

Strategic Loan Pricing

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Agenda: Nine Strategic Concepts

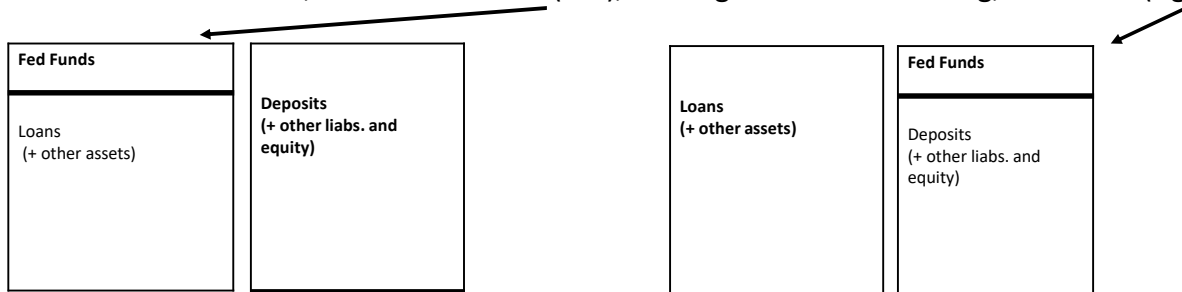
- Part 1 – Five Key Concepts
 - Concept #1 – Know your bank's and competitors' loan-to-deposit ratios
 - Concept #2 – Recognize the drivers of loan profitability (and how to "scout" competition)
 - Concept #3 – Manage your own loan portfolio
 - Concept #4 – Use odd-decimal pricing (taking advantage of bid situations)
 - Concept #5 – Differentiate on all risk metrics
- Part 2 – Discussion and More, Brief Concepts
 - Discussion: How is your bank's liquidity level affecting pricing? If your bank uses a pricing model, what are the pros and cons? If not using one, why?
 - Concept #6 – Recognize economies of scale; Concept #7 – Options, options, options;
 - Concept #8 – Avoid under-pricing; Concept #9 – Using "grid" or performance pricing;
 - Discussion: What has worked for you and/or your bank?

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1. Loan-to-Deposit Situation

- It all starts with your bank's financial structure, especially loan-to-deposit ratio
- Basics of bank funding (liabilities) and inevitable imbalances to loans (assets) levels, and the role of Fed Funds as the temporary balancing item
 - But worst return, if short on assets (left), and highest cost of funding, if needed (right)

