THE 5C's OF CREDIT IN THE

LENDING INDUSTRY

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TOPIC OUTLINE

WHAT IS CREDIT

Most dictionaries indicate that the term credit is derived from the Latin word ‘credito’ which simply means faith. It is an agreement by which something of value – goods, services, or money is given in exchange for a promise to pay at a later date.

The definition above means the term credit is used and can be used in various human endeavors.

Credit as a financial term, used in such terms as credit line, credit card, refers to the granting of a loan and the creation of debt. Any movement of financial capital is normally quite dependent on credit, which in turn is dependent on the reputation or creditworthiness of the entity, which takes responsibility for the funds.

A similar usage is in commercial trade, where credit is used to refer to the approval for delayed payments for goods purchased. Sometimes if a person has financial instability or difficulty, credit is not granted. Companies frequently offer credit to their customers as part of the terms of a purchase agreement. Organizations that offer credit to their customers frequently employ a credit manager.

Credit is denominated by a unit of account. Unlike money (by a strict definition), credit itself cannot act as a unit of account. However, many forms of credit can readily act as a medium of exchange. As such, various forms of credit are frequently referred to as money and are included in estimates of the money supply, e.g. Commercial Paper, Bankers Acceptances.
Credit is also traded in the market. The most notable is the "Credit Default Swap" market, which is essentially a traded market in credit insurance. A credit default swap represents the price at which two counterparties will exchange the underlying risk – the protection "seller" takes the risk of default of the credit in return for a payment, commonly denoted in basis points (one basis point being 1/100 of a percent) of the notional amount to be referenced, while the protection "buyer" pays this premium and in the case of default of the underlying risk (a loan, bond or other receivable), delivers this receivable to the protection seller and receives from the seller the par amount (i.e. is made whole). This credit is also known as Credit Derivative.

In Accounting the term credit is a bookkeeping entry representing a deposit of funds into an account. A credit entry notes an increase in liability, owner's equity, and revenues and a decrease in assets and expenses.

In Banking, for which this research paper is mostly concerned, the term credit refers to the commercial Lenders agreement to advance funds, based on an estimation given by the borrower and promise that the debt will eventually be repaid, or to refrain from collecting a previously existing debt, as in a refinancing.

Bank Credit is classified by type of borrower, for example, loan to consumers (mortgages, auto loans, credit cards) as apposed to loans to business (commercial lines of credit, working capital loans), type collateral pledged, if any, and terms of repayment. Some bank loans are repaid according to fixed schedule, for example, a 30- year mortgage; others such as a demand loan to a business that may be called at anytime by the lender.

The extension of credit by banks to borrowers creates debt. A debt is created when the commercial lender ‘effectively delivers’ credit to a bank customer at the request and acceptance of the customer. The customer is expected to repay the principal and other interest costs to the lender based upon the agreed repayment terms. This is a process.

THE COMMERCIAL LENDING PROCESS

Just as the commercial lender must be aware of the participants and the environment in which commercial lending takes places, so must the lending process be understood.

Although commercial lending mutually benefits both banks and businesses, not every loan does. Neither a bank nor a business profits from a loan that cannot be repaid. To identify the loans that should not be made from the ones that should, banks rely on an investigative process that begins with an application for credit followed by an interview between the commercial lender and the prospective borrower. In commercial lending, the application for credit is often done verbally during the initial interview. After the initial interview, there may be credit inquires, on-site visits, evaluation of business plans, analysis of income statements and balance sheets, collateral valuation, sale of other bank products, a presentation to the loan committee, and loan documentation. On the surface, the commercial lending process may seem lengthy and unnecessarily complex, but the alternatives of loan losses and foreclosures are certainly unattractive as well. [1]

Banks generally develop their lending process to fit their unique circumstances and needs, but the variation is usually with form (electronic or paper). The loan process

