Hedging Short-Term or Floating Rate Funding

Creating Low Cost Funding

Transaction Details

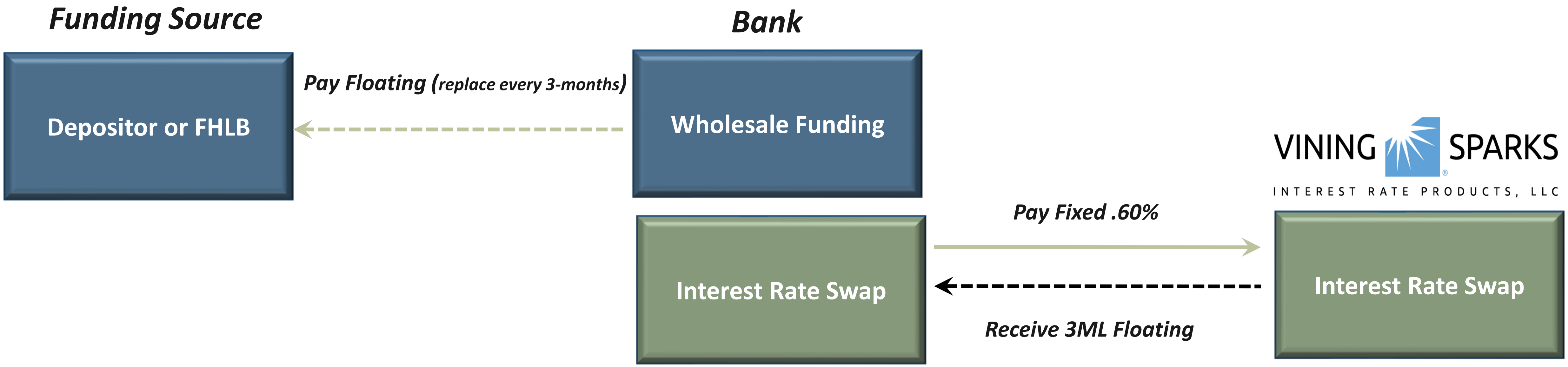
1. **Bank issues 3-month Brokered CDs or borrows Short-term FHLB Advances**

2. **Bank expects to replace these borrowings every 3-months**

3. **Bank executes pay fixed interest rate swap**

- Bank issues $5mm of short-term or floating rate funds
- Bank executes $5mm, 5-year interest rate swap indexed to 3-month LIBOR
- Bank replaces these funds every 3-months until maturity of interest rate swap
- Net result is low cost fixed rate funding

What Role Does the Pay Fixed Swap Play in Fixing Rate on Funding?



Institution's Cash Flows

Pays Floating to Depositor or FHLB	(Floating)
Institution Pays Fixed (Vining Swap)	(.60%)
Institution Receives Floating (Vining Swap)	Floating (3ML)
Net Fixed Rate Paid	**(.60%) +/_ difference in floating rate funding and 3ML**

Creating Low Cost Funding

Example Trade

Trade Idea 3/30/2020:

- Bank borrows from FHLB using 3-month advances (bank rolls these advances every 3-months)
- Bank executes a 5-year pay fixed swap with VSIRP

Details:

1.	Bank pays on 3-month FHLB borrowings:	.32%	varies by FHLB
2.	Banks pays fixed on interest rate swap:	.59%	
3.	Bank receives floating on swap (3ML):	1.43%	resets every 3 months
	Net funding cost for first three months:	**negative .52%**	