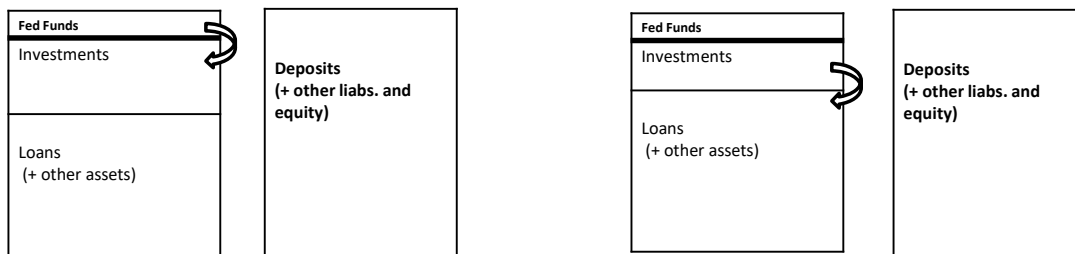


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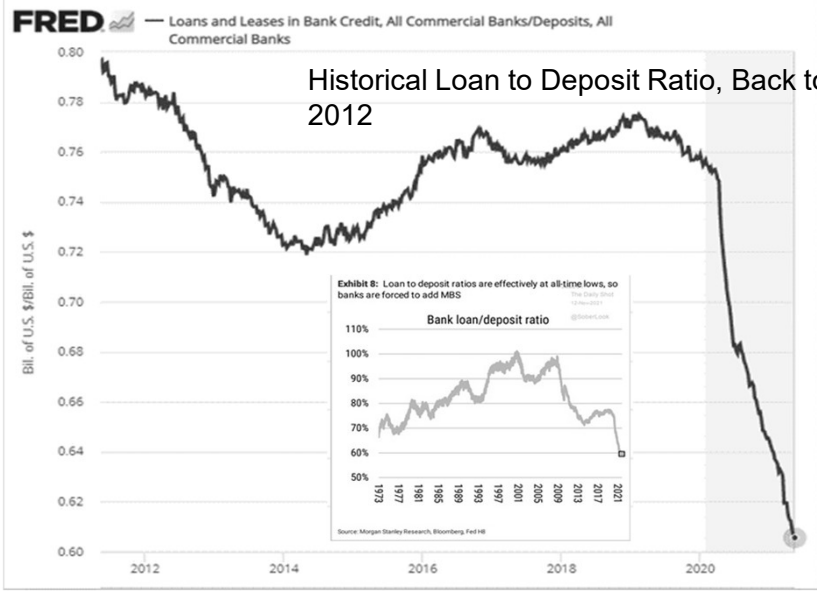
1. Loan-to-Deposit Situation (cont.)

- If a bank consistently has excess deposits versus loans (typical of many banks prior to COVID and almost all banks during COVID), it makes sense to reduce the usage of Fed Funds shift into investments/bonds (much better return)
 - If loan growth (even better returns) happens, the bonds usually can be liquidated to fund loans rather than chasing new deposits, if interest rate are relatively stable



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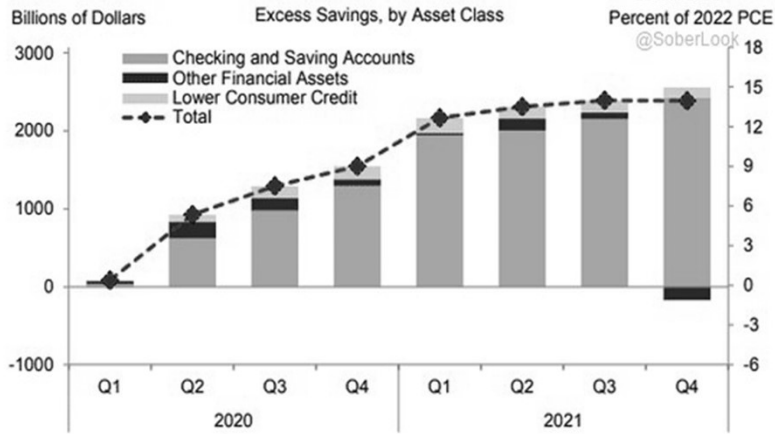




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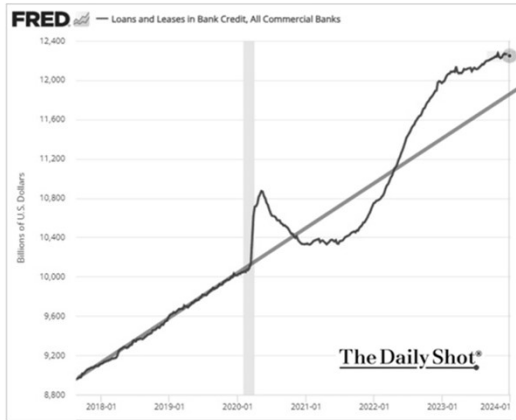


Exhibit 11: Households Have Accumulated Around 14% of a Year's Spending in Excess Savings, With Almost All Saved in Checking and Saving Accounts



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Loan Growth Had Stalled in 2024 and Loan-to-Deposit Ratios Were Stuck Below Pre-COVID Levels (Due to Unrealized Losses on Securities) . . .

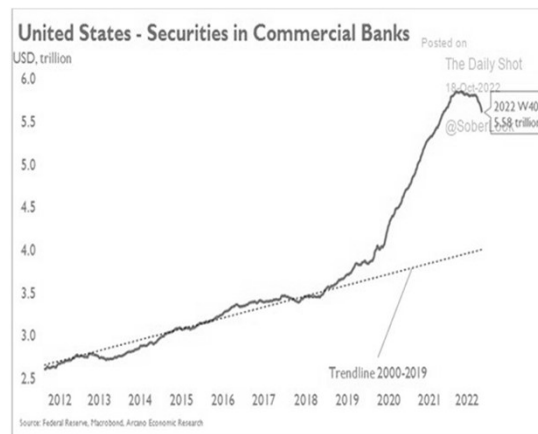


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1. Loan-to-Deposit Situation (cont.)