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[1] Ruth, George E. 2004: Commercial Lending. 5th Edition

substantively remains universal for all commercial lenders. The substantive process basically involve two principal parties whose association ranges from initial loan request (solicited or unsolicited) to the successful and unsuccessful repayment of the loan. The process, most agree is an interdependent one. When a loan request is solicited, it means specific companies are selected for solicitation based on their attractiveness as potential bank customers. The unsolicited requests on the other hand are those requests initiated by customers or borrowers in need. Solicited or unsolicited, the commercial lending process starts with the initial interview and following through the financial analysis stage, the negotiation stage, the approval process and the closing and booking of the loan. After booking, the operations department oversees the loan in terms of monitoring and collection of payments.

In a nutshell the Loan process involves three broad stage processes – Application /Interview, Underwriting /Commitment and Closing.

The application and interview stage is when the lender initially contacts the prospective borrowers or loan applicant to review the application, financial situation and financing options of the applicant.

A commercial lender needs to be able to ask the right questions and accurately interpret the customer’s responses. Often, in answering questions, customers reveal more in their actions than in their words. All the required personal skills – listening and observing, expressing empathy, being positive and ethical are important during the interview, credit investigation, and negotiation process. In the loan interview, the lender is focused on efficient communication, effective questioning, note taking, and professional behavior.

The underwriting stage is post interview when the loan underwriter (lender), reviews the applicant's financial profile and compares to guidelines of the chosen product. The underwriting process involves detailed credit analysis preceding the granting of a loan, based on credit information furnished by the borrower, such as employment history, salary, and financial statements, publicly available information, such as the borrowers credit history, which is detailed in a credit report, credit rating (in case of corporate bodies) by accredited credit rater's like Moody's and Standard & Poor; and the lenders evaluation of the borrower's credit needs and ability to pay. If approved, the Lender sends the applicant a written commitment of the terms and conditions. Processing may include the verification of financial information, collection of documents to satisfy conditions of the commitment and a review of the appraisal of the property. The closing stage is a meeting of all related parties to finalize the transaction. At closing, paper work associated with the transaction will be signed and witnessed, and arrangements are made for the disbursement of the loan proceeds.

The story of a business is more than what is portrayed in its balance sheets and income statements. Loan interviewing, credit investigation, and negotiation are critical to the commercial lending process. If lending decisions were made solely on the basis of calculations of financial data received from a company, banks could turn the commercial lending profession over to computers and be assured that every loan would be a good one. This is not the case, however. Successful lending requires commercial lenders who can negotiate effectively, judge human character, and assess accurately the customer's financial records and business circumstances (past and prospects). Such skills cannot be programmed into a computer. By knowing how to conduct interviews, investigative work, and negotiations, a commercial lender can make an accurate appraisal of a customer.[2]

The lending process is 'due diligence' so necessary for 'safe and sound lending'. The lending process is facilitated by the use of 5 financial analysis themes or tools: Character, Capacity, Capital, Condition and Collateral. These tools are very helpful guides in credit analysis for the underwriter to come to a lending decision. These 5 tools for credit analysis is commonly called 'The 5C's of credit'. Of these five important components of lending decision- capacity, capital and collateral forms the basis for quantitative financial analysis. Character and Conditions are subjective. Their meaning emanates from the senses and circumstances of the underwriter.

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[2] Ruth, George E. 2004: Commercial Lending. 5th Edition

FACTORS OF LENDING THE 5C's OF CREDIT ANALYSIS

1. CHARACTER

Character refers to the customer's willingness and determination to meet a loan obligation. From a commercial lender's perspective, this is probably the single most important component of a customer's makeup. If their business experiences financial difficulties, business people of good character make every effort to repay a loan and work openly and cooperatively with their bankers. Character can be partially confirmed by determining how the customer paid previous obligations. Conversely, persons lacking character assign a low priority to repaying debts and are quick to default on any loan commitment at the first sign of financial trouble [3]. Some lenders won't proceed any further if one's character is unacceptable by the bank's credit policy.

