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2017-2018 Student Project

5 C's of Credit

Credit standards – also called guidelines – are used to analyze and approve loans, as well as protect both the lender and borrower from excessive risk. Every lender has their own unique set, but they are all universally based on the Five C's of Credit: Character, Capital, Capacity, Collateral and Conditions.

Character

When making lending decisions, character can be defined as the customer's willingness and determination to repay the loan, regardless of unforeseen adversity. Character includes qualities such as: honesty, cooperation with the lender, openness, integrity and self-discipline. An applicant's character can be evaluated based on:

Credit History	Production Practices	Risk Management
Planning for the Future	Marketing Plans & Strategies	Resolve to do what's needed

Capital

Capital refers to the customer's financial position and progress, asset quality, liquidity, and debt structure. The analysis of these factors involve historical and current balance sheets. Lenders will evaluate if a customer's financial position has improved or deteriorated over time and use the structure of the applicant's balance sheet to determine an operation's ability to withstand adversity, or take advantage of growth opportunities.

Capacity

Capacity is the ability of an individual or operation to generate sufficient earnings to cover their current debt obligations, repay any new debt and maintain an adequate margin for family living, capital asset replacement and accumulation of a reserve for adversity. This is often determined by calculating capital debt repayment capacity (CDRC).

CDRC Margin = Net Income + Depreciation Expense + Interest Expense from Term Debt
CDRC % = CDRC Margin ÷ (Current Principal and Interest on Term Debt + Capital Asset Replacement Requirement)

Collateral

Collateral is the property the customer pledges to the lender to secure their loan. For most operating loans and all equipment, livestock and land loans, collateral is required. Collateral must be evaluated to ensure that an adequate margin will exist and that the collateral is marketable in the unlikely event that a collection action should be necessary.

Conditions

Conditions relate to the purpose of the loan as well as other items the lender has control over (i.e. loan amount, use of funds, terms of repayment). Lenders may, in certain circumstances, add additional requirements or restrictions to the loan. These are usually based on the individual's current situation as well as what is predicted to happen in the future.

Loan analysis focuses on the strengths and weaknesses of the application based on the five credit factors. However, because every customer and loan is unique, the weight given to each factor varies depending on the circumstances of the loan request. In some cases, weaknesses in one area may be offset by strengths in another.