. . . and allowed banks to make modest reductions to securities holdings, but this was somewhat limited due to the losses upon sale, unless the securities matured or paid off



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1. Loan-to-Deposit Situation (cont.)

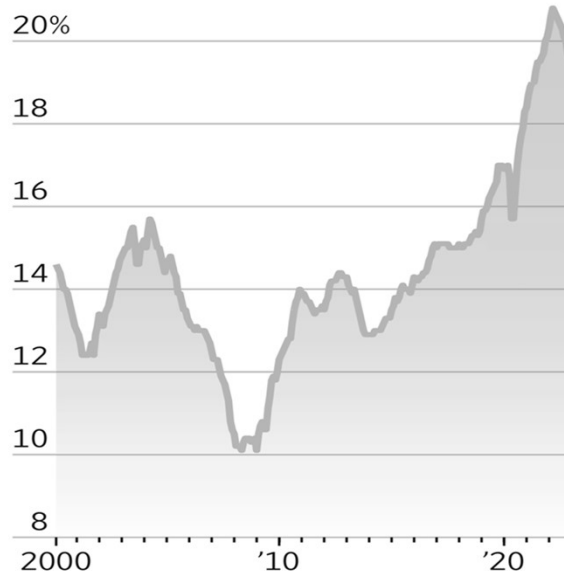
- 2022 distorted the use of LTD ratio as liquidity barometer or indicator of a bank's appetite for loans
 - Typically, a bank with a low LTD will be more aggressive (lower) in loan pricing, because a low loan rate still is better than Fed Funds and most investments/bonds
 - In 2021 and early 2022, many banks deployed their excess liquidity into securities, primarily bonds
 - As the Fed raised rates at a record pace (see below), these bonds lost market value, creating a large potential loss if sold
 - I heard one banker say that their bonds were being held hostage by these unrealized losses
- So, until this situation is corrected, using LTD is not as straightforward

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Loan-to-Deposit Situation

- Some history back to 2000 – Treasury and federally-backed securities as a share of banks' total assets (WSJ 03-22-2023)



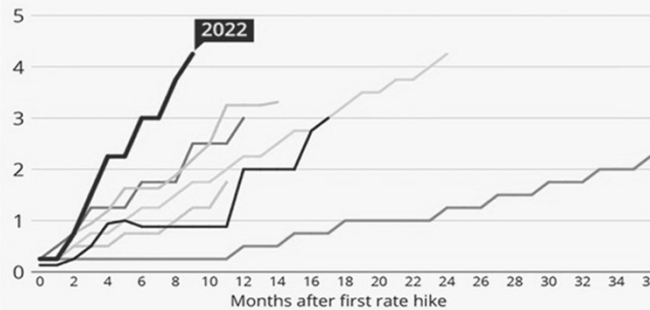
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The Fed Is Moving Historically Fast to Tame Inflation

Changes in the federal funds target rate in past tightening cycles (in percentage points)

1983 1988 1994 1999 2004 2015 2022



Source: Federal Reserve

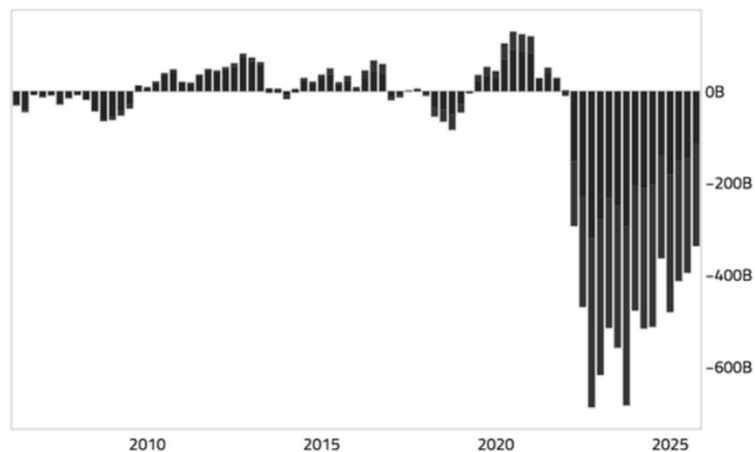
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Unrealized Securities (Bonds) Losses in Dollar Amounts and Down to About 15% of Banking-Wide Capital by End of Q3

Unrealized Gains/Losses on Investment Securities

Available-for-Sale Securities Held-to-Maturity Securities



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Loan-to-Deposit Situation (cont.)

