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Ranking The 5C's Of Credit Analysis: Evidence From Ghana Banking Industry

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Abstract: *This research study was to find out how banks in Ghana rank the 5C's in the evaluation of loan applicants. Based on the Yamane (1967) statistical formula among 35 banks in Ghana, 32 banks credit departments responded to this ranking survey. The results indicated in general that banks in Ghana rank from the order of importance: Capacity, Character, Collateral, Condition and Capital. However, foreign-controlled banks ranked Condition as third and Collateral as fourth and domestic-controlled banks ranked Collateral and Capital the same as the least.*

Keywords: *Capacity, Character, Collateral, Condition, and Capital*

I. INTRODUCTION

The use of the 5c's is among the techniques banks use in considering loan request. The names of these C's are Condition, Character, Capacity, Collateral, and Capital (Wachira, 2017 & Afram & Mills-Robertson, 2014). These elements have a universal application in credit evaluation to manage the risk levels of borrowers. When banks make a wrong lending decision it has the highest probability of the loan going bad (Wachira, 2017). According to Owusu-Dankwa and Gyamfi (2013), the 5c's model is used by banks in Ghana to determine the creditworthiness of borrowers and it impacted on the quality of the loan portfolio.

The banking sector stability report issued by Bank of Ghana (2017) indicated that there were thirty-three banks with universal banking license of which seventeen are foreign controlled and sixteen domestic controlled. The report depicted that non-performing loan (NPL) rate has been increasing. The March 2017 report stated NPL rate of 17.7% as compared to 15.6% in February 2016 (Bank of Ghana, 2016) whereas the July 2017 indicated NPL rate of 21.2% as against June 2016 NPL rate of 18.8% (Bank of Ghana, 2017). The reasons given for these poor performances of the NPL rate were due to the downgrade of banks loans portfolio in

2016 as indicated in the Asset Quality Review (AQR) report and the energy sector debt. The NPL portfolio as at June 2017 has private firms contributing 94.9% and this is an indication of poor credit analysis of loan applicants.

The above situation gives an indication of how credit analysis with 5c's is important. A study in Ghana by Addae-Korankye (2014) has poor loan appraisal also as a cause of loan default. The quality of loan appraisal with 5c's has an impact on loan default (Ojala & Otieno, 2015). This study is to determine the importance and the weight banks in Ghana put on each the 5c's in credit analysis of loan applicants.

II. LITERATURE REVIEW

A. CAPACITY

The assessment of capacity is to determine the ability of the borrower to repay the loan (Sharma & Kalra, 2015). The submitted financial information will help in the determination of the borrower's capacity. Capacity may be calculated by comparing cash generated to pay the loan. The prediction of capacity can be known by using performance factors of Net

Profit Margin, Debt Service Coverage Ratio and Quick Ratio (Kabir, Jahan, Chisty & Hasin, 2010).

B. CHARACTER

It is a subjective evaluation of the personality of the borrower of management of the borrowing firm. This assessment is performed to check the integrity and trustworthiness of the borrower (Abbadi & Karsh, 2013). Their past borrowing records are investigated for honesty in loan repayment without compulsion. This is a moral and human factor assessment of business ethics, commitment and responsibility (Kabir, Jahan, Chisty & Hasin, 2010). The observance of character may be noted in the profile, reference given by the borrower and existing credit reference institutions.

C. CAPITAL

Banks analysis of firm capital is important because it helps in determination of borrowers' risk to an unexpected loss in the industry. A firm with high equity is capable of covering all expenses to ensure break-even and profitability (Strischek, 2000). Capital is ownership and it shows commitment and confidence in the business as depicted by Equity ratio, Debt to Equity Ratio (Noradiva & Azlina, 2016).

D. COLLATERAL

This is the alternative source for the loan repayment should there be a failure (Wilkinson, 2013). Collateral relates to the security made available to secure the financial exposure. This security should have a proper title, marketable and valuable enough to cover the loan amount (Sharma & Kalra, 2015). The collateral quality is assessed by using Loan-to-Value Ratio.

