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UNDERSTANDING 5Cs OF CREDIT ANALYSIS FOR SMALL BUSINESSES

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In Malaysia, under Financial Services Act 2013 (FSA 2013) a bank is licensed to conduct a banking business. One of the activities categorized as banking business is the provision of finance. The lender or financier encounters several risks while providing funding, including business risk, industry regulation, and competition, not to mention repayment and collateral risk. The bank has a stringent credit analysis procedure because there are so many factors to consider before approving a loan. In commercial lending, the credit analysis and review process occurs during the origination and approval stages of the loan application. To determine if a borrower is creditworthy, the 5Cs model is utilized. According to Mohd Harif et al. (2011), the evaluation of creditworthiness for commercial borrowers is commonly conducted by financial institutions in Malaysia using this technique. Because it bases its evaluation of a borrower's creditworthiness on five factors, all of which begin with the letter C, this method is called the 5Cs model. These elements include character, capacity, capital, condition, and collateral. Every pertinent detail regarding the prospective borrower would be disclosed and examined in light of these five criteria, in addition to the mitigation strategy devised to alleviate any associated risk.

To have a better understanding of the information that pertains to each of the 5C elements, we will be utilizing the Lending to the Agriculture Sector Toolkit—December 2012, which is available on the World Bank website. This toolkit is designed specifically for small companies.

1st C: Character

In the case of small businesses, the bank considers the owners' or managers' conduct and character to be a reflection of their capacity to properly manage the firm and handle the loan account; hence, the owner's financial situation is critical. The borrower's and its owner's exemplary conduct in borrowing and non-borrowing accounts would define the new loan account's future status. Furthermore, the status of experience and degree of education is significant in determining the company's decision-making, especially if the economic condition is not favourable.

2nd C: Capacity

Capacity is evaluated by considering the borrower's borrowing history and their track record of prior and current borrowing. This information would be included in the CCRIS report for situations involving Malaysia. In addition to the borrower's repayment history, capacity also considers the borrower's ability to repay their loans.

Hence, the financial statement data is necessary to extract key financial indicators such as sales trends, solvency ratios, and gearing ratios to assess the financial well-being of the prospective borrower. Each industry would have its own set of standards for the chosen financial ratios.

3rd C: Capital

The term "Capital" denotes the extent of the borrowers' dedication to the firm, as indicated by the amount of financial resources they have put in. A substantial capital

investment demonstrates a strong dedication from the owner and the company would have a good probability of seeing growth. This will incentivize the bank to expand its loan facility for this particular company, facilitating future mutual growth. The financial statement is utilised to authenticate the quantity of capital that has been invested.

4th C: Conditions

The fourth C is conditions. The term "conditions" describes the external factors affecting the company that might pose a risk to its operations. Changes in the economy, government policies, or technology might become a threat since they can impact the company's bottom line, market share, and other key performance indicators.

5th C: Collateral

Lenders emphasise the significance of collateral. If the borrower is unable to repay the loan because of a change in the company's cash flow, the lender will have a means to recover their investment. While there is always some risk associated with collateral, just having it would reduce that risk to a lesser extent. Various assets, including properties, fixed deposits, debentures, unit trusts, and insurance policies, are commonly accepted as collateral by banks.

Every company has its unique characteristics, hence the assessment of each company's loan application, even when utilising the same technique, may exhibit some discrepancies. In addition, despite our knowledge of the information required by the bank for credit analysis, the procedure remains both private and discreet. To safeguard their client information from outside parties, banks are required by law to maintain the confidentiality of certain information, including data on loan processing. In addition, how a bank looks at each of the 5Cs elements may be different based on the current policy of the bank, new directives from the central bank, regulations, or any updates on the specific industry and not forgetting internal filtered systems such as bank in-house credit scoring and credit rating. However, it is good enough for the owner of a business to understand the basic interpretation of the 5Cs to equip their company for a bank loan as needed.

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