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The Role of Risk Management in Disruption & Innovation

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We live in an age of disruptive innovation, as a number of new technologies make possible innovations that threaten traditional industry structures and economics. Incumbents turn to innovation as a means to stimulate growth or ensure survival, however innovation is also not without risks. The opportunity for risk managers in established organisations is to rethink some fundamental risk management techniques, adhering to the adage: 'disrupt yourself, before you are disrupted'.

The Age of Disruptive Innovation

Innovation and disruption are terms that are becoming overused, overhyped, and often misunderstood. By 'disruption', I refer to a situation where an established industry's economics are significantly undermined, typically by new players over a relatively short time. Classic examples include Kodak and digital photography, and music downloads which disrupted CDs/ record sales, but is now facing its own disruption from music streaming.

'Innovation' is a far broader term but I would settle on the simple definition of 'a new idea, implemented successfully'. Innovation can apply to any aspect of an organisation's value chain, and a useful framework is an extension of the "four P's" of Product, Price (or Pricing Models), Promotion and Place (Distribution) often found in classic marketing textbooks, to "six P's" by adding Process and Platforms.

Using this framework, it is useful to discuss innovation in terms of new products, new pricing, new distribution methods, new promotion, and also new processes to bring that product or service into existence (eg a new manufacturing technique such as 3D printing), and new platforms or marketplaces (eg Airbnb).

Innovations that have the potential to disrupt many industries include the internet of things, robotics, artificial intelligence, material science, 3D printing, blockchain, virtual reality, big data, and various biomedical breakthroughs involving genomics and nanotechnology. Drones and driverless cars, cryptocurrencies, and synthetic organs are only the nascent applications of the convergence of these disruptive technologies.

Interestingly, innovation itself has been subject to disruption, as methodologies such as design thinking, agile and lean startup have helped to systematise what was previously considered a mysterious process, gifted to a bold and creative few. We are living in an age of disruptive innovation.

Risks for Established Organisations

Disruption from new players obviously creates significant risks for incumbents, as industry profitability can fall abruptly. The prescription for an industry facing disruption is often 'innovation'. However, the success rate for true innovation is lacklustre, and so innovation is not without its own risks.

Many established organisations have what I'd call 'steady-state' risk management approaches in their risk management teams, in management committees, and around boardroom tables. This approach emphasises risk minimisation or avoidance, risk reporting over active risk management, and avoiding volatility and change. Many such core risk management approaches and activities remain necessary for compliance purposes or to run existing businesses. However, these approaches alone are no longer adequate for an age when a 'do-nothing' or status-quo option may end up being the riskiest of all.

Rethinking Risk Management Fundamentals

The discipline of risk management has evolved significantly over the last 20 years, with key standards and frameworks such as COSO and ISO 31000 (based on AS/NZS 4360). Significantly, the standards explicitly define risk in terms of 'opportunity' and not just 'hazard'. As such, we can apply the fundamentals of risk management to disruption and innovation, with some tweaks.

The most relevant risk management fundamentals that need to be applied to address disruption and innovation are:

Risk Appetite: An organisation's risk appetite is its view on where on the risk-return tradeoff curve it should operate – ie, how much risk it should take to achieve its objectives. The risk appetite statement will sometimes also include the type of risks that the organisation will or will not take. In disruptive times, organisations need to reassess their risk appetite so that it is more embracing of risk-taking and innovation.

Risk Assessment: In some organisations, risk managers are only involved in compliance-related and operational matters. As a result, extremes like over-caution or unbridled optimism can hamper the balanced evaluation of new ventures or innovations. Instead, risks need to be properly assessed during the proposal or business case stage of strategic initiatives and innovations. It is important to ensure that risk assessment is balanced and that the consequences of 'do-nothing' are explicitly considered.

Managing execution risk: Agile and lean startup style approaches, with their emphasis on experimentation, iteration, time/cost-boxed delivery, have substantially lowered innovation risk. Nonetheless, there needs to be a continuous risk assessment approach that includes the core process of identifying and assessing risks and implementing risk treatments. Furthermore, risk monitoring is more important than ever, to avoid being caught out by external changes that disrupt your innovation initiative before it is even completed.

Towards 'Innovation' Risk Management

In an age of disruption and innovation, we need 'innovation' risk managers who embody a mindset of managed risk-taking instead of risk avoidance, who facilitate balanced risk/reward evaluations instead of merely reporting risks. In doing so, they help build organisational 'antifragility', the quality that makes organisations benefit from changes, shocks and uncertainty. Eschewing volatility and change today is becoming the riskiest option of all. In helping organisations manage the risk of disruption and innovation, risk managers themselves must also self-disrupt before they are disrupted.

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