- So, as a review, bonds that previously were a necessary alternative to Fed Funds, in the face of weak loan demand early in the Pandemic, and could be liquidated, as needed, to fund a rebound in loan demand . . .
- Dropped in value in 2022 as interest rates jumped, creating an unrealized loss (until sold), complicating the ability to sell the bonds to cover loan growth, rather than raising deposits
 - Again, “hostage bonds”??



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Loan-to-Deposit Situation (cont.)

- What about Silicon Valley Bank and others?
 - First, there have been accusations that banks purposefully avoided deploying the excess deposits into loans and took the easy road by investing in bonds
 - This ignores the fact that since loan demand early in the pandemic was very weak, banks had very few options other than treasuries and bonds to get a decent yield
 - Second, accusations that banks recklessly purchased longer-duration securities are somewhat incorrect, given that the consensus was that if or when the Fed started raising rates, it would only be a short time before the Fed would turn around and decrease rates



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Back to Loan Pricing

- As if bank balance sheet issues don't create enough problems, some competitors have unusual funding
 - Online lenders get funds from hedge funds and mutual funds, not deposits
 - Very volatile and can exit if losses occur
 - Continually changing demands for investment/funding return and real cost
 - Farm Credit issues debentures in rounds, so if working from older placements (in a rising rate environment) its rates can look great, and vice-versa
 - Plus, they give the borrower a "patronage" payment, a type of dividend or rebate against the loan rate, so the "net" rate is critical
- Bottom line: Not always a "level playing field"



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2. Recognize the Drivers of Loan Profitability

- To illustrate some of the other bank financial structure elements
 - We'll use a simple loan pricing model that targets return on Equity (ROE)
 - This will allow us to see the critical components that determine loan profitability
 - These same elements will be areas of pricing competitive advantages or disadvantages



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Pricing Model Basics

- Common strategies
 - For individual loans
 - Cost-plus or stand-alone approach (we'll use this in our example)
 - Loan must meet an ROE target
 - Relationship approach
 - Value of fees and deposits added
 - Combination approach
 - Loan(s) must meet ROE goal – if so, then finished
 - If not, then a higher (usually) relationship goal must be met



Pricing Model Basics (cont.)

- Why use a model?
 - Even a basic model is better than not using one
 - Helps assess pricing options and trade-offs between interest rates (fixed vs. variable) or rate vs. fee
 - Inputs can be simple in a loan-only or stand-alone approach, usually
 - Capital ratio
 - Risk weighting of loan
 - Target ROA and ROE
 - Overhead and credit risk costs based on risk rating such as
 - 3 RR = 0.75% , 4 RR = 1.0%, 5 RR = 1.5%, etc. for overhead cost
 - 3 RR = 0.5%, 4 RR = 0.65%, 5 RR 1% OH, etc. for ACLL cost
 - Let's demonstrate the basic math behind most models . . .



Example Stand-Alone Model

| Target ROE | 11.10% | 9.60% | 12.41% | 13.00% |
|------------------------------|----------------|----------------|----------------|----------------|
| Convert to decimal | | 0.09593 | 0.12414 | 0.13000 |
| x Capital ratio | | 0.07000 | 0.07000 | 0.07000 |
| x Risk weighting of loan | | 1.00000 | 1.00000 | 1.00000 |
| Target after-tax ROA | | 0.00672 | 0.00869 | 0.00910 |
| ÷ (1 – tax rate) | | 0.79000 | 0.79000 | 0.79000 |
| Target pre-tax ROA | | 0.00850 | 0.01100 | 0.01152 |
| + Overhead cost | | 0.01000 | 0.01000 | 0.01000 |
| + Risk factor (ALLL) | | 0.00650 | 0.00650 | 0.00650 |
| Req. spread over CoF | | 0.02500 | 0.02750 | 0.02802 |
| Prime vs. CoF | | (0.01500) | (0.01500) | (0.01500) |
| Quote to customer, P+ | 0.01134 | 0.01000 | 0.01250 | 0.01302 |