Character is a person's inner quality of integrity stability, and honesty. The character of a business customer is best judged through a long relationship. With first – time borrowers, commercial lenders do not have the luxury of time. Even with established Borrowers, it usually takes more than one interview to make and accurate appraisal of character. Customers, suppliers, creditors, and business contracts provide valuable insight into the character of a prospective borrower. [4]

Character is without question, the most important element in credit soundness. Loans are always repaid by people, not by numbers. The Financial Statmenets are

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[3] Ruth, George E. 2004: Commercial Lending. 5th Edition

[4] Ruth, George E. 2004: Commercial Lending. 5th Edition

only a medium by which the capability of people can be evaluated. The best financial statements, the best loan documents, and the best collateral will not prevent a loss if the borrower is a crook.[5] While character is widely acknowledged as the most important factor, it is also the factor that is widely misapplied. In a study by John Argenti titled 'Corporate Collapse' lenders did agree, that the tendency to over rely on character than the other C's of credit is real in the industry. The lenders did attest that their biggest charge – offs have come from people and firms that were pillars of the community. Lenders tend to fall back onto assertion about great strength of the borrower's character and the bank's long, excellent experience with that borrower when they cannot adequately answer financial questions. In the study, the fifth largest factor contributing to charge – offs in banks with deposits over $500 million was failure to perform standard credit analysis. With longstanding "good" customers, those lenders over emphasized the social standing of the borrowers, personal relationship with top management and directors, and prior successful performance.

Lenders typically make three serious mistakes in evaluating Character. First they tend to completely misunderstand how Character affects credit. Good Character is never sufficient reason to approve a loan; bad Character is always sufficient reason to decline a loan. Second, Lenders forget that it is almost impossible to assess character, until it is tested by adversity. More than a few otherwise honest men and women have convinced themselves that all will be well again if they can just keep

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[5] Matz, Leonard M. 1988: Bank Soundness. Illinois: Bank Administration Institute.

a problem hidden a little longer or just keep the business open a little longer [6]. Third, lenders often evaluate Character in exclusively moral terms and overlook or underestimate the more prosaic aspects of how borrowers conduct their affairs. It is true that the first rule of lending is: know your borrower, but that does not necessarily mean the bank must judge his or her moral fiber or personal conduct. The character of borrowers have less to do with subjective feelings about trust – worthiness, honesty, and moral beliefs and more to do with their bill paying habits, the way they manage their business affairs and the way they respond to adversity.[7] The issue of Management Reporting is a major issue of Character. A company's failure to provide useful but concise information raises doubts as to whether it has, or uses properly, information to run the company and to identify problem areas and the impact of remedial actions. [8]

Management deficiencies and 'creative accounting' when financial ratio's deteriorate characterizes 'bad' character for business borrowers. Management deficiency and 'creative accounting' are certainly abuses of perceived good character of Lenders enjoyed by business borrowers, examples are the Enron, WorldCom and Adelphi financial scandals.

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[6] Matz, Leonard M. 1988: Bank Soundness. Illinois: Bank Administration Institute.

[7] Matz, Leonard M. 1988: Bank Soundness. Illinois: Bank Administration Institute.

[8] Donaldson T. H 1986: How to Handle Problem Loans. New York: St Martin's Press

In spite of some abuses of established good character, good character is still the most important factor in lending. Privileges such as character or good faith loans still exist to motivate borrowers, personal or corporate. Recent laws like Sarbanes – Oxley Act is intended to safeguard character in terms of accurate and reliable corporate disclosures

2. CAPACITY

Capacity which defines management's ability to generate enough excess cash to satisfy all obligations also refers to the ability to manage cash. With the emphasis on cash, some commercial lenders refer to capacity as cash flow. Although a company may generate sufficient excess cash to pay its debts, it may use cash for other purposes, such as purchasing fixed assets rather than payment off debts.[9] To the lender, capacity represents the primary source of repayment for a loan and is the most critical of the five C's of credit. Banks never consider collateral a primary source of repayment but rather a borrower's cash flow. Cash flow has therefore become synonymous with Capacity and is simply the quantitative determination of one's ability to service a debt. For consumer lending, the two most important issues are the borrower's ability to make the debt service after meeting food, shelter, and other fixed payment and the dependency of that capability on such factors as employment and normal conversion of current assets to repay borrowings. For long-term commercial lending, the key issue is the ability of the normal conversion of current assets to repay borrowings. For long-term commercial lending, the key issue is the ability of cash flow to meet loan amortization.

