

# Innovation – Highly Commended: Risk Limited

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The global crisis in financial markets highlighted only too clearly the danger of relying solely on ratings agencies for counterparty credit information. Seeing a demand in the market for a better, more transparent credit risk management tool, energy consultancy Risk Limited last year developed a ground-breaking web-based counterparty credit system.

The product, RiskRank, provides the client with a comprehensive assessment of the credit default risk probability for all counterparties in its portfolio, thereby providing an alternative to the sole reliance on credit rating agency ratings. The business model is fundamentally different to that of the rating agencies.

“I think we’ve avoided a fundamental flaw of the ratings agencies in that the RiskRank subscriber pays for the ratings of their counterparties, not their own rating,” says Shannon Burchett, CEO of Risk Ltd.

The RiskRank ratings are arrived at through a combination of traditional and transparent data and a proprietary algorithm developed by Risk Ltd. Burchett believes a new product was necessary because of the drawbacks of traditional credit assessment methods and the weakness of the current rating agency system, especially in turbulent market periods with high systemic risk.

“Traditional financial statement analysis always has a time lag,” he notes. “In stable markets this hasn’t mattered so much and it’s tended to still be a good indicator. However, in volatile markets – which is when you really need an accurate assessment – an analysis relying only on data from prior financial statements is not necessarily good enough.”

RiskRank provides traditional analysis tools such as financial statement analysis and credit default predictor scores such as Altman Z-scores and financial strength indicators such as Piotroski scores, but complements them with more sophisticated analysis. “As traditional credit scores are also based on financial statements, they lag as well, so it’s not now enough to provide just those,” Burchett says.

The product also tracks the credit default swap spread so that companies can look at the probability of default of a counterparty as implied by the dynamically traded credit instruments. “It’s not an entirely efficient market, but it is one of the risk indicators that should be monitored and it has the considerable benefit of being live market information,” explains Burchett. In addition to the ratings, the product website serves as a credit risk portal that also provides subscribers with filtered credit-related news, wider news if required, a tutorial on credit risk metrics, a credit watch service and a credit line allocation tool.

“RiskRank also conducts a trend analysis of counterparties and looks at outliers in a portfolio in order to identify for the subscriber whether there are companies in the portfolio that they should reduce their exposure to,” says Burchett.

The current market for the product is primarily mid- to small-sized energy players who don’t have extensive dedicated credit risk staff. There is already significant demand for the service, which in the future may extend to commercial trade credit, says Burchett.

If enough companies sign up for the product it has the potential to make markets a lot safer from a credit point of view, Burchett believes. Already the product is helping breed a culture of greater transparency in energy credit and increased access and disclosure of credit risk information. “Gradually this greater disclosure will become the norm as people get used to a higher level of credit scrutiny,” he predicts.

Developing RiskRank presented a lot of challenges, says Burchett. “This may at least partially explain the lack of alternatives developed for a function that is in high demand,” he notes. He ranks the greatest challenge as developing a better default probability algorithm and methodology.

Offering a web-enabled system also held challenges in terms of technical design and programming issues. However, being offered on a secure web-enabled basis, lowers the cost at which RiskRank can be offered, and provides a more efficient delivery of the information and related tools for a consolidated credit risk management approach, Burchett says.