Drivers of Competitive Advantage

- From example pricing model
 - But using the old 34% corporate tax rate, which some banking advisors use as the theoretical tax rate for an S corporation bank, since many shareholders are closer to that rate
- Where can you gain competitive advantage?
 1. Starting with a lower target ROE



Example Stand-Alone Model Competitive Advantage Example - Different ROEs

| Target ROE | 10.0% | 11.0% | 12.0% | 13.0% |
|-----------------------------|----------|----------|----------|----------|
| Convert to decimal | 0.10000 | 0.11000 | 0.12000 | 0.13000 |
| x Capital ratio | 0.07000 | 0.07000 | 0.07000 | 0.07000 |
| x Risk weighting | 1.00000 | 1.00000 | 1.00000 | 1.00000 |
| = Target after-tax ROA | 0.00700 | 0.00770 | 0.00840 | 0.00910 |
| Divide by (1- tax rate) | 0.66000 | 0.66000 | 0.66000 | 0.66000 |
| Pretax ROA | 0.01061 | 0.01167 | 0.01273 | 0.01379 |
| + Overhead factor | 0.01000 | 0.01000 | 0.01000 | 0.01000 |
| + Risk factor | 0.00650 | 0.00650 | 0.00650 | 0.00650 |
| = Min. Spread over CofF | 0.02711 | 0.02817 | 0.02923 | 0.03029 |
| Diff: Prime vs. CofFunds | -0.01500 | -0.01500 | -0.01500 | -0.01500 |
| = Spread quoted to customer | 0.01211 | 0.01317 | 0.01423 | 0.01529 |
| Quote Prime + | 1.21% | 1.32% | 1.42% | 1.53% |

Drivers of Competitive Advantage (cont.)

- From example pricing model
- Where can you gain competitive advantage?
 1. Starting with a lower target ROE
 2. Having a lower required or target capital ratio



Example Stand-Alone Model

Competitive Advantage Example - Different Capital Ratios

| | 10.0% | 10.0% | 10.0% | 10.0% |
|-----------------------------|----------|----------|----------|----------|
| Target ROE | 10.0% | 10.0% | 10.0% | 10.0% |
| Convert to decimal | 0.10000 | 0.10000 | 0.10000 | 0.10000 |
| x Capital ratio | 0.06000 | 0.07000 | 0.08000 | 0.09000 |
| x Risk weighting | 1.00000 | 1.00000 | 1.00000 | 1.00000 |
| = Target after-tax ROA | 0.00600 | 0.00700 | 0.00800 | 0.00900 |
| Divide by (1- tax rate) | 0.66000 | 0.66000 | 0.66000 | 0.66000 |
| Pretax ROA | 0.00909 | 0.01061 | 0.01212 | 0.01364 |
| + Overhead factor | 0.01000 | 0.01000 | 0.01000 | 0.01000 |
| + Risk factor | 0.00650 | 0.00650 | 0.00650 | 0.00650 |
| = Min. Spread over Coff | 0.02559 | 0.02711 | 0.02862 | 0.03014 |
| Diff: Prime vs. Coffunds | -0.01500 | -0.01500 | -0.01500 | -0.01500 |
| = Spread quoted to customer | 0.01059 | 0.01211 | 0.01362 | 0.01514 |
| Quote Prime + | 1.06% | 1.21% | 1.36% | 1.51% |

Drivers of Competitive Advantage (cont.)

- From example pricing model
- Where can you gain competitive advantage?
 1. Starting with a lower target ROE
 2. Having a lower required or target capital ratio
 3. Lower overhead and related costs