Analysis of capacity must include four criteria. First, every loan must have a primary source of repayment and an alternative source of repayments. Bankers are not perfect judges of people's character and ability to repay. Even if they were, things do not always work out as bankers or borrowers expect. As one banking sage put it: 'when you make a loan, hope for the best but expect the worst'. The

[9] Ruth, George E. 2004: Commercial Lending. 5th Edition

alternatives sources of repayment should not always be liquidation of the collateral. Often, events that impair the primary source of repayment also impair the value of the Collateral. Oil-drilling rigs and CB radios, for example, were worth a lot when the collateral was not needed and were worthless when it was, hence the Savings and Loans crisis in the early 1980's in the South West U.S.A.

Second, analysis of capacity must consider the quality and reliability of cash flow. The bank must know if the cash flow is recurring or if it resulted from a one-time event, like the sale and leaseback of a building. It also must know if the cash flow is more a result of liberal accounting procedures than actual operations. For example, some firms with significant costs relating to the current year's sales may amortize those costs over many years- benefiting current profits and cash flow at the expense of future profits and cash flow. Even if the cash flow is a result of recurring operations, the bank needs to know if it is sustainable. For example, prior year's rapid sales growth may slow or even decline due to market saturation or product obsolescence. Finally, in capital – intensive business, especially during times of high inflation, the bank must know about needs to replace property, plant, and equipment and how those needs will affect cash flow.

Third, analysis of cash flow should combine reviews of financial information for prior periods, projections for future periods, and in healthy skepticism about whether past results or projections can really give any indication of what will actually happen. Bankers are increasingly interested in borrower's projections of sales, earnings, and cash flow. In one sense, this interest makes sense. It demonstrates better understanding of the central importance of cash flow to credit analysis, and it also shows awareness that financial reports of previous performance are not always reliable indicators of future performance.

Projections are useful, too. They can provide valuable clues about the thoroughness and conservatism of a borrower's management. (Do not be misled by a borrower's assertion that his projections are conservative. Without exception, all borrowers give that response). The problem is that projections are almost always wrong. The only question is, how wrong? Analysts can generally apply three tests to evaluate projections:

1. If the bank received projections from the same customer in the past, it can compare them to the subsequent financial statements for the same periods to assess Management's forecasting ability.

2. Assumptions for elements like growth and margins can be compared to the borrower's historical results as well as to peer-group averages to assess how conservative the projections are.

3. Projections should be reviewed for completeness (for example, is future capital expenditure included?) to assess management's thoroughness.

4. The fourth and final requirement for superior analysis of capacity may be the most important one, which is how to measure the key needed ratio's for sound Lending. In its most basic form, cash flow is defined as earnings before interest, taxes depreciation and amortization (EBITDA). The first step in the analysis of EBITDA is an examination of each of the components. Some of the questions a lender may attempt to answer are: What has been the historical trend in earnings? Are there extraordinary expenses that may have affected earnings performance? What are the trends in sales and gross

profit margin and are those numbers sustainable? What is the trend in operating expenses? How does the depreciation and amortization expense relate to the need for capital purchases (in other words should depreciation be considered a real expense?) Once the lender is satisfied with the EBITDA calculation, it will be compared to the company's current obligations (debt service). Debt service is simply the anticipated principal and interest payments on all debts. When revolving lines of credit are present the lender may use the interest due on the average outstanding balance but will more likely be conservative and calculate the interest payment as if the line of credit is fully funded.

