The 5 Cs of credit analysis

Credit analysis or assessment is the process of determining whether to extend credit or loan to a customer (Ross et al, 2002). The process involves two steps, namely: gathering relevant information on a customer and determining the customer's creditworthiness. The process of credit analysis is very important because the potential for default or loss can be mitigated or avoided altogether. Financial institutions (FIs) including other providers of credit for example, manufacturers selling goods and services on credit, use a technique or process popularly known as the 5 Cs of credit analysis to evaluate customers. The 5 Cs of credit are: Character, Capacity, Capital, Collateral and Conditions (Ross et al 2002; Strischek D. 2000).

The essential point to note is that for FIs, credit customers must be subjected to a rigorous assessment process to determine their creditworthiness and this is not a decision that should be made in a hurry because it relies on being able to obtain independently verified information on the customers from elsewhere and that can take time. This information includes credit history of the borrower as obtainable from credit reference bureaus, banks/FIs, other businesses a customer has dealings with, including in the case of a business financial statements, court judgements, etc. As a matter of fact, FIs need information about the customer both at the time of receiving a loan application and after granting the loan because they have to keep track of and monitor the performance of the customer over the life of the loan because this information can become handy to the lender in future should the customer apply for another loan.

FIs have to exercise care when conducting credit analysis because sometimes a loan applicant can decide to conceal some information about his/her characteristics, for example, if it's a business it can decide to withhold information about its market position, the size of the competition, its reliance on a partner for instance, existing debts it is not servicing that may become non-performing, etc. The attitude of the loan applicant, not to provide the lender with this information, is unacceptable as it could lead to the lender not being able to correctly assess the creditworthiness of the customer. In a credit relationship, poor-quality borrowers, by hiding information, seek to be considered as being of good-quality, thus presenting themselves as risky borrowers (Tupangiu, 2017). This arises as a result of the problem of information asymmetry, a situation where one party has information that the other does not have, and this can jeopardise decision making as the party with a deficit of information can make an uninformed decision, often to its detriment. As a result of the problem of information asymmetry, lenders have difficulty to differentiate between borrowers of good quality and those of poor quality. Therefore, identifying good loan applicants remains a difficult and problematic process not to be taken lightly (Stiglitz and Weiss 1981).

Using credit analysis, a FI would rate a borrower on a scale of 1 (very poor) to 10 (very good) on each element of the 5 Cs based on all the information assembled on the borrower. By tallying the ratings for each element of the 5 Cs, a rating would be arrived at and based on its own experience the FI would decide to grant credit only to customers with a credit score that is above 30. Therefore, the result of a credit assessment is a credit score, which is basically a numerical rating for a customer based on information collected and credit is then granted or refused based on the score (Ross et al, 2002).

While all FIs undertake credit scoring it is worth noting that in microfinance for instance this process is not done in the conventional way but has been simplified. In the case of group loans members of groups conduct their own vetting using a concept known as self-selection, whereby only those who meet set selection criteria qualify to join groups (Ledgerwood, 1999). However, as SME loans are introduced which carry a greater risk credit assessment assumes a more rigorous approach.

In this article we shall only look at the first C, Character and subsequent articles will be devoted to the other four Cs.

Character

Every man has three characters—that which he exhibits, that which he has, and that which he thinks he has.
Alphonse Karr (1808-1890)

Being the first on the list of the 5 Cs criteria does not necessarily mean character is the most important of the 5 Cs neither is it unimportant at all, it is an important criterion. But it is interesting to note that different institutions might actually rank the 5 Cs differently as a study in Ghana demonstrated that local banks rated the 5 Cs differently from foreign banks operating in Ghana (https://www.researchgate.net/publication/320445357).

Character is a human characteristic that describes the behaviour and attitudes that distinguish one person from another and this can be extended to groups or people or even entire nations (Strischek, 2000). Assessing character can be subjective and/or intuitive, but can also be fact based to the extent that it may relate to assessing verifiable information about a person. Strischek (2000) also suggests that character ranks first among the 5 Cs in determining creditworthiness because unless the borrower is willing to honor his obligations by repaying the debt, which would signify the value he/she places on reputation, integrity and honesty, all the other Cs would be of no consequence.

Fact based character assessment involves a review of

i) credit reports on an individual or a company,
ii) FIs communicate with current and former bankers to the borrower with the aim of learning about how the borrower has conducted himself with his bankers in the past.
iii) FIs communicate with some of the borrower’s customers and suppliers so as to determine his/her dealings with their business partners.
iv) Etc.

Subjective character assessment would be based on observations made during interactions e.g. how the customer deals with the FI during the application process. FIs and indeed other businesses want to deal with trustworthy people, who they can trust to act in good faith at all times, whether in good times or bad times. They want to be given assurances that even if things were to go wrong the borrower can be relied upon to work towards fulfilling his/her obligations to the FIs.

Therefore, even if the borrower's credit score is good on the other 4 Cs, the character test outcome is still very important and any indication of doubtful character or lack of trustworthiness would result in rejection of a loan application. It is normal for people or businesses to go through difficult and challenging times, this would not matter so much, but the important thing would be for the FI to know how the situation was dealt with. Did the customer proactively inform the FI about the situation? Or did the borrower wait until the FI called about a looming default situation? Did he/she cooperate with the FI during the period of financial distress? This is what character is all about and it matters a lot.

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AMIZ Association of Microfinance Institutions of Zambia