CEDAR ROSE ®

How to Conduct a Full Credit Risk Assessment of Your Clients in the United Arab Emirates

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What is Credit Risk Management?

Credit risk is a term used to define the probability of loss to a supplier (offering products and/or services) if a client fails to pay their invoices. In a business environment, supplying organisations need to take measures and manage their credit risk to minimise the risks of payment defaults. If these losses occur on a large scale, they can impact the organisation's ability to continue the business and even affect its future business prospects as more sales and profits are needed to offset the incurred loss. Effective credit risk management aims to avoid delinquent clients and maintain a positive cash flow.

Credit risk management provides an efficient and effective structure to manage the organisation by creating synergies among various risk management activities. It also offers an increased risk awareness for facilitating educated strategic and operational decision-making. An effective credit risk management strategy ensures that the risk-taking decisions made throughout the organisation are aligned with its organisational objectives.

Implementing an effective credit risk management strategy gives the supplier increased financial control and security. It can be used as a strategic opportunity to secure a competitive advantage and enhance overall performance.

The process of credit risk management involves various steps that can be split into two categories:

Measurement

Organisations can measure the credit risk posed by their clients based on their credit history, terms and conditions, repaying capacity, capital, and the associated collaterals.

Mitigation

Credit risk mitigation refers to applying various processes and safeguards by organisations to reduce the overall risk of default or delayed payments by their clients.

Why is Credit Risk Management Important in Your Relationship with the Client?

Credit risk management helps organisations protect themselves against client defaults and late payments. It allows a business to maximise sales while limiting credit exposure in the following ways:

Cash flow protection

Cash flow issues have haunted small businesses in the UAE since the pandemic. To thrive in a competitive business environment, organisations need working capital. An organisation must forecast its cash flow to advance revenue growth, take advantage of business opportunities, and develop financial resilience. Streamlining invoice management, dealing with unpaid debt, and performing timely credit evaluations on its clients are critical steps in ensuring effective credit management.

An effective credit risk management strategy helps enhance an organisation's cash flow by minimising credit risk. This ultimately assists the organisation in cases of unexpected delays or defaults in client repayments.

Days sales outstanding (DSO)

The days sales outstanding is a crucial indicator specifying the average number of days it takes for an organisation to receive payment against a product or service sale. In other terms, DSO measures the time it takes for an organisation to convert its accounts receivable into cash.

Implementing an effective credit risk management strategy can help an organisation reduce the likelihood of clients paying late or not at all, leading to a decrease in the days sales outstanding metric. This can involve analysing the creditworthiness of potential customers before offering credit, establishing clear credit terms that require payment within a specific time frame, and setting credit limits based on customer credit history. By taking these steps to manage credit risk, an organisation can reduce the DSO and minimise the negative impact of late or non-payment.

Lowering late payments

A late payment can be defined as the failure to pay an invoice by the due date agreed upon by the client to the organisation.

Encouraging repeat business and acquiring new clients are the two most common reasons for the use of open credit, highlighting the pivotal role that this practice plays in enabling trade in the United Arab Emirates (UAE). UAE-based SMEs are compelled to offer attractive credit terms; however, the prevalence of late payments makes it difficult for them to keep operating smoothly and maintaining a positive cash flow, with 60 percent of business-to-business invoices in the UAE cleared after the set payment date.

There are several reasons for this delay, including market conditions, management issues, or failure to be paid by the company's own clients, resulting in temporary or permanent cash loss. This can be dealt with by identifying the clients with a higher risk of late payments earlier and taking measures to prevent bad debts. These measures include assessing the client's creditworthiness and negotiating clear credit terms.

An effective credit risk management strategy covers the assessment of a client's ability to pay their debts, cushioning the supplier organisation from the risk of late payments.

What Should be Included in a Credit Risk Management Report?