The key ratio then used to measure the capacity is called the debt service coverage ratio (DSCR). The DSCR is simply EBITDA/Fixed obligations. In most cases, the lender will want cash flow from operations to exceed debt service by 20 percent. Therefore the DSCR should be greater than 1.20.

There are times the lender may also include a debt service calculation based on an amortization of a fully funded line of credit. This is called a "downside analysis" and typically assumes a five- year repayment of the fully funded line of credit. Often this analysis is included with an analysis of the guarantor's personal cash flow. The combination of the business cash flow and personal cash flow is called a "global cash flow analysis" For the " downside analysis" the lender would like to see a DSCR greater than 1.00 [10]

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Makeever, David E. 1986: Loan Review's Role in Risk Management. The Journal of Commercial Bank Lending. (Feb. 1986)

The analysis of capacity gets somewhat more complicated for working capital and seasonal lines of credit. For those types of loans not only will the bank examine EBITDA and the DSCR but will include an analysis of the company's ability to properly manage the conversion of working assets to cash.. Essentially, this involves an analysis of short-term liquidity.

As with EBITDA, the first step in the analysis of liquidity is an examination of the components. Often, some modifications to current assets and current liabilities may be required. Once the lender is satisfied with the composition of the current assets and current liabilities, an analysis can be performed.

The most widely used measure of liquidity is net working capital (current assets – current liabilities) and the current ratio (current assets/current liabilities). To gain more insight, the analysis must always be done on a comparative basis over time. Trends are examined and compared to industry averages. However, as a general rule of thumb the lender is looking for a current ratio in excess of 2.0. [11]

In addition to these static measures of liquidity, it is necessary to analyze the degree of liquidity of the components of working capital. In order to further analyze liquidity, the lender may examine the company's net trade cycle. The net trade cycle is calculated as follows:

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[11] Ruth, George E. 2004: Commercial Lending. 5th Edition

+Days in Inventory

+Days in Account Receivable

= Trade Cycle

- Days in Account Payable

= Net Trade Cycle

The trends in these “turnover” ratio’s and a comparison to industry average may give the lender some insight into the companies’ ability to convert working assets to cash.

One final tool the lender may use to analyze liquidity and cash flow is the statement of changes in financial position statement, also known as the flow of funds cash flow statement. The statement gives insight into what assets have changed from period to period and where the funds came from or went.

Another important ingredient of Capacity, especially with new businesses, is managerial experience and requisite training for the enterprise. A commercial lender considers human capital part of Capacity in the decision to lend.

3. CAPITAL

Capital, also known as equity or net worth is the reserves a business has in the event of a problem. Capital represents the funds retained in the company to provide a cushion against unexpected losses. A strong equity position will prove financial resiliency to help a firm weather periods of operational adversity. Minimal or non-existent equity makes a business susceptible to miscalculation and thereby increases the risk of default. A strong equity position is believed to ensure that the owners of the enterprise will remain committed to the business to mitigate moral hazards.

The primary considerations in evaluating capital adequacy are:

- The amount of capital (equity) the owners have invested in the business
- The amount of future funds available from creditors and owners
- How effectively total capital is employed.

It is usually a negative sign if the owner's equity is considerably less than the capital provided by creditors. The adequacy of capital varies by industry. For example, industries with high fixed asset needs usually require more capital. There are exceptions; such as the banking industry, but commercial lenders generally are wary of a business that primary relies on borrowed funds to maintain its operations. Sufficient equity is particularly important in new, closely held companies, which often fail when the total amount of equity and debt is too small to finance company operations. Another important consideration for commercial lenders is the amount of capital reserves owners would be able to inject into a new business, if necessary. [12]

