

5 C's of Lending

When it comes to lending money, it is essential to have a set of criteria that you use to determine whether or not a loan is a good idea. This criteria will help you assess the risk of default and make sure that you are lending to people who are likely to repay the loan.

One very simple framework that can be used for this purpose is called the five C's of lending. The five C's stand for character, capacity, capital, collateral, and conditions. Let's take a closer look at each one:

Character: This refers to the borrower's reputation and history. Do they have a history of defaulting on loans? Are they currently employed and able to show a steady income? These criteria are somewhat subjective, and different lenders vary as to what it is they are looking for. In general, the better a borrower's history and character, the more likely it is that they will be trustworthy enough to pay back the loan and adhere to the terms of the loan. The higher the character rating, the lower the rate of interest a lender may offer the borrower. When making loans to Small and Medium Enterprise (SME's) and Consumer Loans, character is very important.

Capacity: This refers to the borrower's ability to repay the loan. Do they have the financial resources to make the monthly payments? Are their expenses under control? Exactly, how a borrower intends to repay the loan is always discussed and documented before the loan is made. Often the capacity characteristic extends into how you plan to service the ongoing debt interest payments as well. This is one of the most important criteria for a lender.

Capital: This refers to the borrower's equity in the project. How much of their own money are they investing in the project? The more skin in the game, the less likely they are to default on the loan. Additionally, the higher the capital deposit from the borrower, generally means, the lower the rate of interest will be on the loan. Also, whether the borrower has sufficient capital elsewhere is important in the event the entity or venture doesn't work out as expected. For example, in some SME loans, often the business owner's personal assets are considered a source capital (or net worth) if the SME loan defaults.

Collateral: This refers to any assets that can be used to secure the loan. If the borrower defaults, these assets can be seized and sold to repay the loan. The larger the collateral, the less onerous the terms of the loan and/or the lower the interest rate charged on the loan. Common examples of this in Alternative Investments is loans against life insurance policies, real estate loans or trade finance letters of credit. In all instances a specific asset or transaction collateralized the loan and can be used as a source of repayment in the event of a default.

Conditions: This refers to external factors that could affect the success of the project. Is the market for this product or service favourable? What are the current economic conditions? This typically refers to what the borrower intends to use the borrowed money for. If a commodity trader is using the money to buy a shipment of maize, it plans to transport to another country and sell it at a more attractive price there is a better chance they will get a good rate of interest as opposed to if that same company wanted to use the money to buy a new truck which depreciates quickly. Most loans also stipulate the length of the loan as well as the rate of interest charged on the money lent.

Another C of lending that is sometimes considered is 'Cash Flow'. This is whether the borrower can afford to service the ongoing interest payments prior to the loan being paid.

Adhering to these five criteria can help you lend with a high degree of success and a lower potential risk of default. Make sure to develop robust procedures and criteria for each of the C's to ensure successful lending.

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