 1% (5Y) to 2% (10+Y)

.....the equivalent DSC is 1.4x

16.6% ROE at
Marginal COF

Indicative fixed rates as of 6/12/24, inclusive of hedge fee

Deliver lower fixed rate to Borrower while increasing current yield for the Bank.

The Borrower Can Only Choose Between The Options Available Today.

The Borrower that "chooses" 7.75% is not being shown the 6.96%!



ARC Loan Pricing

ARC Fixed Rate

Target: SOFR + 2.60%

Plus 25bp Hedge Fee

Fixed Rate For 2 to 20 Years

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16.6% ROE at Marginal COF

Sensitivities:

5% Deposit = add 1.2% ROE

10% Deposit = add 3.4% ROE

0.25% Spread = 1.4% ROE

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Prepay: 5/4/3/2/1%

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Prepay: Yield Maintenance

16.6% ROE at
Marginal COF

ARC is designed so that the only difference between these loans from the borrowers' perspective is the prepay convention.

In exchange for a lower rate the Borrower accepts yield maintenance

Explaining Yield Maintenance



Building Comfort With Borrower's





Symmetrical Yield Maintenance: Equates the Difference Between The Agreed Loan Rate and Current Market Rates

Initial Balance:	\$5,000,000
Commitment Term:	5 years
Amortization Term:	25 years
Initial Hedge Rate:	4.36%
Credit Spread:	2.60%
Fixed Rate to Borrower:	6.96%

Symmetrical yield maintenance allows borrowers to protect cash flow with a fixed rate of interest. At the time of prepayment, the borrower may move the rate to a new property or project (subject to bank credit approval). Alternatively, the borrower may pay or collect a breakage fee if the facility is no longer needed.

Remaining Term	Prepayment Hedge Rate vs. Initial Hedge Rate						
	-75 bps	-50 bps	-25 bps	0 bps	+25 bps	+50 bps	+75 bps
5 years	(164,266)	(108,861)	(54,108)	-	53,472	106,315	158,537
4 years	(134,722)	(89,376)	(44,470)	-	44,039	87,650	130,839
3 years	(101,874)	(67,663)	(33,706)	-	33,456	66,665	99,627
2 years	(68,471)	(45,531)	(22,708)	-	22,593	45,072	67,437
1 years	(34,439)	(22,929)	(11,449)	-	11,419	22,807	34,165

\$22,593: If the loan is prepaid with 2 years remaining and the prevailing 3-year hedge rate is 0.25% higher, the borrower will collect a fee*.

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- Partial prepayments are calculated using the same method, on a proportional basis.

➤ Note that this prepayment provision is in line with a borrower’s motivation for fixed rate protection and holding period. And if rates rise the borrower will collect a fee upon partial or full prepayment.

Back
To:

How To Position ARC In The Current Environment

How Hedging can Help You Benefit From an Inverted Yield Curve





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The “Cost Of Carry” Traditional Fixed vs. Hedged Alternative

Traditional Fixed Rate

Choosing To Pay 7.75% Because You Think Rates Will Fall In The Future?

	Breakeven Rate For Remaining Term
After 1 Year	6.76%
After 2 Years	6.44%
After 3 Years	5.79%

ARC Fixed Rate

SOFR + 2.60%

Plus 25bp Hedge Fee

5Yr Fixed Rate To Borrower: **6.96%**

*Deliver lower fixed rate to Borrower while increasing current yield for the Bank
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What If Loan Rates Drop to 5% In 3 Years? Traditional Fixed vs. Hedged Alternative

Traditional Fixed Rate

Originally Paying 7.75%

6%...

5%...

4%...

The One-Way Floater...

This “Free” Option would cost 75 basis points per annum in the capital markets!

ARC Fixed Rate

The same options exist!

