Money Management Curriculum

Module 3: Applying for a Loan the 5 C's of Borrowing

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USDA United States Department of Agriculture National Institute of Food and Agriculture

WESTERN SARE Sustainable Agriculture Research & Education

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Managing Money Curriculum

Module 3: Applying for a Loan

The 5 C's of Borrowing

United States Department of Agriculture

National Institute of Food and Agriculture

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Key Concepts

- What lenders look for in a borrower
- Process of acquiring a loan or money
- 5 C's of borrowing

What Banks and Lenders Look for in a Borrower

- When seeking credit/loans for various sources, the lender wants to know the chances that you will repay the loan.
- Recall Module 2 and the impact of interest rates on borrowed money. Where do you rate?
- The more risk or uncertainty about the borrower, the higher the rates and terms of the loans/money.

Sources of Money

- Where you get the loan/money has an impact on the rate and terms of the funds:
  - Family & Friends
  - Banks and Credits Unions
  - Pay Day Loans
  - Internet: Crowd Funding
- Each of these options have pluses and minuses associated with the loans/money.

A two-week pay day loan that charges $15 per $100 equates to an annual percentage rate of 400%. Credit card interest rates can range from 12% to 30%.

These options may also have different processes and criteria.

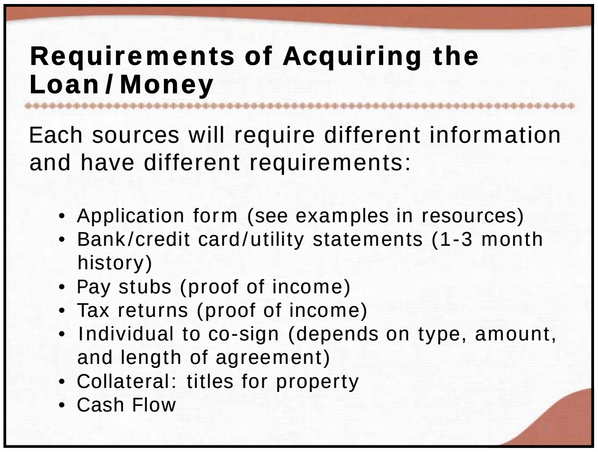
Before Acquiring the Loan / Money Know the Terms

Look carefully at the terms of the funds before accepting:

- Repayment time: Start date for repayment and end of loan
- Type and rate of the interest charges:
  - Compounding daily, monthly, billing cycle, or annual
  - Variable or fixed rates: 4% to 75%
- Late fees and penalties, early payoff fees
- What is listed or required for collateral?
- What does the bank take from you if you do not repay the loan?

For a payday loan $15 may not sound like a lot, but put in terms of how much you are paying for the time that you have it borrowed the fees can be extreme.

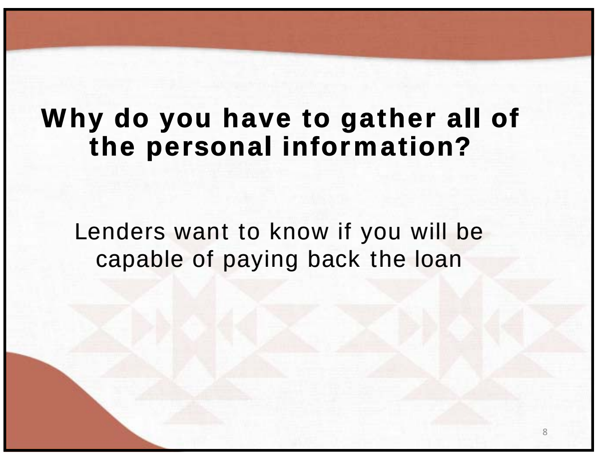
Look for hidden fees. For example, you may have something that is 0% interest, but has another fee, or big penalties if it is not paid off in the time allotted.



Slide 7: If you are asked to be a co-signer remember that you are agreeing to pay back the loan if the borrower does not.

Slide 8: This is one of the methods lenders use to evaluate you as a customer. They want to know how capable you are of paying back the money borrowed.

