Convergent paths

It all seems to be coming together. Two of the top software vendors have merged, businesses within firms are starting to share responsibility for op risk management, and, despite a split over scenario analysis, some expect the market to slowly converge on best practices too. By Alexander Campbell

The biggest change at the top of the 2012 Operational Risk & Regulation software rankings has nothing to do with shifts in popularity – October last year saw IBM take over Algorithmics in a $380 million deal and begin the process of merging the company with OpenPages, which it bought in September 2010. Algorithmics and OpenPages were overall first and third, respectively, in last year’s rankings (www.risk.net/2070104); this year the merged company, listed in our rankings as Algorithmics/OpenPages/IBM, keeps Algorithmics’ first place, putting the Toronto and London-based company at the top for the fourth year in a row. Out of our five individual categories, the company came top in three – scenario analysis, loss data collection, and regulatory and economic capital modelling – and picked up second place both in the risk control and self-assessment (RCSA) and key risk indicator (KRI) categories. The merger comes as prospects for the industry seem to be brighter than they have been in several years.

A survey by ORR’s sister magazine Risk in 2011 found that 60% of financial institutions expected to increase IT spending this year; 56% thought the increase would be more than 10% from 2011, and 8% expected to spend 50% more on IT in 2012 than in 2011 (www.risk.net/2124365). And a survey conducted by UK consultancy Chartis Research predicted a steady industry-wide 10% increase in risk management technology, reaching $21 billion this year and $23 billion in 2013.

Second place in the overall rankings went to...

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London-based software and services provider Chase Cooper, which took first place in the KRI functionality and RCSA categories, and second places in scenario analysis, loss data and capital modelling – up from fourth place overall in 2011 and fifth place in 2010.

Chase Cooper’s chief executive, John Kiddy, agrees that software spending has largely recovered from the freeze it suffered at the peak of the crisis in 2008–2009. Kiddy is particularly optimistic about the prospects of further sales to emerging-market banks in Africa and east Asia.

“One of our biggest deals recently was in west Africa, which got us into another 35 countries,” Kiddy says. “Part of that was all the knowledge transfer – we can provide consulting and run training courses, as well as providing the software. The more of that kind of guarantee we can give the better – we don’t just sell the software and leave. In general, we have seen huge interest from emerging markets. Emerging markets are a massive growth area, which might surprise some people.”

But he also sees a real change in attitude on the part of customers around the world. “After Lehman Brothers there was definitely a slowdown – since then there’s been a change in the spending pattern. Over the past year, it seems, people have been shying away from big-ticket spending. When they spend they want guaranteed results. There is much more caution now, and zero appetite for any risk of project failure.”

One result of customers’ new caution about large software projects, Kiddy believes, is that sales of software alone are becoming rarer – increasingly the software sale is only part of a package that includes training and consulting services. This is no bad thing from the vendor’s point of view, of course – it generally means a stream of revenue lasting several years, and a closer relationship with the customer. And providing services alongside software has tipped the balance in Chase Cooper’s favour in a few recent competitions, Kiddy says: “We are seeing SME services more and more as part of the software sale. On the big wins this year, people are not buying from us just for the software.”

Overhauling and replacing operational risk software that is now out of date or fragile has been a big feature of 2011 for Chase Cooper. “In terms of supplying the core of the system, the demand is coming from people who purchased our system years ago and want to expand, or who have their own systems and want to change – for example, one that’s based on [Microsoft] Excel and now creaks rather badly,” says Kiddy. “I am constantly surprised how many people have been getting by for years with systems based on Excel.”
But though survey after survey has found regulatory change, including demands for better data reporting, to be at the top of the worry list for operational risk managers, Kiddy says this doesn’t seem to have affected the software market so far. “It’s something that’s talked about in the technical press, but it has not affected us at the moment. However, there’s always a lag between what the people who make the rules think and what people on the ground are doing, so maybe we’ll see that coming through over the next year or two. Our software can be configured at the front end, so they wouldn’t necessarily have to come to us to ask for additional reporting.”

This can mean demand for closer and more continuous operational oversight, Kiddy points out. “The idea of continuous control monitoring of, for example, trading systems and KRIs is definitely coming – it’s one of our plans for this year.”

In general, regulatory authorities are taking much less on trust when it comes to operational risk oversight.

But meeting the changing business demands has also meant designing software to cater for another trend in the operational risk management area – the drive to make operational risk awareness, measurement and management part of the day-to-day running of the business (www.risk.net/2131882).

Getting rid of the model in which operational risk is the responsibility of a small centralised cell, and moving instead to one that involves business heads and desk heads, has obvious advantages for software providers – it means a customer no longer buys a handful of software licences, but several thousand, and in many cases similar-sized training and education packages.

Kiddy comments that the financial industry has gone beyond the point of no return in decentralising operational risk. “The old view that the risk management function is the conscience of the company is dying – it’s a job that can’t be properly done by just a small group, it has to be out with the business lines. This has been a big trend in the past 12 months. A lot of sales are existing clients wanting extra licences. And it’s difficult to get risk out to the business lines with, for example, a system based on Excel, because it’s inherently centralised. There is no audit trail, no way to lock it down against changes. In business terms, it means extra training courses as well.”

But another less welcome feature of the market is the continuing disagreement between regulators over calculation methods for operational risk capital under the Basel II capital adequacy rules’ advanced measurement approach (AMA). As previously reported in OpRisk, regulators in the UK, Australia and a few other AMA jurisdictions have encouraged firms to calculate their regulatory capital based largely on the output from scenario analysis. Meanwhile, others, led by the US and Germany, favour the use of a loss-distribution approach based almost entirely on internal and external data. US regulators have said specifically that scenarios cannot be used to initially model op risk capital, only to modify the capital figure afterwards (www.risk.net/2155321).

Kiddy comes down firmly on the side of scenario analysis. “We are seeing more and more interest in that. One thing we really believe in is data mining of all the intellectual capital in the company. We really believe the industry has taken a wrong turn in that respect – only looking at hard data, and thinking you can obtain an accurate distribution, especially the right-hand side of the distribution, just by using loss data. We think that’s doomed to fail. The Bayesian approach, where you effectively model the distribution using people’s opinions as well, is the way forward, and we have tools for that. Unfortunately people have become mesmerised by the capital charge calculation as opposed to the business case for modelling – we are pushing the idea that the op risk toolkit has to include modelling using all the data you get, including RCSA data.”

Chase Cooper has seen growing demand for modelling tools based on RCSA data as well, with 50% of new sales now including a modelling tool that uses RCSA information as the basis of Monte Carlo simulation for sensitivity analysis.