5% Rate Environment

Modify To 10/25

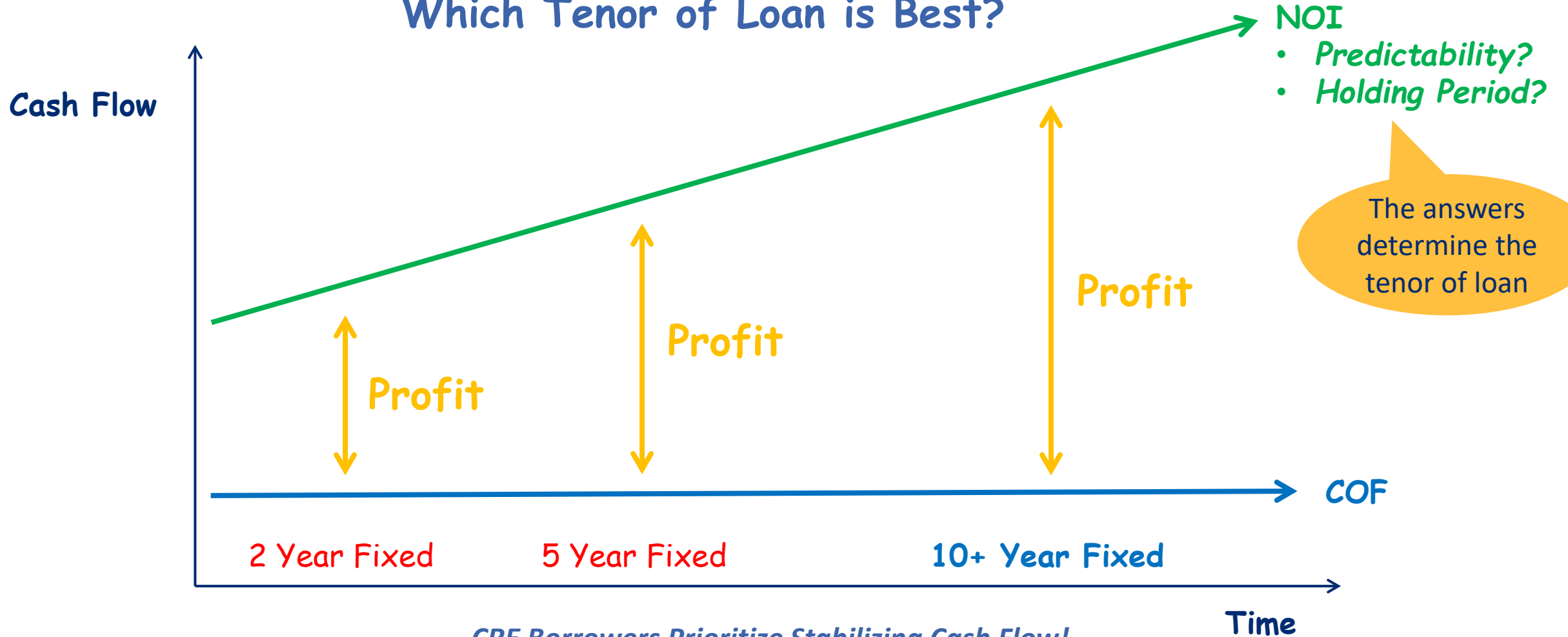
Estimated Fixed Rate Will Be Less Than 5.45%!

*Deliver lower fixed rate to Borrower while increasing current yield for the Bank
The Borrower that “chooses” 8% is not being shown the 6.96%!*



ALM From The Borrower's Perspective

Which Tenor of Loan is Best?



CRE Borrowers Prioritize Stabilizing Cash Flow!

ARC Strategies to Retain Profitable Relationships



Protect Your Most Valuable Relationship While Boosting Returns





ARC Is More Than A Product – It's A Relationship – Gratis!

