

## THE FIVE “C’s” OF LENDING

*Capacity – Capital – Character – Conditions – Collateral*

Credit analysis serves the function of screening loan propositions, identifying risks, structuring an appropriate loan, securing quality assets when necessary and monitoring the loan on an ongoing basis.

### **CAPACITY**

Capacity is defined as the borrower’s ability to satisfy debt obligations from predictable or consistent income sources.

The principal tool used to measure capacity is the Debt-to-Income ratio; a cash flow analysis of the borrower’s total debt obligations compared to the verifiable gross monthly income. To determine the continuity of income, and hence, long term solvency, the employment and income histories must be carefully analyzed.

### **CAPITAL**

The term capital relates to how well the borrower has managed his/her financial affairs. There are three dimensions to consider; *net worth, liquidity, and financial responsibility.*

*Net worth* is a borrower’s total assets minus his/ her liabilities. Naturally, an individual with significant net worth has a greater incentive to protect investments and repay obligations.

*Liquidity* is the ability of the borrower to meet his obligations with cash is necessary or to convert assets to cash quickly. A sufficient level of liquidity, over and above the equity position (down payment) and regular income stream, afford the borrower a cushion against unforeseen developments.

*Financial responsibility* relates to a borrower’s risk management. Lenders will be extremely cautious with borrowers who seem to take imprudent risks or to leverage themselves beyond conventional limits.

### **CHARACTER (CREDIT)**

The term “character” relates to willingness to pay or a person’s sense of honor toward obligations and is often used with “integrity”. The most direct evidence of this is the actual record of how debt payments have been handled historically, as revealed by the credit report, as well as checking with employers and creditors.

The most significant aspect of the credit report is a consistent good payment performance. A few isolated delinquencies may be insignificant if an overall pattern of prompt payment history exists. A reported delinquency with a mortgage lender is quite significant and considered to be derogatory unless the borrower can demonstrate otherwise.

Another aspect of character comes from evidence of stability and roots. Stability in residence and employment are positive factors. Being in business in a community and building a community standing over time creates roots. It is equally important when weighing character, for a person to have a stake in his / her lifestyle and status. A career commitment can also create a sense of roots since maintaining a good reputation and credit standing are necessary to the achievement of major career goals.

## **CONDITIONS**

Conditions refer to factors essentially beyond the borrowers control that could impair or enhance his / her ability to meet commitments. There are many risks to payback that cannot be foreseen even with prudent credit analysis. The likely collapse of an employer could be a consideration even though that person's credit picture looks otherwise favorable. While it may be difficult to judge outside influences certain industries are more apt to these influences including; medical, insurance and financial services.

## **COLLATERAL**

Collateral is defined as the security or asset pledge by the borrower to the lender. Lenders first try to reduce risk by sound experienced credit analysis. When the practical limits of good credit analysis have been reached, the remaining uncertainties are mitigated by collateral. The value and quality of the collateral is determined by the property appraisal. Lenders review the appraisal to determine whether or not the collateral is sufficient to secure the mortgage.

Since all the preceding factors require some element of judgment the function of collateral is to protect lenders from the imperfections of judgment as well as from the adverse impact of unanticipated changes in conditions.