Example Stand-Alone Model

Competitive Advantage Example - Different Overhead Costs

| | | | | |
|-----------------------------|----------|----------|----------|----------|
| Target ROE | 10.0% | 10.0% | 10.0% | 10.0% |
| Convert to decimal | 0.10000 | 0.10000 | 0.10000 | 0.10000 |
| x Capital ratio | 0.07000 | 0.07000 | 0.07000 | 0.07000 |
| x Risk weighting | 1.00000 | 1.00000 | 1.00000 | 1.00000 |
| = Target after-tax ROA | 0.00700 | 0.00700 | 0.00700 | 0.00700 |
| Divide by (1- tax rate) | 0.66000 | 0.66000 | 0.66000 | 0.66000 |
| Pretax ROA | 0.01061 | 0.01061 | 0.01061 | 0.01061 |
| + Overhead factor | 0.01000 | 0.01250 | 0.01500 | 0.01750 |
| + Risk factor | 0.00650 | 0.00650 | 0.00650 | 0.00650 |
| = Min. Spread over CofF | 0.02711 | 0.02961 | 0.03211 | 0.03461 |
| Diff: Prime vs. CofFunds | -0.01500 | -0.01500 | -0.01500 | -0.01500 |
| = Spread quoted to customer | 0.01211 | 0.01461 | 0.01711 | 0.01961 |
| Quote Prime + | 1.21% | 1.46% | 1.71% | 1.96% |

Drivers of Competitive Advantage (cont.)

- From example pricing model
- Where can you gain competitive advantage?
 1. Starting with a lower target ROE
 2. Having a lower required or target capital ratio
 3. Lower overhead and related costs
 4. More accurate credit risk assessment
 - Or more granular rating scale
 - Smaller banks tend to have a four-point pass scale
 - Larger banks tend to have nine or ten points, which subdivides smaller banks' broader categories
 - Example at left

| Smaller Bank | Larger Bank |
|--------------|-------------|
| 3 = 0.5% | 4 = 0.4% |
| | 5 = 0.5% |
| | 6 = 0.55% |
| 4 = 0.65% | 7 = 0.6% |
| | 8 = 0.65% |
| | 9 = 0.7% |

Example Stand-Alone Model

Competitive Advantage Example - Different Risk/ALLL Factors

| | | | | |
|-----------------------------|----------|----------|----------|----------|
| Target ROE | 10.0% | 10.0% | 10.0% | 10.0% |
| Convert to decimal | 0.10000 | 0.10000 | 0.10000 | 0.10000 |
| x Capital ratio | 0.07000 | 0.07000 | 0.07000 | 0.07000 |
| x Risk weighting | 1.00000 | 1.00000 | 1.00000 | 1.00000 |
| = Target after-tax ROA | 0.00700 | 0.00700 | 0.00700 | 0.00700 |
| Divide by (1- tax rate) | 0.66000 | 0.66000 | 0.66000 | 0.66000 |
| Pretax ROA | 0.01061 | 0.01061 | 0.01061 | 0.01061 |
| + Overhead factor | 0.01000 | 0.01000 | 0.01000 | 0.01000 |
| + Risk factor | 0.00500 | 0.00650 | 0.01000 | 0.01500 |
| = Min. Spread over CofF | 0.02561 | 0.02711 | 0.03061 | 0.03561 |
| Diff: Prime vs. CofFunds | -0.01500 | -0.01500 | -0.01500 | -0.01500 |
| = Spread quoted to customer | 0.01061 | 0.01211 | 0.01561 | 0.02061 |
| Quote Prime + | 1.06% | 1.21% | 1.56% | 2.06% |

Drivers of Competitive Advantage (cont.)

- From example pricing model
- Where can you gain competitive advantage?
 1. Starting with a lower target ROE
 2. Having a lower required or target capital ratio
 3. Lower overhead and related costs
 4. More accurate credit risk assessment
 5. Not paying income taxes
 - Credit unions?



Example Stand-Alone Model Competitive Advantage Example - No Income Tax (Cr. Unions)

| | | |
|-----------------------------|----------|----------|
| Target ROE | 10.0% | 10.0% |
| Convert to decimal | 0.10000 | 0.10000 |
| x Capital ratio | 0.08000 | 0.08000 |
| x Risk weighting | 1.00000 | 1.00000 |
| = Target after-tax ROA | 0.00800 | 0.00800 |
| Divide by (1- tax rate) | 0.66000 | 1.00000 |
| Pretax ROA | 0.01212 | 0.00800 |
| + Overhead factor | 0.01000 | 0.01000 |
| + Risk factor | 0.00650 | 0.00650 |
| = Min. Spread over Coff | 0.02862 | 0.02450 |
| Diff: Prime vs. Coffunds | -0.01500 | -0.01500 |
| = Spread quoted to customer | 0.01362 | 0.00950 |
| Quote Prime + | 1.36% | 0.95% |

Drivers of Competitive Advantage (cont.)

