The 5 Cs of credit analysis

If it isn't the sheriff's department, it's the finance company. I have more attachments on me than a vacuum cleaner.
John Barrymore (1882-1942)

In this series of articles on the 5 Cs of credit analysis we continue by looking at Collateral. We have in the last three articles discussed Character, Capacity and Capital. According to Strischek (2000) collateral refers to property or assets belonging to a borrower that are pledged to a lender to safeguard the loan in the event of default. He emphasises that collateral is the final source of repayment and represents the last option of protection against loan loss. Gitman et al (2015) defines collateral as the amount of assets a borrower makes available for use in securing credit and also notes that the larger the amount of available assets, the greater the chance that a lender will recover funds in the event of a borrower defaulting.

Microfinance institutions like other lenders also require collateral, but as noted by Wilkinson (2013) microfinance clients, who largely constitute poor and low-income people do not possess the type of assets that are usually acceptable as collateral e.g., property such as buildings, land, machinery, inventory, vehicles, homes, fixtures, etc. Therefore, microfinance in its attempt to innovate has introduced what are termed "collateral substitutes", and these are: *(i) peer pressure* - whereby members in groups formed for purposes of accessing loans (group lending) subject one another to constant pressure to ensure on-schedule payment of their loans. *(ii) group guarantee* - whereby group members jointly guarantee each other's loans. *(iii) compulsory or forced savings* - whereby loan applicants are required to deposit upfront, a percentage of the loan amount applied for, as a condition to get the loan. These have generally worked well for smaller loans, resulting is recovery rates of more than 90%. However, as borrowers' businesses grow and they graduate from the group loans to individual loans, MFIs begin to demand tangible collateral. In Zambia, microfinance clients, as well as others can now pledge movable assets as collateral. This has been possible by the establishment of the movable assets collateral registry which is housed at the Patents and Companies, Registration Agency (PACRA).

Types of collateral

The best collateral from a lender's point of view is an asset that can be quickly and easily liquidated into cash. Collateral can be grouped into 3 types:

i) Tangible collateral - property such as buildings, land, machinery, inventory, vehicles, homes, fixtures, etc. These are not easy to sell, they take time and incur expenses such as advertising, court processes, etc.

ii) Cash collateral - cash, held in demand deposits, negotiable instruments such as treasury bills, shares/stocks, and corporate bonds. Cash is the best form of collateral since it suffers no discounting at all. Cash equivalents are also as good as cash, although they may be subjected to some processing fees.

iii) Receivables - accounts receivable, notes receivable, and invoices a firm will have sent out. These are riskier than tangible assets because of the possibility that they may not be fully collected.

Apart from cash, the other types of collateral are subject to discounts or haircuts due to the fact that their values may not be fully realizable. Below is the extent to which different types of collateral may be recovered in the event of default:

- Accounts receivable - 80% of value
- Inventory – 50% of value
- Equipment/machinery – 80% of value
- Real estate – 75% of value

These recovery rates may not be universal but will differ by jurisdiction and other factors.

Assessing collateral

According to Fabozzi (2005) collateral analysis is important for lenders as it addresses the question: "What is the probability of default, and in case of default, how much will be recovered?" One ratio lenders' use to determine this, is the loan-to-value ratio (LTV), which is an indicator of a borrower's leverage at the time of filing the loan application. The formula for LTV is simply Loan Amount divided by Value of Collateral. It compares the value of the loan to the market value of the property (in the case of mortgage loans). This ratio is important for two reasons: it is an indicator of the amount that can be recovered from a loan in the event of default; it also has an impact on the value of the expected payment performance of the borrower because high LTV may indicate a greater likelihood of default on the loan. Lenders use LTVs to determine how risky a loan is and whether they should approve or deny it. For example, a higher LTV suggests more risk because there is a higher chance of default. E.g., if a home is valued at K1.5 m and a borrower makes a down payment of K300,000 towards it, the mortgage loan would be K1.2 m. The LTV ratio will be K1.2 m divided by K1.5 m or 80%. At this level the LTV is very high making default risk equally high. In the event that the value of the house appreciates, the opposite would be the case. LTV can be used for different types of loans, including house and car loans as well as for purchases and refinances.

Another ratio lenders use is the debt-income ratio, which is made up of all an individual's monthly debt payments, divided by the gross monthly income. It helps lenders measure a borrower's ability to manage the monthly payments to repay a loan.

Rating of elements of the 5 Cs by different financial institutions

Some lenders will evaluate a borrower's credit score in addition to the amount of collateral provided. For example, some lenders will require a good credit score even if a borrower has suitable collateral. A typical money lender, on the other hand, will look at the value of collateral, with little, if any regard to the credit score. In general, collateral will help a borrower to get a loan more easily, but it's not a panacea for a poor credit score.

In the Ghana study referenced in previous articles, with regard to collateral, local banks ranked it as number 3 while foreign banks operating in the country ranked collateral as number 2 (on a scale of 1 to 5, with 5 being the most important and 1 the least important). This implies that the latter ranked collateral as less important compared to the former.

Conclusion

The point of assessing a borrower's collateral is to look for indications that the borrower is committed to repaying the loan by pledging valuable assets as collateral. Collateral by itself may not be good enough unless and until it is perfected in other words the lender ought to ensure there are no other liens or claims on the collateral to ensure protection for the loan should need to liquidate it arise. For this reason, collateral must have value, be marketable, and easy to liquidate. There are three types of collateral; *i)* tangible assets such as fixed assets, machinery, property, fixtures, etc; *ii)* paper assets like cash held in demand deposits, negotiable instruments such as treasury bills, shares/stocks, and corporate bonds; and *iii)* receivables such as accounts receivable, notes receivable, and invoices a firm will have sent out. The best of them is cash as it is the most liquid. Because collateral may not be collected in full, because lenders discount it.

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