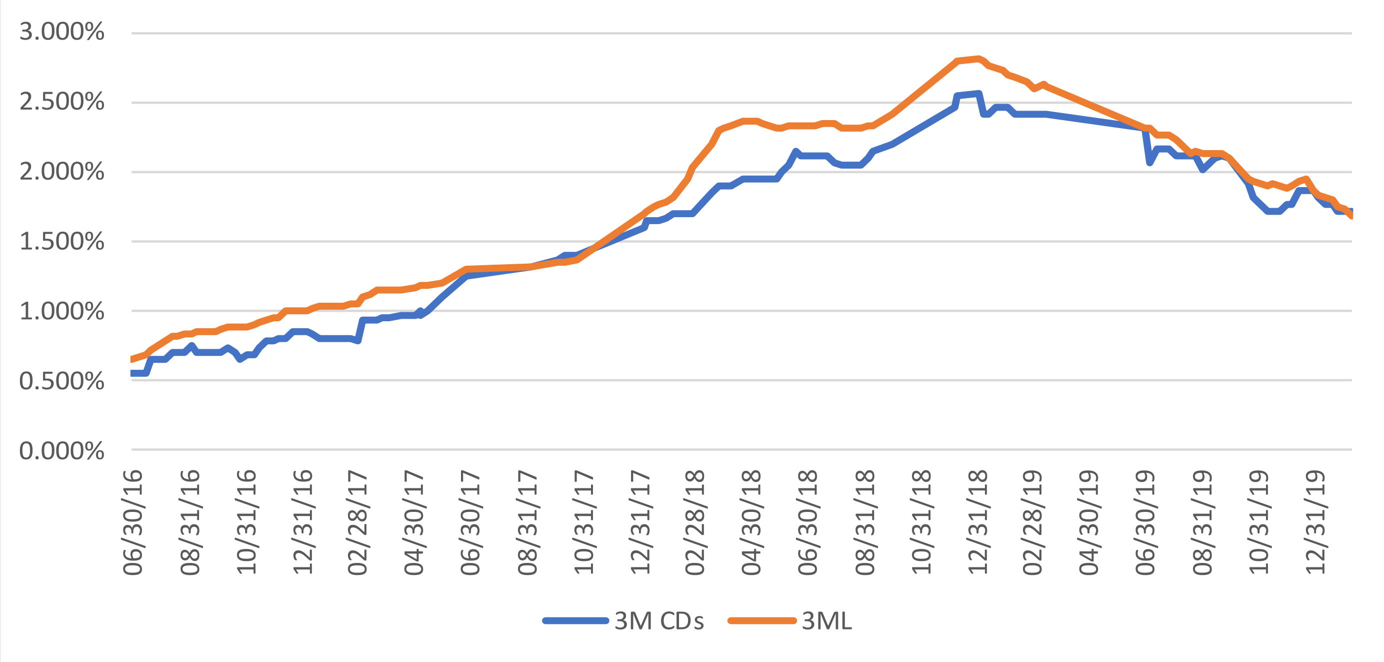
Primary Risk

While the net funding cost is negative today, we expect this cost to revert to normal levels as soon as the LIBOR market dislocation abates. You should expect the fixed cost over the life of the transaction to approximate the fixed rate on the swap, plus or minus the difference between 3-month LIBOR and actual borrowing costs. See correlation analysis on page 7.

Will the Transaction Qualify for Hedge Accounting?

Hedge relationship qualifies for hedge accounting treatment

- Regress 3-month Brokered CD rates vs 3M LIBOR
- Results:
  - Slope = .945
  - R^2 = .974
- **Hedge qualifies for Cash Flow Hedging accounting Treatment**
- While highly correlated, 3M LIBOR is generally slightly higher than 3-month Brokered CD Rates



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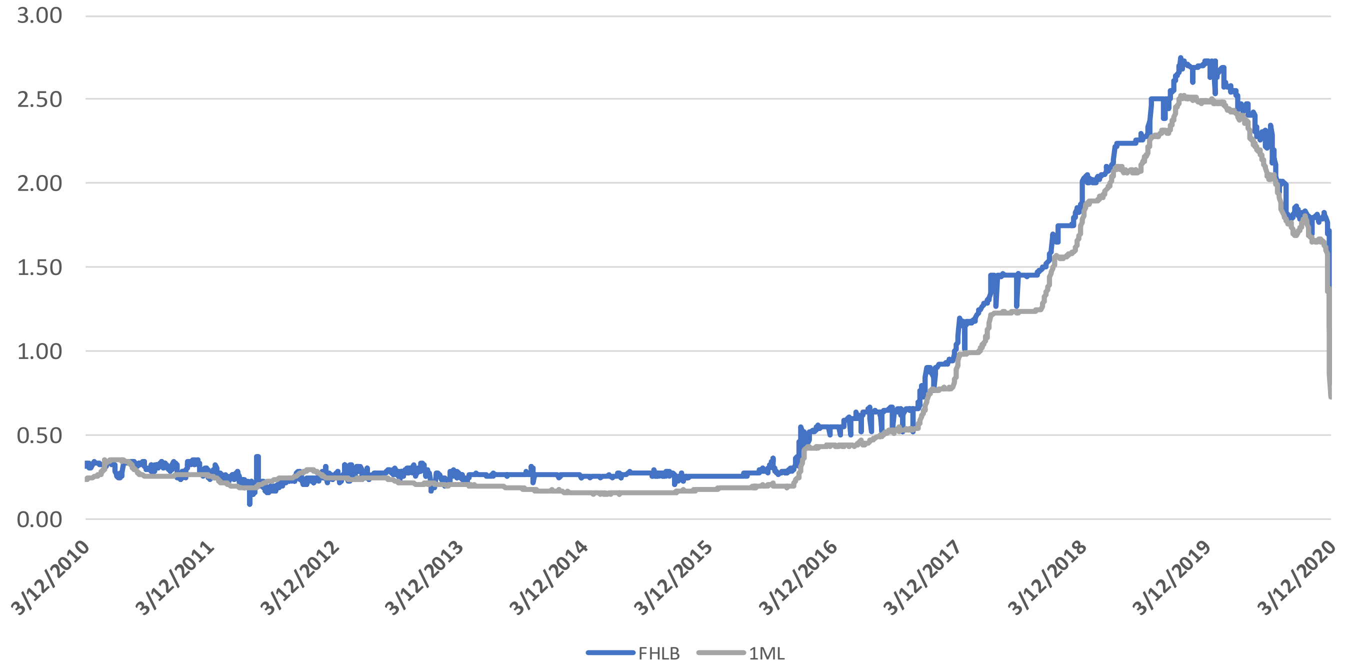
Will the Transaction Qualify for Hedge Accounting?