- From example pricing model
- Where can you gain competitive advantage?
 1. Starting with a lower target ROE
 2. Having a lower required or target capital ratio
 3. Lower overhead and related costs
 4. More accurate credit risk assessment
 5. Not paying income taxes
 6. Having a lower cost of funds
 - Greater spread between cost of funds and Prime, in sample model



Example Stand-Alone Model Competitive Advantage Example - Lower Cost of Funds

| | | | | |
|-----------------------------|----------|----------|----------|----------|
| Target ROE | 10.0% | 10.0% | 10.0% | 10.0% |
| Convert to decimal | 0.10000 | 0.10000 | 0.10000 | 0.10000 |
| x Capital ratio | 0.07000 | 0.07000 | 0.07000 | 0.07000 |
| x Risk weighting | 1.00000 | 1.00000 | 1.00000 | 1.00000 |
| = Target after-tax ROA | 0.00700 | 0.00700 | 0.00700 | 0.00700 |
| Divide by (1- tax rate) | 0.66000 | 0.66000 | 0.66000 | 0.66000 |
| Pretax ROA | 0.01061 | 0.01061 | 0.01061 | 0.01061 |
| + Overhead factor | 0.01000 | 0.01000 | 0.01000 | 0.01000 |
| + Risk factor | 0.00650 | 0.00650 | 0.00650 | 0.00650 |
| = Min. Spread over CofF | 0.02711 | 0.02711 | 0.02711 | 0.02711 |
| Diff: Prime vs. CofFunds | -0.01600 | -0.01500 | -0.01400 | -0.01300 |
| = Spread quoted to customer | 0.01111 | 0.01211 | 0.01311 | 0.01411 |
| Quote Prime + | 1.11% | 1.21% | 1.31% | 1.41% |

Putting This Knowledge to Use

- **Scout the competition**
- Financial structure of bank competitors available from quarterly Call Reports
 - Problem: Time lag
 - Problem: Not sure their board's goals
 - Benefit: Can reveal some obvious advantages/disadvantages
 - Benefit: You can develop a strategy
 - Play to your bank's strengths
 - Scout your own portfolio (next slide)
- Quote: If you don't have a strategy, your competitor's strategy becomes your strategy



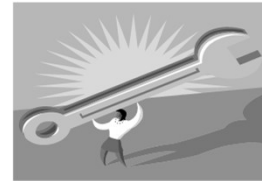
3. Scout Your Own Portfolio

- Putting this knowledge to use, again
- Be proactive, each lender should
 - Start with 10-20 largest customers
 - Determine what fixed-rate loans exist
 - Rate or spread
 - Length to maturity or rate adjustment
 - Any call protection in terms of
 - Prepayment penalties
 - Cost for customer to move the loan (recording fees, other closing fees, etc.)
 - Long-time relationship that is not likely to move
- If you don't have a plan ready, then you will be forced to make a quick response if/when a competitor enters the picture



4. Use Odd-Decimal Rates

- Take advantage of bid situations
- Avoid $\frac{1}{2}$, $\frac{1}{4}$, etc.
- If a bid situation, adjust down to rate ending in “8” or “9”, or
- Use non-fractional endings to
 - Get closer to desired (higher) rate
 - Debating between Prime + $\frac{1}{4}$ or Prime + $\frac{1}{2}$?
 - Don’t split the difference with another fraction
 - Come back with Prime + 0.4136% or similarly odd-looking number
 - Or as a slight inflator that enhances ROE



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4. Use Odd-Decimal Rates (cont.)

- Example from our stand-alone pricing model
 - Model yields Prime (P) + 1.134% for targeted ROE
 - Most lenders would round DOWN to P + 1.0%
 - Giving up 151bp of ROE
 - You may not be comfortable rounding UP to P + 1.25%
 - But it adds 130bp of ROE
 - Consider P + 1.302 (odd-decimal) for a 13% ROE
 - +190bp ROE from original model result
- Interesting result
 - Customers perceive more precision or “science” on your end
 - You set the stage for smaller adjustments in the final negotiating, or at least less haggling for the sake of haggling
 - Much of this is the “psychology” of setting loan rates

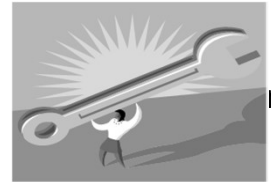


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5. Differentiate on All Risk Metrics

- Collateral coverage or loan-to-value (LTV)
- Collateral “match” to loan type
- “Strength” of debt service coverage (DSC)
debt-to-income (DTI)
- Length of amortization/maturity vs. policy
- Adopt mentality of customers paying for exceptions to policy or more generous (usually riskier for bank) loan terms
- Example grid on next slide . .



