WHAT QUALIFIES YOU FOR CREDIT?

The Six "C's" of Credit

How do you qualify for credit? To know the answer, you need to know what credit grantors look for when deciding whether or not to loan money, extend credit or issue a credit card to you. Credit grantors gather information, primarily from your credit application and a credit bureau report, to determine whether you will be able and willing to repay your debt. Are you a good risk? In other words, credit grantors want to know if you are creditworthy. Creditworthiness is based on a number of things, often referred to as the six "C's" of credit.

The important thing to remember is that every credit application is analyzed in relationship to these six "C's." This is true whether or not a risk score is assigned. And this approach applies to applications processed both manually and by automated systems.

The Six "C's" of Credit

The intent of this analysis is to determine: 1) Will the borrower pay? (**character or credit reputation**); 2) Can the borrower pay? (**capacity**); 3) Does the borrower have enough cash on hand to pay if a period of adversity arises? (**capital**); 4) Will something adversely affect the borrower's ability to pay? (**conditions**); 5) Will the credit issuer be protected if the borrower fails to repay the loan? (**collateral**); and 6) Does the borrower demonstrate an ability to make wise decisions? (**common sense**).

Assessing the Six "C's"

Character or Credit Reputation:

How trustworthy are you? Are you the type of person who will willingly repay your debts as agreed? Do you have a history of paying rent, telephone, utility and other debts in the past? Have you made payments on time? Have you contacted credit grantors directly and promptly if you've had problems repaying?

How a borrower handles financial obligations, especially during periods of adversity, is a significant indicator of character or credit reputation.

Information compiled by the national credit agencies, known as a credit report, is perhaps the most vital indicator of creditworthiness. And when coupled with a generic or custom risk score, they are an accurate indicator of credit performance. Many credit grantors, especially those making high volume credit card and retail store charge loans, rely strictly on the credit report, plus a risk score, to assess credit performance.

Capacity:
Do you have the ability to repay the debt? Do you have a steady job? How long have you worked for your present employer and previous employer? Do you earn enough to pay what you will owe? Is it likely you can continue to earn your present salary or even more in the future? How much do you already owe?

Capacity pertains to the borrower's ability to make payments on time. It is determined by weighing the borrower's income (including the likelihood of continued earnings ability) against the amount of debt now carried. In figuring capacity, the credit grantor must also determine how much leeway the borrower's budget can handle.

Capital:
What assets or financial resources stand behind your commitment to repay a debt? Do you have savings in a bank or credit union? Property in your name?

Credit grantors only consider cash reserves and other assets that are of tangible value at the time the application is being processed. Capital is not expected to be a means of payment. However, it gives the credit grantor a measure of assurance that debts will be paid if a period of adversity arises.

Conditions:
What economic conditions might influence your ability to honor your credit agreement? Are you likely to become unemployed? Is there talk of a strike which might affect your job? If your spouse is applying with you, what are his or her job prospects?

In assessing economic conditions, credit grantors look at both national and regional (or local) forecasts. For instance, a national forecast of the health of the economy is based on criteria such as inflation, unemployment, productivity and consumer confidence (as measured in spending). The national economy might be healthy, but regional or local economies such as unemployment could be negatively impacted by a company buyout, plant closure or strike.

Collateral:
What tangible possessions or other collateral can you provide as a pledge that you will pay what you owe? Can the goods or property being purchased be used as security for the debt?

Collateral is property or an object of value, which a credit grantor can take and sell in case of default. A **secured loan** is one in which collateral is required as security to the lender. An **unsecured loan** is one where there is no collateral required; just an agreement to repay what is owed as agreed.

A credit grantor may ask to use a home, car, savings, bonds, insurance policies, jewelry or other property as collateral or security that can be pledged to pay off a loan or other debt in the event payments aren't made according to the credit agreement.

Common Sense:
Do you have or have you demonstrated an ability to make wise decisions regarding your personal financial matters? Do you inspire confidence that you will use credit only within the bounds of good judgment? That you will make only sensible purchases and not overload yourself with debt you are unable to pay?

A borrower's inner ability to make wise decisions is often referred to as common sense. A credit grantor might determine that a borrower has good common sense based on how questions are answered, either orally, from the written credit application or from information gleaned from a credit report. Good decisions are reflected in answers such as reasons for changing employment, number and types of credit cards, balances outstanding, or references listed on an application.

Risk Scores

Finally, the credit grantor may utilize a generic risk score that summarizes the credit history or file (credit report) into one number reflecting the borrower's expected credit performance. These scores evaluate more risk factors quickly, enabling credit grantors to process applications faster <u>and objectively</u>. It is important to note that risk scores are <u>not</u> a part of a credit report but merely an analysis of the report at the point in time it was acquired. Such scores are dynamic and can change each time the credit file is accessed or updated.

While generic scores are an extremely useful tool in the hands of human processors, they are less effective than automated processing systems that use custom scores. That's because generic scores are based on credit data only, enabling them to capture only one dimension of the lending decision…the borrower's likelihood of defaulting on a loan.

Automated underwriting systems, on the other hand, use custom scores, which are most often based on the credit grantor's historical experience with their borrowers. Custom scores often us both credit and non-credit data. Such systems account for the layering of risk across the first four "C's" of credit granting…character or credit reputation, capital, capacity and conditions. The fifth "C," collateral, becomes apart of the equation when a loan requires security, as in the case with a home mortgage or an automobile loan.

Whether generic or custom, risk scores are a tool that enhances loan and credit application processing. When credit grantors use these scores effectively, they can quickly identify creditworthy consumers. Those applications which may not score in an acceptable range can then be referred to an experienced manager for review. Such a review relies on human judgment and experience and is where the sixth "C," common sense, come into play. In the final analysis, the manager must determine if the strengths offset risks, meaning the consumer will most likely not default on the obligation to repay.

To Lend or Not to Lend

In the final analysis, every credit grantor attempts to answer the question: How risky is it to lend or extend credit to this applicant? This decision is relatively easy for most because the applicants will fall at one end of the continuum or the other.

Definitions:

Capacity

Factor in determining creditworthiness. Capacity is assessed by weighing a borrower's earning ability and the likelihood of continuing income against the amount of debt the borrower carries at the time the application for credit is made.

Capital

Factor in determining creditworthiness consisting of a borrower's tangible assets and resources. The presence of sufficient capital in a borrower's profile is an assurance that a debt could be paid from the borrower's assets if the need arose.

Character

Factor in determining creditworthiness. Character is determined by analyzing how a borrower has handled past obligations.

Collateral

Real or personal property that a borrower pledges for the term of a loan. Should the borrower fail to repay, the creditor may take ownership of the property by following legally mandated procedures.

Conditions

A factor often considered with the factors of capacity, capital and character when creditors are analyzing an applicant's creditworthiness. This factor consists of economic conditions that could affect a borrower's ability to repay, such as unemployment, seasonal work, etc.

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