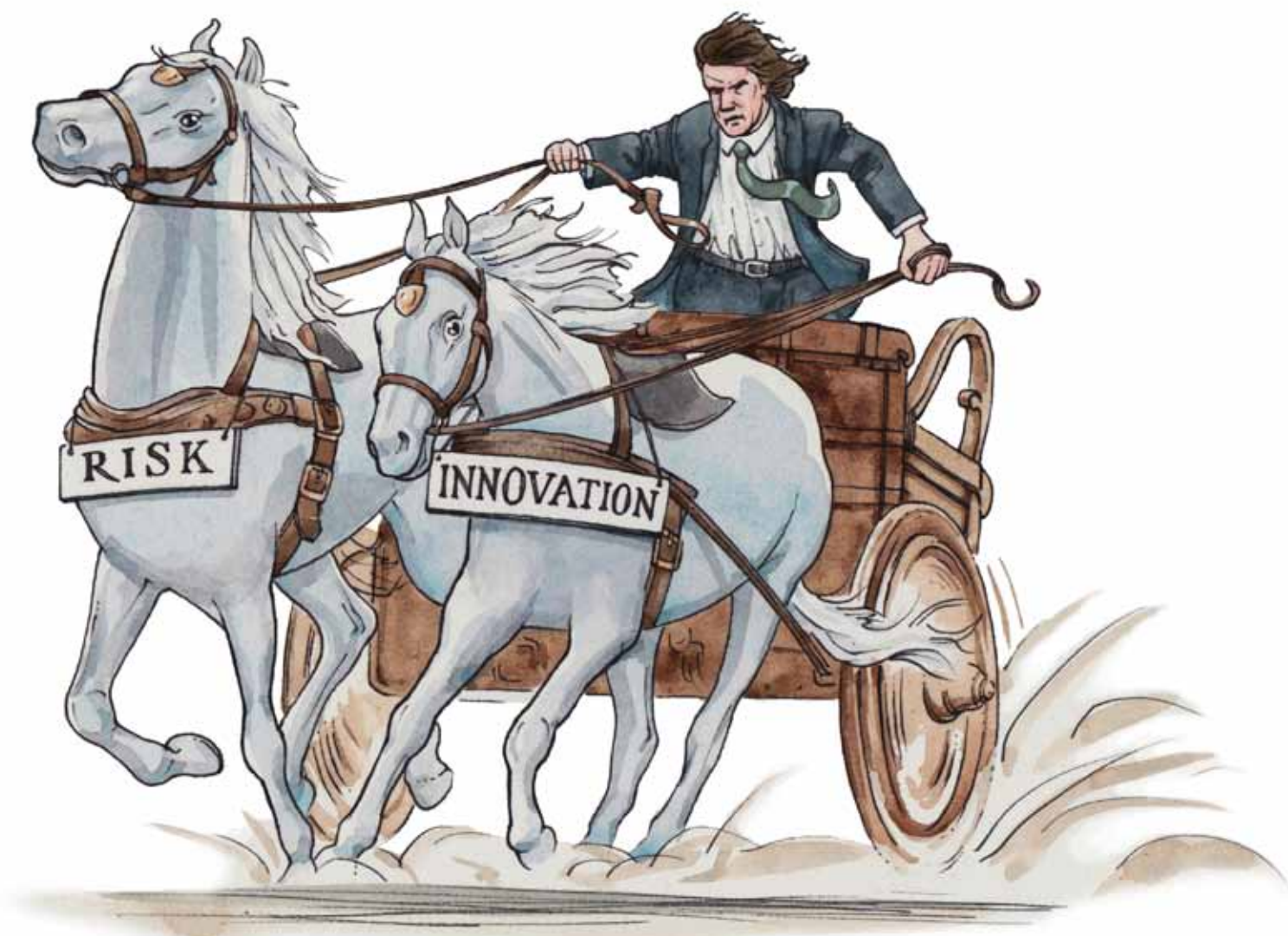


# RISK-INFORMED INNOVATION

## Harnessing risk management in the service of innovation

A report by The Economist Intelligence Unit



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## 1

## RISK IS OPPORTUNITY

Good risk management can identify new business opportunities and be a powerful aid to innovation. When working effectively together, risk management and innovation can help to create agile organisations that are capable of exploiting today's dynamic business environment.