[12] Ruth, George E. 2004: Commercial Lending. 5th Edition

There is generally a careful examination of the debt-to-worth ratio of the company to understand how much money the lender is being asked to lend (debt) in relation to how much the owners have invested (worth). As a rule of thumb the maximum a lender is generally willing to contribute to the operation of a company is 75 percent compared to the owners 25 percent. Therefore, a good rule of thumb is a debt to worth ratio of three to one. [13]

[13] Donaldson T. H 1986: How to Handle Problem Loans. New York: St Martin's Press

4. CONDITIONS

Conditions refer to the national, international and local economic events, the industry and the bank itself. Conditions are difficult to quantify but the lender should be sensitive to the following:

1. Changes in general economic conditions (Market Fundamentals-interest rates, employment, GDP, etc),
2. Changes affecting the specific industry of the borrower-Technology and Competition
3. The local economy
4. Trends within Borrowers industry
5. The financial Institution current level of losses and problem credits.
6. Conditions and terms attached to the loan

Conditions refer not only to the borrower, but the lender as well. To the borrower, it is the conditions the borrower is operating under. The conditions the borrower is operating under can have a major influence on credit quality. Part of the credit analysis must be an assessment of the borrower's vulnerability to changing conditions. Some examples of the changes are in demand, supply, prevailing technology, suppliers, customers, workforce, labor standards and local employment conditions.

For a Lender, the conditions are market related – interest rate risk, credit risk and liquidity risk. Also, the Lender has to deal with lending rules put out by its regulators and the ever present operational risks especially in these times of terrorism.

In good times it is hard to lose money; in bad times it is hard to prosper. General economic conditions obviously affect almost all credits, but some merit special consideration. For example, floating – rate loans that depend on sources of repayment that are fixed by leases or contracts are very vulnerable to increases in interest rates. Another example is commercial real estate ventures, which often are heavily influenced by factors such as household formations, businesses relocations, and new business formations.

General economic conditions vary much more from one industry to the next than from one borrower to the next and therefore need not be analyzed for each borrower. Furthermore, factors affecting the specific industry are probably more significant. In fact, both Moody's and Standard and Poor's say a firm's primary industry affiliations is a factor "more equal than the rest" in determining its bond rating. [14]

Some industries, such as the pharmaceuticals, have historically demonstrated far less vulnerability to cyclical fluctuations than others.

When evaluating industries, firms, and products, it is often useful to consider how they are affected by changes in life cycles and whether the firm is adapting to such changes.

Finally, it is valuable to remember that firms and products also have competitive advantages such as market share, low-cost production, superior quality, or patent

[14] Pouschine, Tatiana. 1987: Now you see it. Forbes Magazine (Feb. 9, 1987)

protection. These competitive issues should not be overlooked. The absence of any sort of competitive advantage is reason for caution.

5. COLLATERAL

Collateral is the asset or assets pledged to secure a loan. Most commercial loans are secured by accounts receivable, inventory, equipment or real estate. A borrower can pledge collateral to offset weaknesses in the other Cs. A commercial lender, concerned about an industry's overall financial condition, many not lend to a new business in that industry unless certain assets are pledged as collateral. A commercial lender must remember, however, that collateral itself does not repay loans and, therefore, should not justify making a loan. Collateral provides that bank a secondary source of repayment if the primary source of repayment is not available. To repay a loan, collateral must be liquidated (turned into cash). If the bank can overcome sometimes, legal hurdles. [15]

Collateral is considered a secondary or even tertiary source of repayment for a loan. However, its importance to the structure of the loan should not be underestimated. There are two considerations to the loan structure that are affected by the collateral used to support the request:

1. The term of the loan
2. The loan amount.

A lender will normally want the term of the loan to match the useful life of the asset used as collateral. Current assets are normally financed with lines of credit that are reviewed annually. Equipment may be financed over three, five or seven years, and commercial real estate is normally financed over 15 or 20 years.