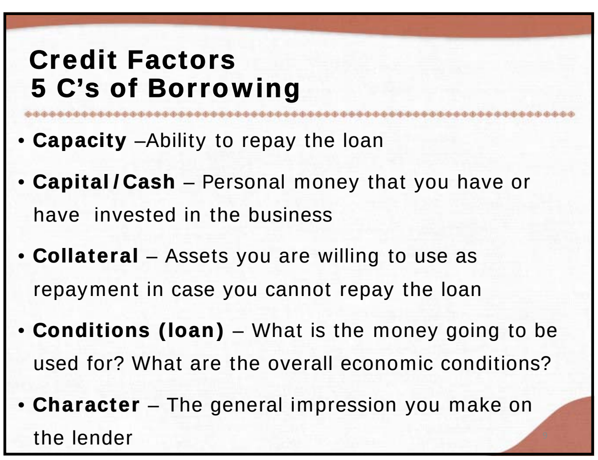
They want to see how stable your source of money is. Do you have a lot of other debt? Do you owe on your utilities?



Slide 9: The 5 c's of credit are one way of looking at what lenders consider in evaluating a potential borrower.

Capacity – The lender would like to know how you intend to pay the loan back. The lender will consider current cash flows from the business, timing of repayments, and the overall probability of loan repayment. The lender will look at the payment history of existing credit relationships, both personal and business related. Lenders will also want to know if there is any other possible sources of repayment.

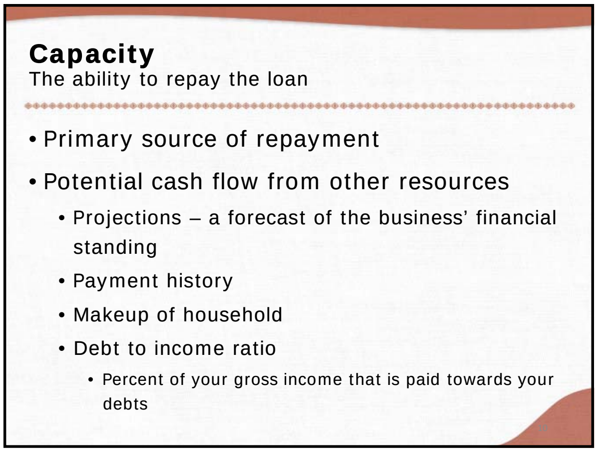
Capital – Is the money that you have personally invested in your business? This is an indication of how much you have at risk should the business fail. A lender wants to see that you are willing to take a risk with your own funds before they will be willing to invest.



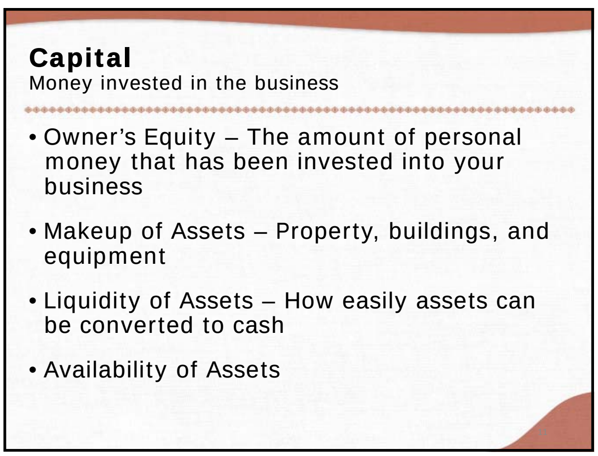
Collateral – The lender wants additional security should you not be able to repay the loan. Collateral can mean that you pledge your own assets, like your house, or someone else signs a guarantee promising to repay the loan if you can't.

Conditions – The lender will consider what the money is being used for. Will it be used for working capital, additional investments in equipment, and/or inventory? The lender will also consider the economic conditions of the industry as well as the local market.

Character – The lender will form a subjective opinion as to whether or not you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your business. Your educational background and the personal references will also be considered.



Slide 10: Capacity – The lender would like to know how you intend to pay the loan back. The lender will consider current cash flows from the business, timing of repayments, and the overall probability of loan repayment. The lender will look at the payment history of existing credit relationships, both personal and business related. Lenders will also want to know if there is any other possible sources of repayment.