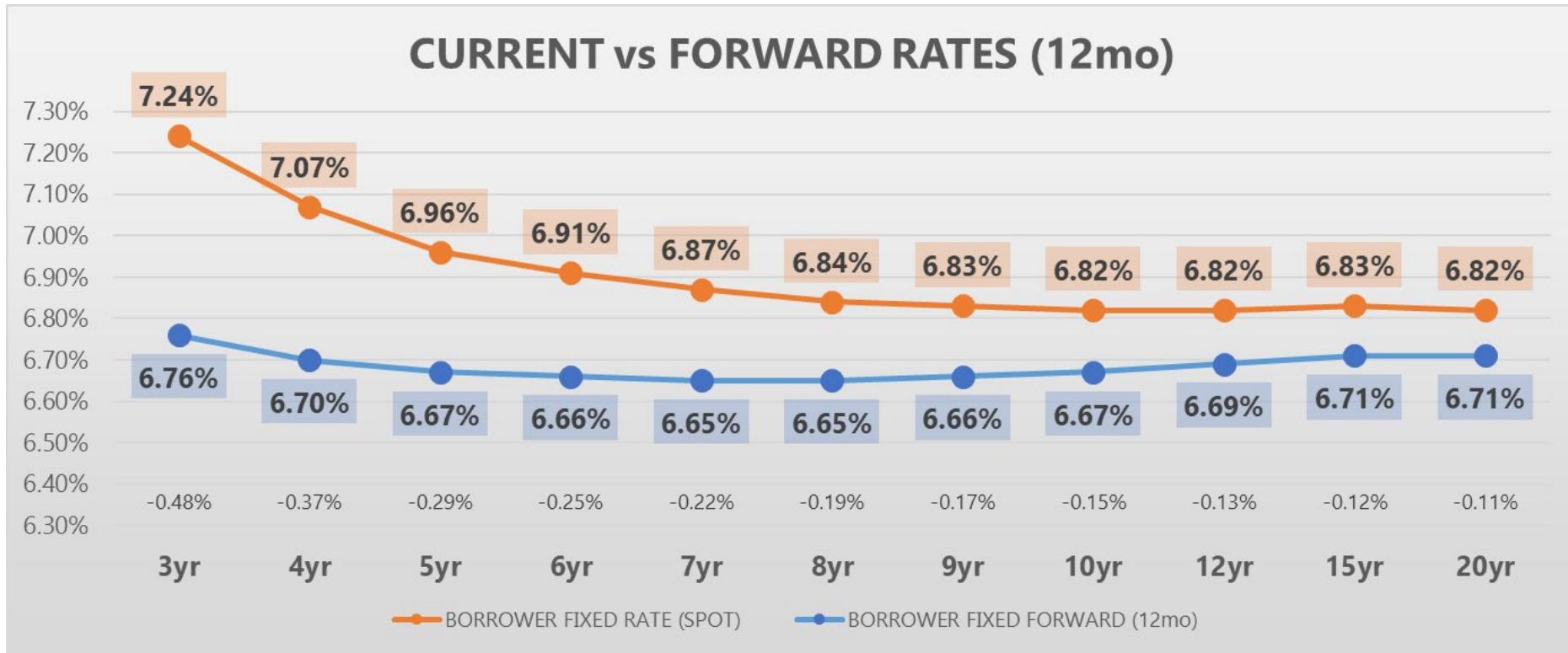
- ✓ Customized Borrower Presentations
- ✓ In-Person Meetings With Your Borrowers
- ✓ Marketing Campaigns, Materials, Content and Support
- ✓ Loan Structuring and Profitability Assistance
- ✓ Lender and Operational Training
- ✓ Loan Pricing Model Analysis
- ✓ Assistance With Participations
- ✓ General Bank Performance Support – Deposit Pricing, Technology, etc.

We're not just a vendor, we are a user of the product



New Investment In CRE And Refi's

*Perm Loan Pricing 1m SOFR + 2.60% (reset/paid monthly) PLUS Hedge Fee
Borrower Locks In The Perm Rate Now, Stabilizing Cash Flow For The Long Term*



Indicative fixed rates as of 6/12/24, inclusive of hedge fee



Step-Up Mod

Protect Relationships and Boost Yield Now

Example: Borrower has a current fixed-rate loan on the books at 5.00%, reset in 12 months

Current Loan \$3,000,000

Collateral: Long-term CRE

Fixed Rate: 5.00%

Reset: in 1 year

Step-up Structure allow your borrower to keep existing 5.5% fixed, and lock in an attractive refinancing rate 1 year forward, and ALSO converts the 5.5% fixed rate to a higher floating rate plus a spread for the lending bank.

Step-up Refinance Example: 6 year/ 25 year am, SOFR + 2.60% , +25 bp hedge fee

	Stream 1 (yr 1)	Stream 2 (yrs 2-6)
Borrower Pays	5.00% Fixed	6.91% Fixed
Bank Receives	SOFR + 0.89% (6.22% Initially, Plus \$29k hedge fee (~96 bps))	SOFR + 2.60%