[15] Ruth, George E. 2004: Commercial Lending. 5th Edition

The amount of the loan is typically limited by the lenders perceived liquidation value of the collateral. Some standard advance rates are shown below:

Accounts Receivable- 75% of eligible receivable (less than 60 days)
Inventory -50% of raw materials and finished goods.
Equipment -50% of the book value or 80% of purchase price.
Real Estate -75% of the lesser of purchase price or appraisal (some statutory limits allows banks to advance up to 85%. [16]

It is important to remember that collateral is not the primary source of repayment and is only one of the five Cs of credit. Exceptional capacity, capital or any of the other components of the five Cs may allow for exceptions to the standard terms and advance rates listed above.

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The role of collateral in credit analysis must be understood in a unique context. Except for deposits in the bank and properly managed and perfected interests in marketable securities, collateral will never be sufficient to transform an unsound loan into a sound loan. Collateral can only make the difference between successful and unsuccessful resolution of problem situations.

Collateral is not a substitute for Character and Capacity. The best loan documents drafted by the best Lawyers cannot protect a bank from an unscrupulous borrower. Too often bankers will lull themselves into a sense of false security by assuming that adequate collateral exists to secure a loan in the event that unforeseen circumstances adversely influence a borrower's capacity to repay.

[16] Donaldson T. H 1986: How to Handle Problem Loans. New York: St Martin's Press

Bank of America for example, in its apparent willingness to accept appraised collateral values and failure to analyze capacity had serious problems. According to one source, Wells Fargo made commercial real estate loans on the strength of cash flow and got all the good risks, while Bank of America lent on report collateral values and got the bad risks. [17]

External as well as intrinsic factors must be considered when collateral is evaluated. In many cases, the external factors that lead to an unforeseen impairment in a borrower's capacity to repay can simultaneously impair the liquidation value of the collateral. Collateral that has significant value when the loan is made may have much less value in the wake of an industry downturn, such as the one that occurred in the oil and gas industry after 1982. Other kinds of collateral, like technological equipment loose value through rapid depreciation or obsolescence. Still other kinds, like fixtures and restaurant equipment, simply do not have much resale value. A 1981 Canadian study found that collateral liquidations brought only 30 percent of the anticipated resale value when debtors became bankrupt or insolvent. [18] In spite of the stated shortcoming with collateral there are still good reasons to take collateral.

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[17] Mayer, Martin. 1987: The Humbling of Bank America. New York Times Magazine (May 3, 1987)

[18] Fletcher, Robert M. 1986: Managing Collateral. Canadian Banker (June 1986)

A perfect security interest in a borrower's assets can scare off other potential creditors, preventing a borrower who is experiencing cash – flow problems from getting into deeper trouble by borrowing more money than he can repay. Furthermore, loans do go bad, and collateral can make a great deal of difference in resolving a workout.

With these advantages in mind, credit analysis procedures should reflect three ideas. First, they should address the use of appraisers: when to use them, what qualifications they should have, and how they are to be engaged and reviewed. Small banks also should question whether directors are always appropriate appraisers. (They rarely are) Large banks should establish and maintain lists of eligible appraisers.

Second, procedures should address the subject of collateral evaluation. Margins are usually appropriate as are adjustments to reported values. For example, appraised equipment values may be adjusted to exclude small items of relatively large value, like tools, which often disappear just before the bank takes possession. Adjust the fair market value down to estimated forced – sale value, and subtract costs of cleanup and auction. Then deduct a collateral margin of, say, 15 percent.[19]

Third, collateral must be controlled. It is not enough to perfect an interest in collateral and then ignore it. The degree of control depends upon the bank's degree of reliance on the collateral which in turn depends on the perceiver degree of risk. In some cases, it is appropriate to receive daily receivable reports or have inventory kept in controlled warehouses.

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[19] Matz, Leonard M. 1988: Bank Soundness. Illinois: Bank Administration Institute.

SUMMARY AND CONCLUSION

Credit underwriting is the practice of analyzing structuring, approving and documenting extensions of credit. This practice constitutes the lending process. Lenders need ‘tools to guide them through this process. The well known Five C’s of Credit, Character Capacity, Capital, Collateral, Conditions, are the ‘tools’ or framework used for credit analysis.