Risk management and due diligence professionals can conduct a comprehensive credit analysis to reduce an organisation's credit risk. The following key factors are included in a credit risk management report:

Registered information

The three most important business registration documents in the UAE include the Memorandum of Association (MoA), Articles of Association (AoA), and a trade license.

- A **Memorandum of Association** represents a company's charter and is a legal document prepared during the company's formation and registration process. It defines the company's relationship with its shareholders and specifies its objectives.

- **Articles of Association** is a document that indicates the regulations for a company's operations and defines the company's purpose. The document describes how tasks are executed within the company, including the process for appointing directors or how financial records are handled.

- A company must obtain a **trade license** from its local authorities before commencing business. The trade license permits a company to perform certain activities legally with the legal document providing legitimacy and giving the company authority to perform the actions it was granted for.

Obtaining the registered information of a client is critical to conducting an effective credit assessment. Information such as the client's registered company name, trade license registration numbers, registered address, stakeholders, legals forms, activity descriptions/ codes, capital or any historical amendments to the company's shareholders, directors or addresses should be attained to conduct an effective evaluation.

The ideal source of this information is to acquire the company's Memorandum of Association and trade license documents from the client as these provide the most comprehensive data. However, it's not always possible to attain this corporate information from the client, resulting in organisations needing to trust publicly available data sourced from the relevant registries directly.

When sourcing publicly available data it is crucial to use official sources. As a first step, searches through local commercial authorities' records and directories are recommended to confirm the existence of the client. Local commercial authorities may include commercial registries, chambers of commerce, ministries, and other governmental departments..

Although businesses in the UAE are required to provide comprehensive commercial information, including the declaration of their ultimate beneficiary owners, it is important to note that third parties have limitations to accessing this corporate information in the UAE, making it difficult for them to attain reliable and comprehensive information on their subjects.

Commercial information

Commercial information comprises any details about an organisation's business activities. A potential client's commercial information includes data related to its customers, imports, exports, suppliers, relationships with banks, and products and services offered.

The types of information that can be reviewed and considered as part of a client credit assessment are:

- Which **banks** does the client deal with? This also includes assessing the client's **mortgages and charges**.
- What is the **method of payment** agreed between the client and its third parties (e.g., suppliers)?
- Who are their top **clients**?
- Who are their top **trade suppliers**?
- Is the client an **agent** for another company?
- Does the client have any sister companies or **affiliates**?
- If the client is a manufacturer, what **volume of production** are they capable of?
- Does the client have any investments or **subsidiaries**?
- Does the client engage in **international trade**? What is the **value of their imports and/or exports**?
- What **certifications** have been acquired by the client?
- Who has **audited** and/ or is auditing the client?
- Have the client's past or current suppliers provided them with a positive **trade reference**?
- Who are the **legal practitioners** representing the client?

Financial information

The financial information of an organisation is a summary of the company's financial performance which clarifies a company's profitability, assets, and growth prospects. You can find the financial information in the company's financial statements, which include cash flow statements, income statements, and balance sheets.

Cash flow presents the company's inflow and outflow of monetary transactions. The **income statement** shows a summary of an organisation's income and expenditure and assists with evaluating its assets and liabilities through the balance sheet. **Ratio analysis** is also a credible way to judge an organisation's operational efficiency, liquidity, and profitability.

All companies registered in the UAE, including free zone companies, are required to prepare and maintain accounting records that accurately reflect their financial position whilst complying with the International Financial Reporting Standards (IFRS) and the UAE Commercial Companies Law.

Payment behaviour

An organisation's payment behaviour is a good indicator of what to expect in the matter of payment and is important to understand a company's creditworthiness and assess its ability to meet its financial obligations.

Tracking payment behaviour can assist with identifying payment patterns, and revealing the speed at which the client pays invoices whilst highlighting potential payment delays or issues with the client. This important step allows organisations to make informed decisions about setting the appropriate payment terms to manage their credit risk.

A key indicator of a company's financial performance is its ability to pay its debts and manage its cash flow, however, a company with good financial performance may still delay paying their invoices on time.

