Chapter 5 – Credit Evaluation

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Learning Objectives

What you should achieve after completing this chapter:

- Be able to describe the 5 'C's of credit and the CAMPARI model used in the subjective judgemental evaluation approach and give examples of the characteristics considered for each;
- Be able to explain how objective credit scoring systems are used and describe the benefits that these systems offer banks;
- Be able to discuss how and why some banks combine elements of subjective judgemental and objective credit scoring evaluation systems; and
- Be able to list and discuss the primary objectives of credit evaluation and decision making stages of the lending process.

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1. Introduction

The final stage of the consumer credit process is credit evaluation where the decision is made to either approve or reject the credit.

Once the information is verified, the financier proceeds to the evaluation stage. The objective of credit evaluation is to:

(a) provide the best tailored loan for the customer and a quality loan for the lender;

(b) ensure compliance with regulations and bank policy;

(c) keep the goodwill of the consumer; and

(d) ensure that the level of risk is acceptable.

Credit evaluations are not based on a single factor but upon how an applicant matches up to a set of lending criteria laid down by the lender. These lending criteria inherently reflect the risk attitudes and risk tolerance levels of the credit grantor concerned. In short, these criteria reflect how the lenders want to do business, their business policies, strategies, their risks propensity, etc. The risk attitudes, tolerance, business philosophy, policies and strategies however vary from one financier to the next. What one financier finds unacceptable may well be within another's tolerable limits. Ultimately, lenders will only assume risks that they find comfortable and acceptable within the limits set by their organisations.

To assist the financier in evaluating and coming to a decision, the financier can rely on simple models. Mentioned below are the **5 'C's,** and **CAMPARI** which are subjective approaches whilst **credit scoring models** aim to be objective in their approaches.

2. The 5 'C's Approach

The subjective judgemental approach of decision-making is an approach to evaluating credit worthiness using different variables. This is commonly categorised as the 5 'C's of credit, namely:

2.1 Character

To lenders, this is the most important requisite and the most difficult to measure precisely. The financier needs to determine whether there is a willingness in the character to pay. Even if the character has the capacity to repay, his/her credit may still be declined if his willingness to pay is questionable. Empirical evidence has shown that there are some characters of high means who will not pay their instalments simply because of their influence and high standing in society. The bank will then be faced with a dilemma of balancing the valuable relationship and at

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the same time recovering the loan. In such cases, bankers would be prudent not to market or approve the loan in the first place.

The factors normally considered in examining a character are:

(1) Past records of the client or credit history;

(2) Stability and duration of his employment/business;

(3) Experience and qualification; and

(4) Reputation.

2.2 Capacity

Capacity looks into the client's ability to pay and handle the proposed new level of debt.

The client's income is evaluated firstly. Secondly, his net monthly flow and his ability to repay credit obligations as well as other expenses. Thirdly, the client's marketability or ability to change jobs. This is determined by past earnings, future earnings and past records of meeting obligations.

The client's age must be above legal minority to be capable of entering into a contractual borrowing relationship with the financial institution (FI).

2.3 Capital

This is a measure of the net value of a client's assets which form back up liquidity to meet his repayment. In a housing loan, the higher the client's margin contribution (his capital), the higher is his psychological commitment to pay the loan.

The client's capital is determined by his current level of liquid assets, current level of unsecured borrowings and his list of income sources, fixed expenses and contingent liabilities.

2.4 Conditions

This is will prompt the financier to examine whether the client's employment or business will withstand the vagaries of the economy, social, political and international environments, government regulations, competition or changes in the bank's policies.

As an example, a client who is employed in a manufacturing company which is shifting its operations to China may soon find himself without a job. His future prospects may be bleak if his special skills are not in demand locally.

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2.5 Collateral

As character is listed as the first and most important 'C', Collateral is listed as the last. This is so because, collateral is considered only as a cushion for the financier to rely on when the primary source (income) does not come in. A financier would prefer that a loan is repaid rather than having to collect proceeds through auction of the collateral. Herein lies the test of a true banker. If the banker considers loans purely on the comfort of the collateral, he is not considered to be doing banking but pawn broking.