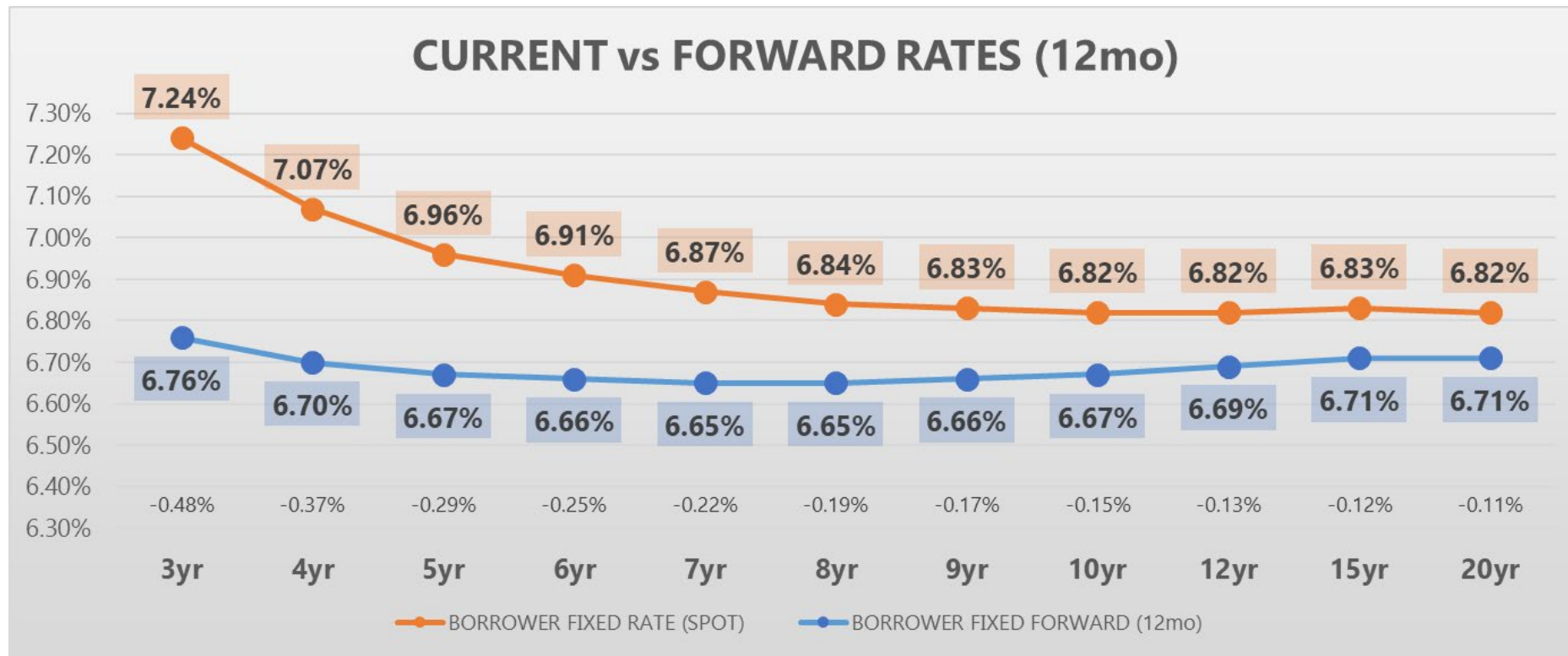
Strategic Early Refinancing Action Steps

1. Identify your most valuable relationships with current loans maturing in the next 36 months
2. Reach out to ARC for indicative pricing – show at least 3 options
3. Provide lenders with goals and direction on target clients



Construction-To-Perm Lending

*Perm Loan Pricing 1m SOFR + 2.60% (reset/paid monthly) PLUS Hedge Fee
Borrower Locks In The Perm Rate Now, Stabilizing Cash Flow For The Long Term*



Indicative fixed rates as of 6/12/24, inclusive of hedge fee

Thank you!

Want more ideas and data?

Sign up at:

SouthStateCorrespondent.com



ARC Program Overview

All the benefits of a large bank hedging program without the headaches





What if you had a tool that allowed you to...