A good way to uncover payment behaviour is through a trade reference check. A trade reference is a trader's opinion on the creditworthiness and a first-hand testimony of their past payment experience with another trader. It comes from a business-to-business supplier with whom the company is dealing on a credit account basis.

How Do You Collect and Analyse the Information?

Risk professionals collect data and analyse it to draw meaningful outcomes. This information is then presented as a report to help organisations manage a client's credit risk.

Collecting the information

Commercial information comprises any details about an organisation's business activities. A potential client's commercial information includes data related to its customers, imports, exports, suppliers, relationships with banks, and products and services offered.

Official sources

The primary step is to confirm the prospective client's existence and registration details through publicly accessible official sources. These sources include local commercial authorities' directories and records, which can be government departments, ministries, and commercial registries.

However, commercial information is often not publicly available in the UAE. **Companies in the UAE operate in over 40 different jurisdictions including free zones**, all of which have different requirements for how much commercial data a company is required to disclose publicly. This makes it more challenging for organisations to gain access to trusted and verified data about clients, resulting in the need to reach out to authorities to verify or complete the profile of a company they are reviewing.

Trusted databases

Searches through trusted databases and commercial directories are essential to be able to locate a client and collect additional details such as contact details, additional registration information and credit scores, etc. Access to trusted databases assists risk professionals to accelerate their investigation processes and client onboarding.

Credit references agencies

To minimise credit risk, supplying organisations can gain valuable insights into their potential and existing customers through reputable credit reference agencies that conduct in-depth due diligence and alert you of any potential red flags.

Open-source searches

Searching through open sources is the most common way of finding information about any organisation. However, this is also the most time-consuming process. Most due diligence firms use trusted and targeted open sources to find relevant information about all organisations, delivering a detailed review and analysis in the credit risk report.

Debt collection agencies search

A debt collection agency is an organisation that specialises in recovering money from companies and individuals after payment defaults. You can collect a prospective client's historical and current debt profile from the records of official authorities or trusted debt collection agencies.

Phone interviews

This method of remote data collection requires the preparation of stringent guidelines and protocols. Collecting data through phone surveys includes approvals, timelines, instrument design, and enumerator training. There are instances where companies resist revealing vital information that may be sensitive; however, the data may be crucial to completing the client's credit profile.

To deal with such circumstances, the researchers and analysts representing the diligence organisation are highly trained to assure the client of the importance of sharing the information and how it can benefit and facilitate their business with their national and international partners and suppliers equally.

Determining the creditworthiness

Accurately judging a potential client's creditworthiness is more effective than chasing the client for payment defaults. It can reduce the risk of late payments that can eventually become bad debts. This makes it important for all supplying organisations to determine a client's creditworthiness before onboarding them.

Challenges in accessing important data points and possible remedies

As the demand for reliable and validated customer information through cross-verification with business intelligence organisations increases, companies in the UAE may encounter various challenges in procuring business data. Here are some potential solutions to these challenges.

Challenge #1

Unverified documents submitted by potential clients.

Remedy

Cross-verify information provided by clients against trusted and verified data provided by business intelligence agencies.

Challenge #2

Difficulty in determining the creditworthiness of potential clients

Remedy

Consult data exchanges to gauge the creditworthiness of a client. Data exchanges are closed groups of companies that contribute data on clients and receive alerts on payment behaviours.

Challenge #3

Sourcing and checking the references of potential clients.

Remedy

Utilise a business intelligence agency to perform a reference check on the client to check:

- What is the average ticket size/ business with the client?
- How many credit days do they have with the client?
- How many days the payment was delayed (if any) beyond the agreed credit days?
- What is their method of payment?
- Any comments from the reference about payment challenges they have observed or any invoices that went into litigation etc.

