The Five C's of Credit

One of the most common questions among small business owners seeking financing is, "what will the bank be looking for from me and my business?" While each lending situation is unique, most banks evaluate applicants based on some variation of the 5 C's of credit. The lender will look at character, capacity, capital, conditions, and collateral involving the applicant and his or her business. Let's review each of these from the perspective of the bank and what they mean to you as the applicant.

Character: Basically investors, including banks, want to know who they're dealing with. This includes things like the trustworthiness, responsibility, and reputation of the applicant(s) and/or their business. The primary source of information for this evaluation is your credit score (FICO) and overall credit history as reported by the major credit reporting agencies. . A Lender will conduct a complete review of **both** your personal and your business borrowing and repayment history.

Capacity: Most of us are familiar with how our personal income is used to determined mortgage and consumer financing limits. The "debt/income" ratio of the business (and probably person as well) will be the primary basis for evaluating a borrower's capacity. This is true whether its an existing or startup business. Banks will be very cautious and particularly concerned with determining how much debt your company can safely handle. As the likely guarantor of any business loan your personal repayment ability weighs heavy in the bank's funding decision even if your business has a positive financial history.

Capital: Simply stated this refers to how much of your own money you have invested or will invest into your business. Banks want to see that you have a personal commitment in the business and have something substantial to lose if the business were to fail. Banks will ask to see both your business and personal financial statements to determine if there are sufficient resources to support the repayment of the loan. Not all capital resources are monetary. Your business may be just starting but already have an excellent customer base established or you may have proprietary or patented products which gives your business an excellent opportunity to produce future profits. Bottom-line…you want the bank to see your commitment to the business and its potential for future profits.

Conditions: How will the funds you are requesting be used to improve your business revenues? What are the current and future economic conditions and how is (or will) your company be positioned to benefit from them? How does the future look for your type of business? A bank will be much more comfortable if they see you addressing these questions and there's stable cash flow and profits in your future.

Collateral: While cash flow will always be looked to as the primary source of business loan repayment, banks will also look for a secondary repayment source to serve as security. This loan security is also known as "collateral". Collateral represents personal or business assets pledged as an alternative source for repayment of the loan. Most collateral is in the form of hard assets such as property, buildings, and/or manufacturing equipment. In some circumstances vehicles, inventory, accounts receivable, stock investments, or even the cash value of your retirement plan may qualify. Pledging your personal assets as collateral for a business loan clearly has its risks. You don't want to be in a situation where you could lose your home or your retirement nest egg if the business cannot repay its debts. However recognize that the bank will not likely want to take on the risk of granting you a business loan without some guarantee of repayment. When it comes to securing a business loan, your sincere promise and good intentions are no substitute for prime real estate!

Final Thoughts: Keep in mind that when evaluating the five C's of credit, lenders rarely give equal weight to each area. Every business concept, circumstance, and loan applicant is different. Lenders are a cautious lot and one weak area could reduce or even negate all other areas of strength. Without a doubt the most important evaluation element will be you, both as the business owner and a person. Good character, a solid loan repayment history, management knowledge, and experience in your business will be as important as adequate repayment capacity in order to convince a lender to make the loan.