When they are treated as different parts of the business, the results can be catastrophic. Look no further than the bursting of the dotcom bubble in 2000. While Internet entrepreneurs were busy floating companies that were still little more than a good idea, investors were lining up to buy shares without thinking hard about the long-term viability of those companies.

It is only with the benefit of hindsight that such an uncoupling of innovation from risk looks so obviously foolhardy.

### Risk in reform

Since the 2008-09 global financial crisis, governments, regulators and businesses have begun to realise that it is important to couple risk and reward more tightly. The EU's Action Plan on Company Law and Corporate Governance, for example, places strategic risk management at the centre of reforms aimed at all corporations trading in the region. The Plan wants businesses to consider risk in every facet of their organisation, including innovation. Indeed, many organisations in a wide range of industries, from banking and pensions to social media and telecommunications, are exploring ways to turn something that is often seen as a mere compliance exercise—ticking the boxes—into something that can be an engine for more sustainable innovation and growth.

To move on from the view that risk management is solely a compliance exercise, however, a better understanding of what businesses mean by risk is necessary, given that the term entails two apparently contradictory sides. The International Organisation for Standardisation (ISO), a member body that produces voluntary guidance for various industries, defines risk as the “effect of uncertainty on objectives”. Those effects can be either positive or negative, it says. Risk can enhance or destroy value in a company. Its standard on the issue says that the primary aim of risk management is to direct and control risk in an organisation.<sup>1</sup>

The problem is that, until recently, the risk management and internal audit professions whose responsibility it has been to perform those tasks have been more concerned with the control side of that definition than with direction. Standard-setters within industry, such as the hugely influential Committee of Sponsoring Organisations of the Treadway Commission (COSO), have associated events with a negative impact as risks and those with a positive impact as opportunities, thereby obscuring the dual nature of risk itself.

Paul Sobel, chairman of the board at the Institute of Internal Auditors (IIA), an international professional association, says that this distinction has helped to downplay the value-creating potential of both the activity of risk management and the role of professionals working in these areas.

“I don't subscribe to the COSO view,” he says. “Both risk management and internal audit can help enable future value creation—that's the

<sup>1</sup> ISO 31000:2009

upside of risk. You use the same framework and some of the same principles to figure out where your organisation can exploit and take on more risk as you do when you want to reduce the effects of risk in other areas.”

That cuts across all area of business—from protecting against cyber-risk to helping to develop new products and initiatives. For Mr Sobel, business managers and directors are there to make the final decision on whether a product goes ahead, but the assurance support functions should provide direction through up-to-date information and business analyses that can help to make those initiatives successful. By focusing on both sides of the definition of risk management—direction and control—risk managers can help business to innovate.

### Harnessing risk to innovation

Risk, for Mr Sobel, revolves around three fundamental questions:

- 1 What does the organisation want to accomplish?
- 2 What would prevent it from accomplishing those objectives?
- 3 What can it do about the barriers to achieving those goals?

He says that business managers and marketing directors working on new products are initially focused on the first question, which is objective-driven and strategically oriented. But, caught up in the excitement of new ideas, they can be less interested in thinking through what the barriers are, never mind the potential solutions to those problems.

“That’s where risk managers and internal auditors are better because we are used to doing that,” he says. “Finding creative, innovative ways of facilitating that discussion will help managers understand their barriers to success. And we are not just talking about downsides. It could be equally about failing to exploit an upside, such as a foreign market, a better supply chain and so on.”

Co-operation between marketing directors and assurance providers is important when

organisations are considering big changes of strategic direction—for example, US-based Apple entering into the telecoms hardware market with its iPhone product. With such initiatives, businesses have to be confident that they have the information to make informed decisions and the capabilities to be successful. Such products entail major changes to supply chains, warranty considerations, order and collection processes, and customer service. If this range of potential barriers to success is too much for the innovation team to deal with, the assurance team may also be lacking in expertise in these areas. Where this is the case, Mr Sobel says that the assurance team should identify the skills gap as a risk and engage external help.