Analysing the information

After the information is collected from various sources, it is then analysed by the organisation. The data collected can be analysed through the following methods:

Scoring model

The credit scoring model is a method used to estimate the risk associated with short-term credit repayment granted by using the collected statistical information. Through this method, the diligence organisation prepares a credit risk scorecard in which they assign a score to a business that reflects the business's risk level in short-term credit repayment.

Size indicator

A size indicator is a tool that can automatically review and analyse the collected data points to determine the size of the client’s company.

Decision makers within an organisation can utilise size indicators to understand the client’s size and scale to enable them to make informed decisions. Artificial intelligence can classify the size of the company under categories such as small, medium, and large; taking into consideration variables including but not limited to the number of employees, annual turnover, the number of premises occupied by the company and capital.

Credit limit

After calculating the company’s credit risk score and size, the credit limit is assigned to the client. This limit recommends the maximum credit, considering the business's payment, size, and risk level. While deciding on the credit limit, investigating organisations also automatically classify companies under different risk levels, e.g., low risk, medium risk, and high risk.

Quality checks

Accurately compiling credit risk assessments requires several quality checks. Quality checks aim to judge the source and level of accuracy of the information collected from a client during the scope of the investigation. Credit risk assessment quality checks can range from checking the company’s address, management, and shareholders to operational activity as well as any financial details if available.

What Can You Put in Place to Monitor and Mitigate the Risks Moving Forward?

Following are some of the fundamental data-based processes that must be put in place to monitor and mitigate credit risks and make a sound credit decisions:

Credit risk monitoring

The global business landscape is highly dynamic, and even small changes in global trends can have a significant impact on various market sectors. To stay ahead of these changes, proactive credit monitoring and management are essential. This approach enables companies to stay on top of the latest developments and make informed decisions.

A reliable credit risk monitoring system can provide instant updates on critical factors such as changes in legal status, ownership, financial standing, liquidation, or bankruptcy. By leveraging this information, companies can take appropriate and timely actions regarding their clients.

Ongoing credit monitoring data can be included in quarterly reports to ensure that organisations always have the most recent information to automate their credit risk management activities. Utilising technology to assist in credit risk monitoring can help businesses manage individual customer credit risk while mitigating risks associated with their overall short-term credit repayments portfolio.

The risk of one client against the risk of the entire portfolio

In addition to the transaction level, supplying organisations manage and measure their credit risk exposure at the portfolio level. The primary reason for a greater focus on portfolio management is that individual credit exposures may leave the supplying organisations with the possibility of facing adverse payment failure events multiple times. Portfolio management and diversification can help in reducing such undesirable credit risks.

Portfolio diversification is a credit risk management strategy that aims to maximise returns and mitigate risks by allocating investment funds across industries, companies, and categories. A diversified portfolio allows you to distribute the financial risks across different sectors and instruments, thereby balancing risks and returns.

For an organisation with a diversified portfolio, each client represents a small amount of the total portfolio. Market fluctuations, late payments or bad debts from a specific client cannot impact the portfolio significantly, protecting the organisation from high credit risks.

Planning, management, and monitoring portfolio diversification are crucial for each organisation to minimise the associated risks and maximise returns.

In addition to the portfolio's over-diversification, specific operational challenges impact the company's profitability and increase risks. These operational challenges may include disruptions in the supply chain, mismanaged business processes, or delays in the launch of new partnerships/ projects.

An effective credit risk management strategy is crucial to minimise risk, increase financial security and improve your business's overall performance. Companies in the UAE and MENA region, especially, are recommended to establish effective credit risk management practices to combat the region's unique problems, such as the unavailability of reliable public data.

Cedar Rose's database and comprehensive credit assessment reports can help organisations access trusted, verified business information about their clients. We understand the unique challenges faced by companies in the UAE, that's why our database is backed by data that is extracted from reliable and ultimate sources, ensuring risk professionals have access to the most accurate and up-to-date information. Cedar Rose's solutions can help organisations make informed decisions and improve their business's overall performance confidently.

To find out how Cedar Rose can help your business with credit risk management:

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