- ✓ Earn up to 1% or more initial yield
- ✓ Expand your product offering
- ✓ Provide your lenders with a competitive advantage
- ✓ Compete for larger relationship loans
- ✓ Generate significant fee income of up to 2% or more
- ✓ Reduce risk for your bank and your borrower



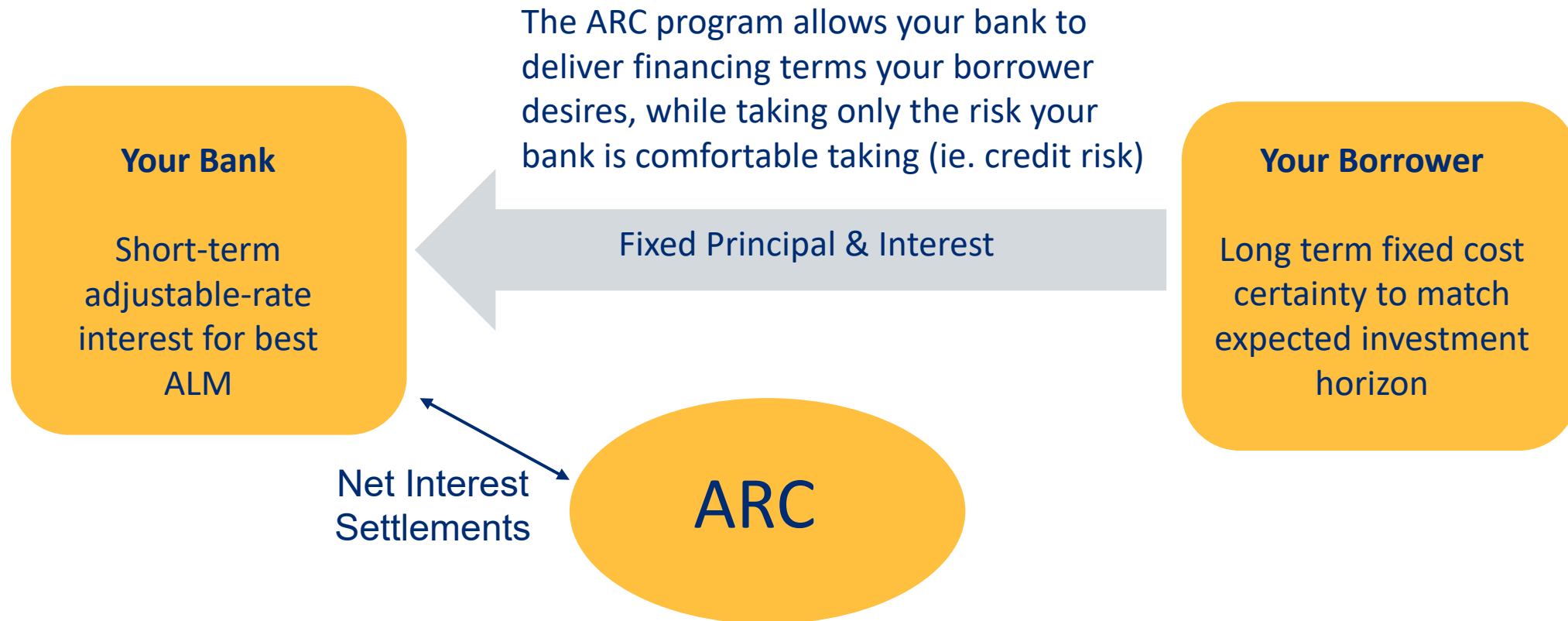
ARC was Developed for Community Banks and Borrowers

All the benefits of a large bank hedging program without the headaches:

- ✓ No derivative on your books
- ✓ Simple and clear documentation (No ISDA)
- ✓ Plain English risk disclosures
- ✓ No daily collateral posting, accounting, regulatory reporting
- ✓ Borrowers make one payment to your bank
- ✓ Flexible prepayment and modification options
- ✓ Fee income



Best Risk Profile For Your Bank ^{and} ~~vs.~~ Best Risk Profile For Your Borrower





The Conversation With The Borrower Should Continue To Be Focused On The Borrower's Cash Flows - If The Project Cash Flows Well At Today's Rates Then It Is A Candidate For ARC

The Tenor Of The Loan Should Be A Function Of The Predictability Of Their Revenue Stream & Their Expected Holding Period

Benefits From the Borrower's Perspective

Borrower Goals – Make Money!

- Stabilize Cash Flow & Enhance IRR with a Fixed Rate Loan
- Financing Aligned with Holding Period, at Lowest Fixed Rate
- ***Simple Form of Documentation***
- ***Defined Prepayment Feature***
- ***Single Monthly Invoice From The Bank For Fixed Rate***
- ***Fixed Rate Loan Accounting***

Simplicity Sells



Priority Should Be Placed On Acquiring Deposits - Deposits Become Much More Valuable In A Rising Rate Environment.