### Changing habits

Unfortunately, old habits die hard. Current thinking in the telecoms industry, for example, often veers towards promoting the narrow view that risk is primarily a form of threat. For example, the strap-line of the industry risk forum, the Telecommunications Risk Management Association, is “reducing fraud and uncollectibles in the telecom industry”.

The emphasis of industry leaders is on managing the downsides of risk, rather than exploiting the upsides. The reason for this neglect in the sector seems cultural rather than ideological. Risk managers in the industry often work in individual parts of the business and are not integrated across the whole organisation. This was one of the faults levelled at the financial services industry after the 2008-09 crisis—the risk was siloed, to use the industry jargon.

There is also a problem with the pace of change. “In the telecoms sector, innovation is happening all the time and the problem can be that innovation takes place without any reference to risk management because it’s moving very quickly,” says Phil Tarling, vice president of the Internal Audit Centre of Excellence at the Chinese telecommunications multinational Huawei.

To help deal with the issues of culture and the pace of innovation, Mr Tarling is developing

Huawei’s enterprise risk management programme—a tool meant to both minimise, track and exploit risk. By taking a holistic approach to the issue, the tool helps the innovation and assurance teams understand each other’s needs and work closely together.

He says that the more his department can demonstrate the positive value the department brings to new products and innovations, the more the business will be prepared to listen and engage with his function. “That’s one of the things that we are working to develop,” he says, “because you only really get involved with the business if the business sees you as being able to add value.”

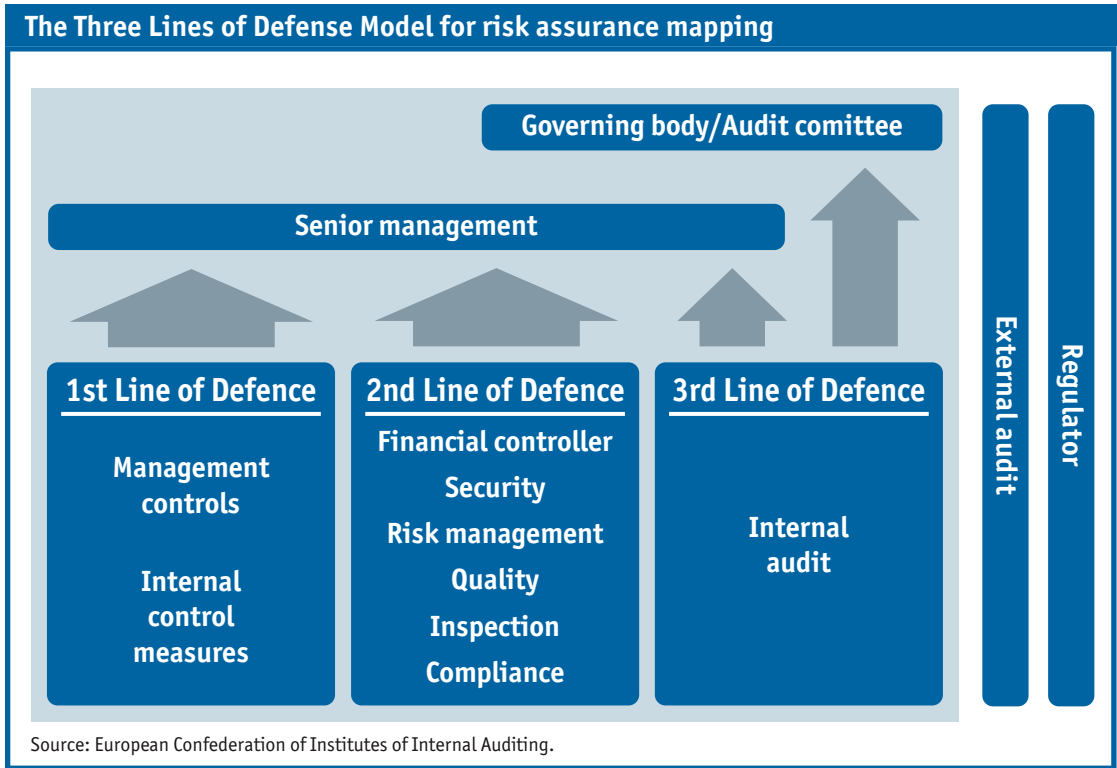
He wants the innovators to speak to his team about their ideas so that they can better understand where the risks are, what the controls need to be and to be open to issues that they may not have considered. If the initiative has been through that process, Mr Tarling says, the commercial success of new products is more likely—although not guaranteed.