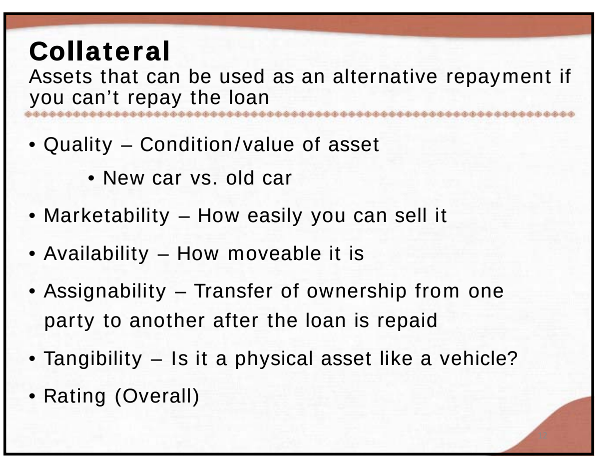


Slide 11: Capital – Is the money that you have personally invested in your business? This is an indication of how much you have at risk should the business fail. A lender wants to see that you are willing to take a risk with your own funds before they will be willing to invest.

Owners equity can come from three sources: money or assets you contributed to the business, Profits you retained in the business, and appreciation in your assets. This last one is normally from land that you purchased years ago that has gone up in value.

One banker once told me that "I do not want to be more invested in your business than you are."

This also compares the business' assets (what they own) with their liabilities (what they owe). If assets are much greater (more than double) the liabilities, there could be room for additional borrowing. A business that has additional room for borrowing versus one that has borrowed all they can will look less risky.



Slide 12: Collateral – The lender wants additional security should you not be able to repay the loan. Collateral can mean that you pledge your own assets, like your house, or someone else signs a guarantee promising to repay the loan if you can't.

There can sometimes be issues in using trust land as collateral.

Collateral
Offered or Available as a Security Measure

- Determining collateral requirements
  - Ability of borrower
  - Type of work
  - Creditor risk
- Methods of evaluation of collateral
- Property to include in lien
  - Source of liquidation
  - Secondary collateral
- Description of property taken as collateral
  - Accurate
  - Legal

Conditions
Additional information that can influence the lender's approval of a loan

- Current market conditions
  - Within your industry
  - Local market conditions
- Loan structure
- Feasibility
- Physical limitation
- Sensibility of loan usage
- Business management capabilities
- Element of risk

Slide 14: Conditions – The conditions of the loan, such as its interest rate and amount of principal, will influence the lender's desire to finance the borrower. The lender will consider what the money is being used for. Will it be used for working capital, additional investments in equipment, and/or inventory? The lender will also consider the economic conditions of the industry as well as the local market.

Character
Moral qualities that distinguish the borrower

- Willingness to repay
- Ability to repay
- Integrity
- Persistence
- Community acceptance/reputation
- Flexibility of individual
- Background knowledge

Slide 15: Character – The lender will form a subjective opinion as to whether or not you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your business. Your educational background and the personal references will also be considered.

The Borrower

- Moral Responsibility
  - Unpaid bills or judgements
  - Complete and correct financial statements
  - Inaccurate or false production or sales data
  - Bankruptcy or compromise of debts
- Ability
  - Age
  - Health
- Continuity of Management
  - Time on present property; owner or renter?

Slide 16: All unpaid bills or judgements may not be looked at the same way. Unpaid medical bills may be looked at differently than unpaid bills related to your business.

Financial Position and Progress

- Assets
  - Cash on hand
  - Farm products on hand
  - Farm real estate
- Liabilities
  - Amount & number of debts
  - When & why incurred? Secure or not?
  - Real estate: first liens, second liens
  - Total Liabilities; effects of payments
  - Net Worth
  - Financial trends

Purpose of Loan & Basis of Approval

- Analysis of loan purposes:
  - Necessities – operation, living costs
  - Needs – taxes, interest, repairs
  - Wants – non-essentials
- Determination of loan amount
- Method of disbursement
- Split line of credit – A loan split into a personal line of credit and a business line of credit
- Plan for repayment

Slide 18: These are all questions that will be asked and evaluated in applying for a loan.