Banks Will Benefit By Onboarding More Variable Rate Loans In The Current Environment, Stabilizing NIM and Improving ROE.

Benefits From the Bank's Perspective

- Bring in a high-quality client and lock them in for a long-term relationship
- Cross Sell - Sticky deposits and other cross-sell opportunities
- Hedge Fee Income
- Variable = Better Asset/Liability match
- No Derivative = No Costs
 - No capital, no cash collateral, no accounting, no regulatory reporting

ARC Program vs. Swaps

ARC Also Provides:
Marketing Materials
Sales Support
Lender Training
Operations & Docs Training

General: ARC vs. Swaps

Fee Generation	✓	✓
Swap/Hedge Portability	✓	✓
Hedge for Unique Structures	✓	✓
Hedges for Forward-Starting Structures	✓	✓

Accounting:

<u>No</u> Hedge Effectiveness Accounting	✓	✗
<u>No</u> Call Report Derivative Disclosure	✓	✗
<u>No</u> Derivative Capital Allocation	✓	✗
<u>No</u> Dodd-Frank Reporting	✓	✗

Documentation:

<u>No</u> ISDA Documentation for Bank	✓	✗
<u>No</u> ISDA Documentation for Borrower	✓	✗

Capital Charge & Collateral Requirement:

<u>No</u> Capital Charge	✓	✗
<u>No</u> Independent Amount (\$500k+)	✓	✗
<u>No</u> Additional Cash & Securities	✓	✗

Simplified Borrower Experience:	✓	✗
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- ✓ ARC has all the same capabilities of any swap program.
- ✓ ARC eliminates all derivative accounting headaches for banks.
- ✓ ARC reduces the number of pages required for documentation from 45 pages using swaps to four pages for ARC.
- ✓ ARC allows current loan settlement invoicing instead of having borrowers execute separate monthly swap settlements.
- ✓ ARC eliminates the requirement for loan officers to explain a complex transaction.
- ✓ ARC is easier to understand reducing both sales friction and legal risk.

A simplified platform for borrowers and loan officers' results in more transactions booked.



While interest rates have risen recently, they are still very low from a historical perspective. This offers borrowers the opportunity to lock in years of additional rate and cash flow certainty with minimal incremental cost.

$$A + B = C$$

Hedge Index Rate + Credit Spread = Loan Fixed Rate

	3yr final	4yr final	5yr final	6yr final	7yr final	8yr final	9yr final	10yr final	12yr final	15r final	20yr final
3yr Am.	4.67%	-	-	-	-	-	-	-	-	-	-
5yr Am.	4.50%	4.40%	4.37%	-	-	-	-	-	-	-	-
7yr Am.	4.45%	4.33%	4.26%	4.22%	4.20%	-	-	-	-	-	-
10yr Am.	4.42%	4.28%	4.20%	4.14%	4.11%	4.10%	4.09%	4.09%	-	-	-
15yr Am.	4.40%	4.25%	4.15%	4.10%	4.06%	4.04%	4.02%	4.01%	3.99%	4.00%	-
20yr Am.	4.39%	4.23%	4.12%	4.07%	4.04%	4.00%	3.99%	3.98%	3.97%	3.98%	3.98%
25yr Am.	4.39%	4.22%	4.11%	4.06%	4.02%	3.99%	3.98%	3.97%	3.96%	3.98%	3.96%
30yr Am.	4.39%	4.22%	4.11%	4.04%	4.01%	3.98%	3.97%	3.96%	3.96%	3.97%	3.96%

Example: 25 due 5 Index 4.11% + Credit Spread 2.60% = Fixed Rate 6.71%

Indicative fixed rates as of 5/06/24, not including hedge fee



Hedge Fees

Example Loan: \$5mm, 5yr final / 25yr amortization, credit spread 2.60%
PLUS a **25** basis point hedge fee

Add the hedge fee to the swap index rate:

Fee:	0.25%
Loan Amount:	\$ 5,000,000
Amortization (yrs):	25
Loan Term (yrs):	5
Hedge Index Rate:	4.36%
Fixed Rate to Borrower:	6.96%
Approximate ARC Referral Fee:	\$ 51,364

The present value of 25bp per annum on this 5 year loan is paid upfront and equates to \$51,364 per \$5mm loan amount, at current interest rates (~1% of the loan amount).