Collateral is examined on its easy disposability and whether it is adequate as security.

2.6 Other C's

The above 5 'C's are not exhaustive. Other 'C's can be included to fine-tune them.

2.6.1 Consumer relationship

Lenders will want to consider granting a client a facility as he might be an influential personality, e.g. the president of a professional body who can influence his members to apply for loans.

2.6.2 Competition

Depending on the bank's appetite for risk, a client may be granted a loan just to beat the competition. This is often the case of banks in newly set up locations.

2.6.3 Credit structure

There are occasions when loans are structured in such a way that the client is unable to meet the repayment. This would prompt the financier to consider restructuring the facility.

2.6.4 Can we?

This sometimes prompts the banker to pause and think whether they are in compliance with the regulations. For example, "Can we grant an overdraft to a non-Malaysian?"

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A sample of how a financier would analyse the **5 'C's** of his client would be as follows:

Strengths	Weakness
Character • Purchasing a house • 15 years of residence • Professional – Engineer • Previous job – Long term • Wife standing as surety • Bills are settled on time	 - - - • Current job on probation • Wife only 6 months on job -
Capacity Debt to income ratio is 31% of net salary RM2685 / RM8662 (31%)	-
Capital Has a landed property worth RM200,000 with a liability of only RM75,000	-
Condition Demand for engineers with his expertise is good	-
Collateral Unsecured loan	-
Other 'C's New client acquisition	High potential for open-end debt

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3. The CAMPARI Model

Character	–	Willingness to pay versus ability to pay
Ability to repay	–	Adequacy of cash to meet repayment
Margin of finance	–	The client must contribute a certain margin as commitment. The banker seldom grants 100% financing.
Purpose	–	The purpose of the loan must be defined. Speculative purposes are considered risky and will not be entertained.
Amount	–	The amount the financier is willing to contribute to the client. This prompts a question. How much is too much for a client? Any amount beyond the repayment capacity of a client is too much.
Repayment terms	–	The structure and terms of repayment
Insurance	–	In the event the borrower dies, the loan can be settled from insurance proceeds

4. The Credit Scoring Approach

Whilst the 5 'C's and CAMPARI trigger the financier in his evaluation, the financier can use yet another method called the credit scoring approach. The elements and their corresponding weight vary from bank to bank.

4.1 Uses

1. Credit scoring helps processing consumer credit faster.
2. The score is obtained immediately when loan application data is keyed in.

4.2 Benefits

1. A consistency in decision-making is maintained.

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2. There is quicker process time, especially with automated credit scoring.
3. Individual biases are eliminated.
4. Credit scoring provide an objective analysis of loan applications.
5. It ensures that all applications are treated fairly.
6. It provides for easier training and development of new lenders by providing a uniform and systematic approach to decision making.
7. It could prevent credit losses and improve profitability by rejecting high risk applications.

A sample of a credit score is as follows:

Details of Clients	**Points**
Savings and Current account	40
Current account only	35
Savings account only	25
None	10
Resident status	
Own/Buying	35
Rented	15
Living with parents	20
Others	5
Tenure with current employer	
15 years and above	30
12 to 15 years	27
3 to 12 years	14
1 month to 3 years	12
Less than 1 month	6
Student	3
Retired	30
Unemployed with income	-3
Credit report	
All references good	25
Two references good	18
No references	0
Major findings in CCRIS, BMC, BASIS, CTOS	-20
Grand Total	**327**

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5. Summary and Conclusion

The credit evaluation process can rely on a combination of approaches namely the subjective 5 'C's and CAMPARI approach and the objective credit scoring approach for balanced decision making.

The best test of a credit is when the credit is repaid by the identified repayment source and not by sale of the collateral. Which takes one to the question, "How much is too much credit for a consumer?" The answer – any amount, which is beyond the repayment capacity of the borrower is too much.

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Practice Questions

1. Name the 5 ‘C’s of credit and give an example of what kind of information the financier needs to examine.

2. What are the benefits of a credit scoring system?

3. Write briefly on how you would process a consumer credit paper.

4. How much credit is too much for a consumer?

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