Even if you have great performance on all the 5 C's of credit, if the lender feels that the loan amount is not justified for the purpose, you will still not get the loan.

A plan for repayment can be very helpful. Sometimes you may not have a long history. By presenting various scenarios and situations where you show you will still be able to pay the loan back, may help you.

The plan for repayment can be as helpful for you as for the lender. Just because you may qualify for debt, may not mean it is the right decision to get the loan.

Remember the more you borrow, the more you will have to pay back. A higher operating loan, may mean that you spend more during the year. This would mean you would have more to pay back and it would increase how much you need to make to break even.

Money Management Review

- **Module 1 Record Keeping**:
  - Keep track of your cash flows
  - A good set of financial records will help you build a budget and make better financial choices
- **Module 2 Loans and Credit Cards:**
  - Use the MyFi app to become more savvy about credit card usage
  - Build a budget that will help you become independent form credit cards
- **Module 3 5 C's of Borrowing:**
  - Know what a lender looks for in a borrower
  - Knowing the factors for loan approval will give you an advantage for a loan with a good rate

Next Module:

- **Money Management Module 4: Credit Scores**
  - Will cover all the components of a credit score and what that means to you as a borrower.
  - Will cover what a GOOD credit score is and how to increase your credit score.
  - The difference between having a good credit score and a bad credit score could save you hundreds when applying for a loan.

Long-Term Assignment:

Keep Track of Your Budgeting Exercise

Questions?

Thank you!

Teaching Notes:

This module covers the requirements for a loan application as well as the factors that determine whether a loan is approved or denied. Banks and lenders measure the risk of lending to someone; credit scores indicate the level of borrower risk: higher scores indicate lower risk and lower scores indicate higher risk. If the risk is too high, the lender may not approve the loan. This module has various sources of money that can hold positive or negative impacts. For example, obtaining a loan from a family member might mean little to no interest is paid but could lead to a strained relationship if the loan is not paid on time. Understanding the terms and conditions of a loan BEFORE you sign could save you hundreds. Depending on the type of loan, the personal information required will be different (collateral may not be required for some types of loans). Lenders require this information so they can determine whether the borrower is capable of repaying the loan. The 5 C's of borrowing are credit factors that the lenders use to determine if the borrower is capable of repaying the loan. Understanding what a lender is looking for in a borrower can help potential borrowers increase their chances of being approved for a loan or getting a loan with a better interest rate. The 5 C's of borrowing are

- **Capacity** – The ability to repay the loan.
- **Capital** – Personal money invested in the business or your net worth.
- **Collateral** – If necessary, the assets you are willing to use as repayment in case you cannot repay the loan.
- **Conditions** – What is the money going to be used for? What are the overall economic conditions?
- **Character** – The general impression you make on the lender.

Remind your students to keep track of their cash flows and budgets; if they have an accurate budget they may find that applying for a loan is not necessary. Instead, they can cut frivolous expenses and save to buy the things they want. If applying for a loan is necessary, they already have an idea of where they stand in the eyes of a lender.

Educational Objectives:

- Understand what lenders are looking for in a borrower
- Understand the terms and conditions of different loans
- Understand the 5 C's of borrowing

Discussion Topics:

- What is the relationship between risk and interest rates?
- What are the benefits and/or drawbacks of the different sources of loans?
- What is the difference between a secured and unsecured loan?

Resources:

- **Worksheets:**
  - None
- **Other:**
  - None

Outline:

1. Key Concepts
2. Qualities Banks and Lenders Look for in a Borrower
3. Sources of Money
4. Terms and Conditions of a Loan
   a. Repayment Time
   b. Type and Rate of the Interest Charges
   c. Fees and Penalties
   d. Collateral Required?
5. Personal Information Required for Loan Application
   a. Why is it important to have this information?
6. 5 C's of Borrowing
   a. Capacity
   b. Capital/Cash
   c. Collateral
   d. Conditions (of the Loan)
   e. Character
7. Basis Loan Approval
8. Money Management Module Review
   a. Next Module: Money Management Module 4: Credit Scores
9. Reminder to Keep Track of Your Budgeting Exercise