

The 4 Cs of Credit

by Neil on November 25, 2008



The current credit crunch has made the availability of Saloans from financial institutions harder to get. There is simply less money going around and financial institutions are being more diligent about who they lend to.

Over the past few weeks I've met with many clients looking for various types of financing. Everything from loans to mortgages. In many of the cases I felt the applications were borderline regarding their ability of gaining approval. As an advisor in the bank it's my job to make the application as attractive as possible, without fudging numbers, to assist my clients in gaining approval. To accomplish that I use the 4 Cs of Credit and write my comments to the underwriter to reflect the clients situation.

What exactly are the 4 Cs of credit you ask? Well they are aspects of your financial situation that are used to paint a picture regarding your credit worthiness. As it is becoming increasingly more difficult to gain credit, it's important to understand these four principles in order to maximize your ability to gain that mortgage or much needed loan.

The 4 Cs of Credit

- **Character:** Your Character covers things such as employment and how long you've been with your employer. Financial institutions want to know your job history for the past two or three years. If you've had three or four jobs in that time span it doesn't bode well for your Character. Job stability is another factor that plays into the Character assessment, if you have just switched jobs within the last few months and are on probation this can impact the decision. Character also covers your home address, similar to employment history, if you have moved around a lot over the past few years this shows instability and can have a negative impact. Finally, your relationship with the financial institution that you are dealing with. How long have you been a customer? Are you a good customer, have you fostered a relationship with you banker?
- **Capacity:** Capacity speaks to your ability to handle the new debt burden. This is governed by your Servicing Ratio's. Your Gross Debt Service (GDS) is your monthly housing costs (mortgage payment or rent), plus property taxes, heating, and 50% of condo fees if applicable. This is

divided by monthly gross family income, your target number here is 30%. Your Total Debt Service (TDS) is your housing costs, plus other debt divided by monthly gross family income. An ideal range would be to keep this ratio near 40%. Remember that TDS doesn't factor in how much you owe, it factors in how much you could owe. In other words if you keep a zero balance on your credit card you may feel your ratio is low. Your financial institution considers this ratio when the credit card is maxed out as that is your maximum capacity. Each financial institution will have their own guidelines for acceptable ranges for Servicing Ratio's. Capacity is a good reason to not hold multiple credit cards with large limits, as this will effect your ability to gain future credit.

- **Capital:**Capital refers to your assets and your ability to build your assets. One of the most common comments I see from underwriters is "client has no savings." Financial institutions want to know that you have the ability to save. When you ask for financing the bank wants to know you're good for it, that you have the habits of saving in place. If you are already a home owner with a decent amount of your mortgage paid down, with reasonable retirement and non-retirement investments then you have good capital and you need not worry about this C.
- **Credit Rating:**Your Credit Rating is that unseen number that dictates how you've handled past credit. If you've missed payments, defaulted on loans etc this number is going to be low and you should prepare yourself for disappointment. If you are living on credit and borrowing from one source to pay another off, your credit rating is going to be low. If however you make regular payments that are more than the minimum's you should be ok. When you're working with your banker arranging a loan, be sure to disclose all your outstanding debt. It's going to show on your credit report, so if you don't disclose it the bank then asks the question why and you've damaged your Character.

The Four Cs of Credit effect each other, they aren't stand alone entities. Being strong in one area means you should be strong in another.

A final word on Credit. You wouldn't lend \$100 to someone on the street, your financial institution looks at it the same way. You need to prove that you're worth the risk. The burden of proof is on you.