Hedge relationship qualifies for hedge accounting treatment

- Regress 1-month FHLB rates vs 1M LIBOR
- Results:
  - Slope = 1.05
  - R^2 = .997
- **Hedge qualifies for Cash Flow Hedging accounting Treatment**
- While highly correlated, 1M LIBOR is generally slightly lower than 1-month FHLB Rates



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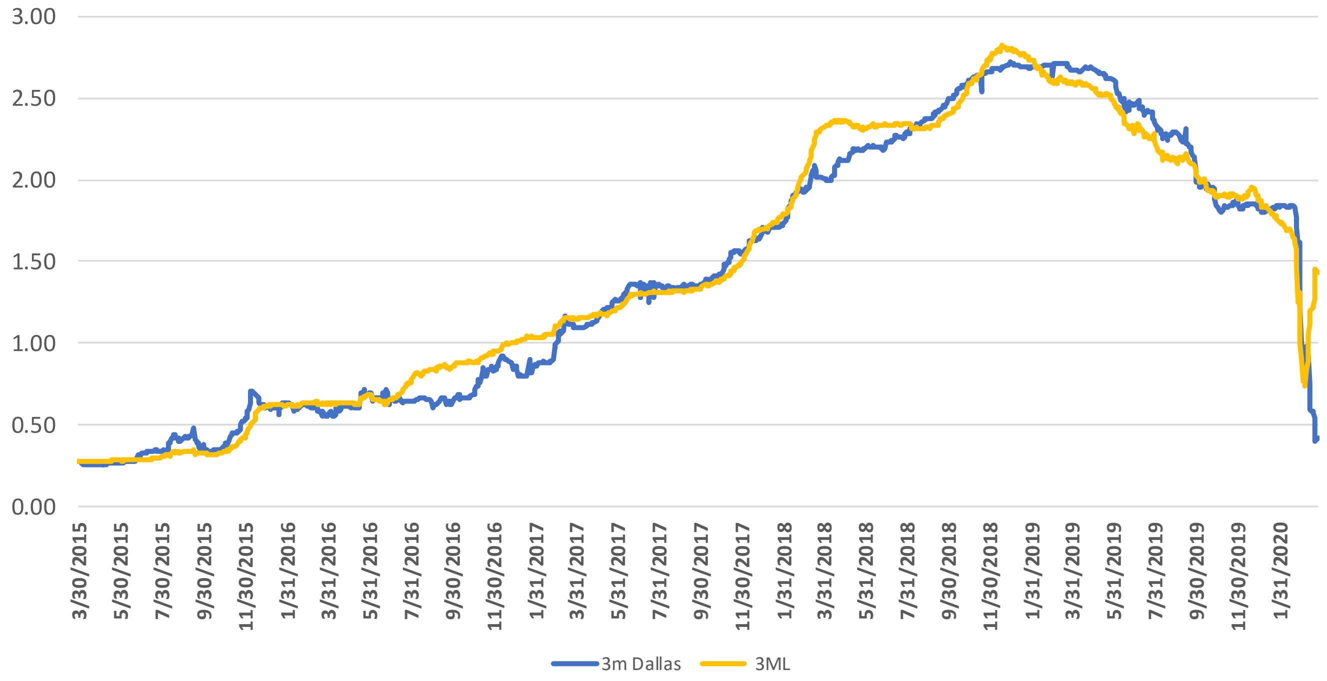
Will the Transaction Qualify for Hedge Accounting?