Character represents the customers’ willingness and determination to meet a loan obligation. Character is generally discovered through interview and investigation into the customers’ payment habits, the way they manage their business affairs and the way they respond to adversity. Character is considered to be the most important of the five C’s because they say “it is people who pay the loans”. Capacity is a quantitative financial analysis to determine whether the customer has the ability to repay the credit extended. This refers to the company’s ability to generate sufficient cash flow from normal operation to meet future obligation. To the lender, this represents the primary source of repayment of a loan and is the most critical of the five C’s.

Capital, also called equity or net worth, represents reserves a business has in the event of unforeseen problem. The lender attempts to investigate capital adequacy of the enterprise. Capital is also indicative of level of commitment by stakeholders of the company. This mitigates moral hazard.

Collateral is the assets or assets pledged to secure a loan. Collateral provides the lender a secondary or tertiary source of repayment if the primary source of repayment is not available.

Conditions are the external variables that can affect credit and credit quality. This refers to national, international and local economy, the industry and the bank itself.

In assessing conditions, the lender determines whether the prevailing conditions are conducive for not only lending but also for borrowers ability to repay the loan.

Capacity, Capital and Collateral are three out of the five C's that form basis for quantitative financial analysis. This means they can be interpreted with numbers or ratios. Character and conditions are subjective interpretations. This means these factor considerations are the discretion of the lender

All the five C's are fundamental tenets of lending and credit. Some have tried to rank the five C's in order of importance. A typical ranking in order of importance is Character, Capacity, Capital, Conditions, and Collateral. Some also rank capacity and capital as the most important, because capacity gives the lender comfort in seeing how the loan will be repaid and Capital shows commitment of owners as pre-emption to moral hazards. Regardless of arguments proffered for the ranking, a lender prudentially must use all the five C's comprehensively for prudence while staying competitive, because they are inter-related for the purpose of risk mitigation and enhancement of shareholders value.

A lender, while using the 5'C's must ideally have the objective of extending a sound credit which is beyond safety. A distinction can be made between 'safe' credit and 'sound' credit.

All sound credits are safe, but not all safe credits are sound. A credit is safe when repayment appears probable, almost all well secured credits are ‘safe’ credits. A sound credit, on the other hand, is prudently underwritten with utmost due diligence, alternative sources of repayment, and conservative structure so that if may be repaid in eventual unforeseen circumstances.

A typical example of the safety and sound distinction are the many “safe” real estate and oil loans that mostly Savings and Loan Banks wrote off in the early 1980’s as uncollectible   because they could not be repaid due to the depression in the southwest of the United States. Original assumptions of these loans were very optimistic. Too bad the Savings and loan banks couldn’t get into various forms of credit derivatives.

In conclusion, using the five C’s will enable the lender to gain the following advantages to make a sound lending or credit decision:

. Identity/Use various elements to verify the integrity and management ability of an individual or entity and know what action to take.

- Define capacity and know why evaluating it is a complex process. Identify questions to consider when evaluating capacity.
- Identify and define financial ratios commonly used to evaluate capacity and the limitations of using ratios and true cash flow.
- Define true cash flow.
- Identify some specialized analytical tools that can be used to evaluate capacity.
- Define projections, sustainable growth and breakeven analysis.

- Define Capital. Identify the importance of Capital.
- Determine how to establish an acceptable debt-to-worth ration. Identify ratios that can be used to assess capital adequacy in businesses.
- Define conditions. Identify how to connect conditions to capacity.
- Identify variables that should be considered when evaluating conditions.
- Identify sources of information about conditions.
- Identify some conditions affecting international lending. Identify techniques to assess conditions affecting international lending.
- Identify some of the benefits and limitation of collateral.
- Follow certain guidelines when assessing Collateral. Identify the steps in evaluating Collateral Cover.