Differentiate on All Risk Metrics - Example



| Minimum Rate Based on Collateral | Risk Rating | | |
|--|-------------|-------|--------|
| | 1-3 | 4-5 | 6-9 |
| Liquid Collateral | P | P+1.0 | P+1.5 |
| Properly Margined RE | P+1.0 | P+1.5 | P+2.0 |
| Properly Margined AR+INV | P+1.5 | P+2.0 | P+2.5 |
| Other Assets | P+2.0 | P+2.5 | P+3.0 |
| Unsecured | P+2.5 | P+3.0 | P+3.5 |
| Reduction to Minimum Rate Based on Guarantor | (1.0) | (0.5) | (0.25) |
| If multiple guarantors, use weighted average risk rating of guarantors (using guarantee percentages) | | | |

Recent Comments on Pricing Grid or Sheet Approach

- Updated weekly and only a guide for our lenders and not the rule
 - If lender has a deal that is within his/her lending authority and wants to price below it, then extra approval needed
- There are additional spreads near the middle of the sheet based on relationship size
- Lenders encouraged to quote higher than our sheet, but at least it gives them a guide and a minimum we want
 - Obviously more competitive deals are always up for discussion
 - Where it seems to work best is on smaller deals; we are trying to push our lenders, including me, to get adequate pricing on smaller deals that most likely are not shopped as much
 - Sell yourself, your service, our timeliness, and ease of use to help explain the rate being offered
 - It can create some nervousness amongst the lenders, but we've found in most instances that the borrower is accepting of the rate

Current Loan Pricing Issues

- How is your bank's liquidity level continuing to affect pricing?
- If your bank uses a pricing model, what are the pros and cons? If not using one, why?
- Does your bank use a "pricing sheet"?

6. Recognize Economies of Scale

- Point: Larger loans better cover booking costs and overhead, so they deserve consideration of lower pricing
- Counterpoint: Larger loans usually entail more risk to a medium-sized or small bank simply due to the loan size relative to capital



7. Options, Options, Options

- In all deals, even if customer doesn't ask
- Quote
 - Both fixed and floating interest rates
 - Combinations of interest rates and origination fees
 - Combinations of interest rates and length/term
- Tilted to what you want
 - Not always economically equal
 - Fees can help sway
 - Pricing as "carrot"
 - Don't overestimate future business
- Negotiating tool



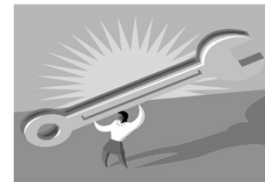
7. Options, Options, Options (cont.)

- Don't forget conversion options
 - Great defensive tool
 - In periods of increasing or decreasing interest rates, after loan already booked and competitors attempt to poach
 - Or if customer "rate shops" and gets proposals for rates different from existing rate, usually fixed vs. floating
 - Minimize re-touching of credits just for re-pricing
 - Helps if customer having difficulty deciding



8. Commonly Under-Priced Situations

- Standby letter of credits (SLOCs)
 - Need 2.00% ++ per annum fee/price to meet required ROE in most models
- Bridge/temporary loans
 - Often short-term, even unsecured
 - Lack proper risk vs. reward trade-off
 - Interest income often does not even cover up front booking costs
 - Need to be an extension of a true relationship



9. Performance or “Grid” Pricing

- Called “grid” pricing in large corporate loans
- Multiple, pre-approved rates or index spreads based on
 - Key financial ratio, such as DSC or leverage
 - Other events or compliance issues
- Can be reward or punishment
- One variation is called a success fee, or an additional origination fee that is collected if loan pays off early, presumably from a successful venture

Conclusion, Other Comments/Questions



- What other strategies has your bank used to stay competitive with pricing?
- Any other questions or issues?
- I have enjoyed working with you again . . .

- Richard -