E. CONDITION

This analyses purpose of the loan, the industry, economic and political environment. Before a loan is approved and disturbed a fair study of these conditions are required. This is done to ascertain the borrower's vulnerability to happenings in the economy (Moti, Masinde, Mugenda & Sindani, 2012). The political analysis involves looking at all levels of everyday politics which include power and agency and its impact on doing business in the country (Hudsons & Leftwich, 2014). This is to measure any external hindrance that will hamper the loan repayment. The industrial analysis is important (Kabir, Jahan, Chisty & Hasin, 2010).

According to Strichek (2000), the 5c's credit analysis should be ranked in order of importance from Character, Capacity, Capital, Condition, and Collateral. It is believed that credit evaluation in this pattern will lessen the burden of non-performing loans. Another study in Palestine ranked the measure of credit risk analysis based on the 5 c's in ascending order of Collateral, Capacity, Capital, Character, and Condition (Abbadi & Karsh, 2013). This shows that there is a geographical impact on ranking for the application of 5c's upon which this study is important.

III. OBJECTIVE AND METHODOLOGY

A. OBJECTIVE

The objectives of this study are:

- ✓ To observe the importance and how banks rank the 5c's in their credit analysis of loan applicants.
- ✓ To detect if the type of ownership impact on the 5c's applications.

B. METHODOLOGY

There are currently 35 Universal licensed banks in Ghana. The selection of banks as respondents is based on the Yamane (1967) statistical formula:

$$n = \frac{N}{1 + N(e)^2}$$

Where n = the sample size of banks in Ghana; N = the total number of universal licensed banks in Ghana; e is the allowable error = 5%. Based on the formula, 32 banks made up of 53% foreign-controlled and 47% domestic-controlled responded. The ranking is done from 1 to 5, where 1 is the least important and 5 is the most important in the credit analysis. The summation of each rank as given by a bank is obtained for each C to determine its rank.

IV. RESULTS AND DISCUSSION

In accessing how banks in Ghana ranked and placed emphasizes on the 5C's in credit analysis of loan applicants, the results indicated that they ranked Capacity 5, Character 4, Collateral 3, Condition 2 and Capital 1.

Summation Results from Ranking						
5C's	Domestic-controlled Banks		Foreign-controlled Banks		Ghana Banks Ranking	
	Raw Score	Rank	Raw Score	Rank	Raw Score	Rank
Capacity	66	5	87	5	153	5
Character	52	4	60	4	112	4
Collateral	44	3	48	2	92	3
Condition	24	1.5	49	3	73	2
Capital	24	1.5	26	1	50	1

NB: 5 is the most important - 1 is the least important

Figure 1

However, domestic-controlled banks ranked condition and capital the same to be the least. The foreign-controlled banks valued condition to collateral as compared to domestic-controlled banks ranking.

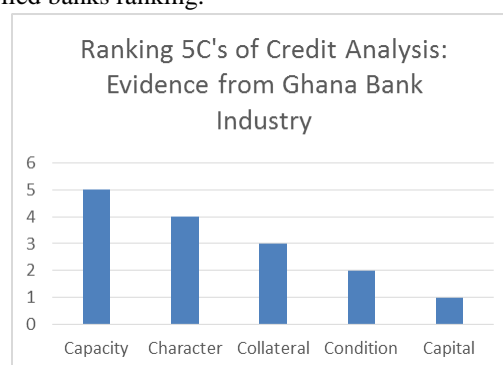


Figure 2

In general, banks in Ghana are more concern with the loan applicant's ability to generate enough cashflow to service the loan; the willingness of the loan applicants to pay and the security backing the loan. The banks placed less attention to the purpose of the loan, the happenings in the economy and finally the equity based of the loan applicant.

V. CONCLUSION

The finding of this study has showed that banks in Ghana rank from the most important of the 5C's is from Capacity, Character, Collateral, Condition and Capital. However, foreign-controlled banks rank condition third and collateral fourth and domestic-controlled banks rank condition and collateral the same as the least. The factor that capacity is the most important in the 5C's for the credit appraisals, point to the fact that banks in Ghana are aware of the high NPL in the industry and the way to reduce it is by vetting the capacity of future loan applicants.

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