- Recognize income immediately and provide a significant boost to return on equity.
- Fee income also allows banks greater competitive flexibility such as offering no-cost closings when targeting new segments of the market, or offering lender incentives.



In periods of rising interest rates and a flattening yield curve we see borrowers become more sensitive to future refinance risk and the impact on their returns, and with that comes a significant increase in demand for fixed rate loans in longer tenors. The inverted yield curve is enhancing that demand.

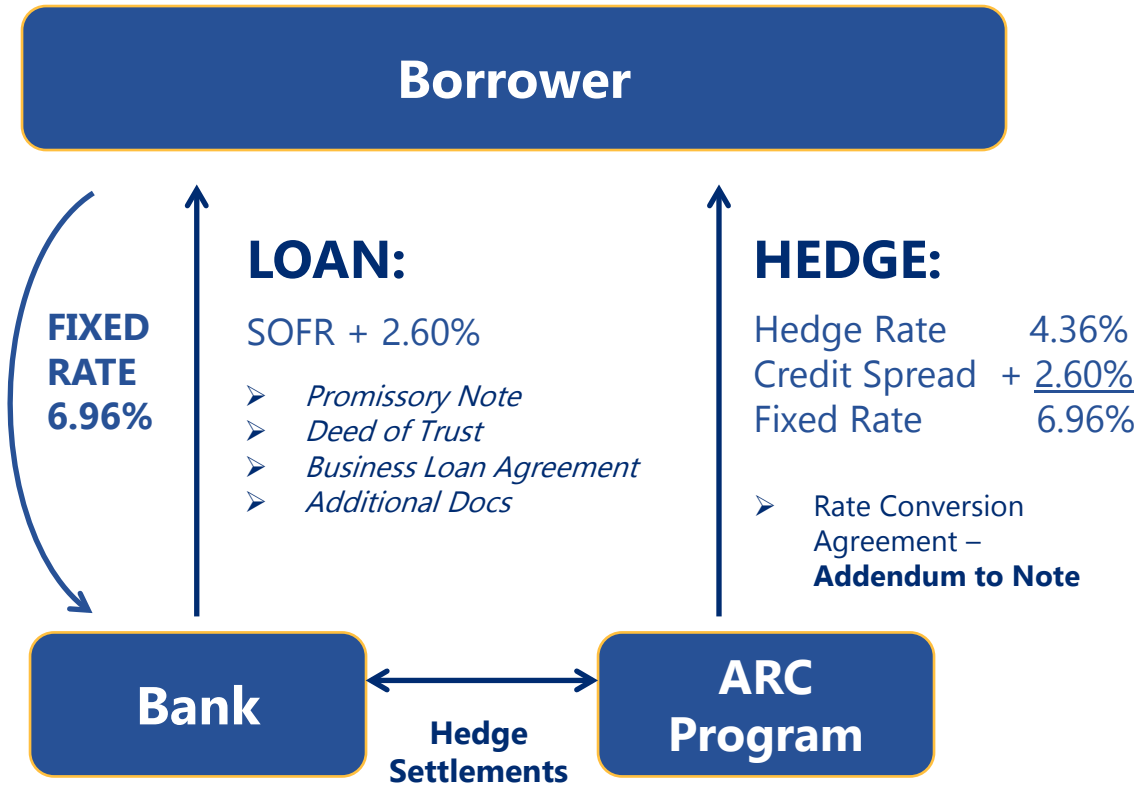
Predictability of cash flow and borrower's holding period determine tenor of loan

EXAMPLE \$5mm LOAN REQUEST

Fixed Term / Amortization	Current Fixed Rate	Hedge-Based Pricing	Approximate Monthly P&I
5yr / 25yr	6.96%	5yr Swap + 2.60%	\$35,531
7yr / 25yr	6.87%	7yr Swap + 2.60%	\$35,239
10yr / 25yr	6.82%	10yr Swap + 2.60%	\$35,078