Hedge relationship qualifies for hedge accounting treatment

- Regress 3-month FHLB rates vs 3M LIBOR
- Results:
  - Slope = 1.01
  - R^2 = .989
- **Hedge <u>qualifies</u> for Cash Flow Hedging accounting Treatment**
- While highly correlated, 3M LIBOR is generally slightly lower than 3-month FHLB Rates



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Swap Market Value Estimate

$5mm swap sensitivity analysis

	$5mm, 5-year Swap Market Value						
	Rate Shocks						
Years to Maturity	**-150**	**-100**	**-50**	**0**	**50**	**100**	**150**
5	(353,900)	(224,100)	(97,900)	(24,800)	144,300	260,600	373,800
4	(311,400)	(202,100)	(95,200)	(9,000)	11,900	212,300	310,600
3	(216,800)	(136,900)	(64,400)	(9,000)	82,700	154,300	224,800
2	(141,100)	(90,200)	(40,000)	(9,000)	58,400	106,800	154,600
1	(86,200)	(54,900)	(23,800)	(7,000)	37,800	68,300	98,700
0	-	-	-	-	-	-	-

Accounting For Derivatives (ASC-815)

Accounting Treatment

ASC-815 (Formerly FAS 133/138)

1. Establishes a common framework for hedging and derivative accounting
2. Requires that derivatives be recorded on the balance sheet at fair value
3. Requires that changes in fair value be recorded in current earnings
   - Debit / Credit - FMV Derivative Contract
   - Credit / Debit - Income
4. Creates notion of hedge accounting
   - Hedge accounting minimizes P&L risk due to the designation of a specific risk being hedged
   - Generally speaking, changes in fair value of the derivative will be offset against the exposure being hedged

Hedge Accounting

Accounting Treatment

Hedge Accounting (new rules)

1. Defines acceptable hedging relationships
2. Defines hedge accounting methodology
   - Fair Value Hedge
     - Fair value of hedged exposure recorded as asset or liability
   - Cash Flow Hedge
     - Fair value of hedged exposure recorded as temporary equity (OCI)
3. Requires contemporaneous documentation of hedge relationship (VSIRP prepares)
4. Effectiveness testing no longer an issue

Hedge Accounting Methods

Accounting Treatment

Cash Flow Hedge

1. Hedges variability in cash flows of a recognized asset or liability, or forecasted transaction
2. <u>Applicable when hedging floating rate assets or liabilities</u>, or forecasted transaction
3. The change in value of the hedging transaction recorded in temporary equity (OCI)

Fair Value Hedge

1. Hedges exposure to changes in the fair value of a recognized asset or liability, or unrecognized firm commitment
2. <u>Applicable when hedging fixed rate assets or liabilities</u>, or unrecognized firm commitment
3. The change in value of the hedged exposure and hedging transactions are recorded in current earnings

Cash Flow Hedge Accounting

Accounting Treatment

Cash Flow Hedge

- Derivative is marked to market and the effective portion of the changes in fair value flow through Other Comprehensive Income (OCI)
- OCI is reclassified into earnings when the hedged exposure affects earnings
- Ineffectiveness not recognized under new accounting standards

Examples

- Swapping floating rate debt to fixed (trust preferred)
- Swapping floating rate loans to fixed
- Purchasing a cap to hedge floating rate debt
- Purchasing a floor to hedge floating rate loans

Accounting for Funding Hedge

Accounting Details

- At inception, hedge has a slightly negative FMV reflecting the bid/ask spread of the transaction
- VSIRP will generate hedge documentation, which establishes the hedging relationship
- This hedge relationship will be accounted for as a cash flow hedge
- Hedges variability in interest expense associated with anticipated changes in 3-month wholesale funding

Accounting for Funding Hedge

Accounting Details

- At the end of the first period, VSIRP will send fair values, hedge effectiveness tests and suggested journal entries using Reval, our SOC 1 and SOC 2 compliant valuation platform
- The swap value is recorded as an asset or liability with the offset recorded in Accumulated Other Comprehensive Income (AOCI)
- Valuations and suggested entries sent monthly for the life of the transaction

Thank You!

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