*Bank Earns Variable: 1m SOFR + 2.60% (reset/paid monthly)
Plus Hedge Fee*

Indicative fixed rates as of 6/12/24, including hedge fee



- ✓ Bank makes a variable rate loan to the borrower
- ✓ ARC enters into a rate-fixing arrangement with the borrower for the term of the loan
- ✓ Bank boards a variable rate asset and does **not** carry a derivative
- ✓ The borrower makes a fixed rate payment for the life of the transaction
- ✓ Bank and ARC settle hedge economics through one monthly servicing entry

- **Bank acts as servicer for both the loan and the hedge, and bills borrower for fixed rate only (curved line above)**
- Bank and ARC settle difference between fixed-rate and floating-rate accrual

A + B = C

A.	5-year Swap Rate	4.36%
B.	Credit Spread	2.60%
C.	All-in Fixed Rate	6.96%

Indicative fixed rates as of 6/12/24, including hedge fee



Symmetrical Yield Maintenance: Maximizing Value for Borrowers

Initial Balance:	\$5,000,000
Commitment Term:	5 years
Amortization Term:	25 years
Initial Hedge Rate:	4.36%
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Fixed Rate to Borrower:	6.96%

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ARC Advantage – Relationship Lending & Flexibility

- ✓ **Customized Solution Tailored To The Borrower = Longer Relationships & Cross-Sell**
- ✓ **Rate Portability** – borrower can replace collateral with another suitable property
- ✓ **Loan Assumability** – ARC hedges can be moved to a new borrower
- ✓ **Blend and Extend** – borrowers needing additional financing can keep their current hedge rate if rates are higher, or enjoy a lower blended fixed rate in a lower rate scenario
- ✓ **Symmetrical Prepayment Provisions** – borrower may choose to terminate the hedge and get paid the positive value of the remaining if rates are higher, or pay the negative hedge value if rates are lower, and the sale or refinancing opportunity outweighs the cost

ARC is a tool used to create value



ARC Program Recent Deal Stats

Average Term: 4.5 years (before curve inversion this was 10.7 years)

**Credit Quality: 1.65x DSCR
62% LTV
Zero past due credits**

Average ARC Fee: 1.4% of initial principal (ie. 20 basis points/annum)



- Loan amounts, LTV, and terms determined by bank policy
- Up to 20 years final maturity and 30-year amortization
- ARC is preapproved for LTV of 85% or better and debt service coverage ratio 1.20x, or better
- Borrower minimum \$1mm net worth
- Property types OO and NOO CRE. General and special purpose.
 - office, industrial, retail, multifamily, special purpose, self storage, among many others
- No consumer, or government. No speculative land.



Steps For Closing an ARC Loan:

- **Borrower Presentations**
 - *Borrower Name, Loan Amount, Terms/Amortizations, Credit Spread*
- **Q&A – Conference Call/Meeting**
- **Hedge Approval (1-2 days)**
 - *Send Credit Memo and Appraisal when each becomes available*
- **Documentation (1 day)**
 - **ARC provides two language inserts to your standard documents**
 - **ARC will send a draft Rate Conversion Agreement for review**

With Those Complete ARC Is Ready To Close



Russ Smith Managing Director 917 324 6641 rsmith@SouthStateBank.com

ARC Group (26 team members) 800 481 2443 ARC@SouthStateBank.com

Disclaimer

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In addition to any specific risks discussed herein, there are other factors that may influence the performance of an interest rate hedge product.

Counterparty Risk – the risk that the counterparty will not perform pursuant to the contract terms. Borrowers should carefully assess counterparty risk when engaging in such a transaction as described herein.

Basis Risk – the risk that the floating rate interest payments made on the loan and the floating rate interest payments received on the hedge contract could be mismatched, specifically if the floating rate indices, spreads, and other terms are not exact.

Amortization Risk – the risk of the potential mismatch between the outstanding principal amount of the loan and the outstanding notional amount of the hedge. Amortization mismatches could also result in termination of portions of the hedge prior to maturity and under unfavorable conditions.

Termination Risk – the risk that the hedge could be terminated as a result of certain events including payment default or other defined events of default. A termination of a hedge may result in payment received by the borrower or owed to the Bank depending on the market at the time of termination.

Prior to entering into any interest rate hedge transaction, recipients should determine, in consultation with their own legal, tax, regulatory, and accounting advisors, the economic risks and merits, as well as the legal, tax, regulatory and accounting characteristics and consequences of any transaction.

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