But to understand risk across the business requires innovators and risk managers to speak in

a language that both understand. One candidate framework that has emerged from the assurance profession is called the three lines of defence model (see below). It is the one that Huawei is introducing and ascribes managers, risk professionals and internal audit professionals specific roles within the organisation. The model is widely advocated by the IIA, the European Confederation of Institutes of Internal Auditing and by the Federation of European Risk Managers’ Associations, among others.

Once the model is in place, internal audit can more easily assess how effective the process of innovation is itself and whether creativity can be improved across all parts of the business.

“We can’t know more about the technical aspects of a product than management,” Mr Tarling says. “That’s not our role. What we can do though is help managers develop processes that make it easier for technical innovation to happen and that are based upon common sense, good ground rules and up-to-date information.”



## 2

## INNOVATING RISK

Although it is crucial for innovators and risk managers to speak the same language, it is only the first essential step on the journey to creating a more dynamic and innovative business. Real competitive advantage comes from innovating the risk management process itself to make it responsive to future changes in the business environment and strengthen the organisation's ability to adapt and take advantage of emerging risks.

"Frameworks and benchmarks tend to simplify reality, but that is a danger," Gerrit Sarens, associate professor in auditing and governance at the Université Catholique de Louvain in Belgium, says. "After the financial crisis, boards realised that the compliance paradigm had made them blind to the future. They are now beginning to realise that if they are to survive in the longer run and create sustainable added value, they have to be much more oriented to the future."

In other words, risk management models have a shelf-life and can become outdated, as many of them did before the financial crisis. For Mr Sarens, creating a business that can look ahead and is able to take advantage of emerging risks means innovation, not just in products and services, but also in the very structure of the business and its operations. The risk management processes need to be able to adapt if they are going to provide grounds for successful innovation. It is a huge job.

The pensions and asset management industry is leading the way in this area. Although stricter regulation has increased the pressure to innovate risk management, the risk-based

view on innovation is now seen as a competitive advantage.

A recent survey by a global consultancy, EY—*Risk management for asset management, 2013*<sup>2</sup>—said: "Given that successful innovators stood to gain first-mover advantage, higher fees and greater customer loyalty, innovation coupled with effective risk mitigation was seen as a vital source of differentiation." Throughout the report innovation and risk management are mentioned as constant bedfellows—the cutting edge of both sound corporate governance and commercial competitiveness.

A good example of the above is the California Public Employees' Retirement System (CalPERS). The organisation administers pensions for 3,000 public school, local agency and state employers, with 1.6m members in its retirement system and more than 1.3m in its health plans.

"The general economic problems of several years ago helped drive the idea that we needed to be more risk-sensing and do more horizon-scanning so that we could anticipate things better," Margaret Junker, chief of audit services at CalPERS, says. "There is a real need for organisations such as ours to look at risk across the enterprise—not just each area looking at their own risk in isolation—and come at it from a holistic perspective."

CalPERS has established an audit and risk committee and an enterprise risk management committee, both of which meet on a regular basis. Ms Junker says that this has increased awareness of risk throughout the organisation.

<sup>2</sup> EY, *Risk management for asset management, 2013*



This enhanced risk-awareness has also helped to underline the view that risk at CalPERS should always be seen as a two-sided coin with a potential upside and downside—not simply a threat that has to be controlled, but an opportunity that can be exploited, too. This outlook has worked itself into the way that new projects are discussed by the board. “Everyone who brings something to our board needs to articulate what the risks are and what the benefits are and put that forward as part of their recommendations,” she says. That prevents enthusiastic management selling only the upsides of their projects because both sides of the risk coin have to be presented at the same time.

Kathleen Webb, chief risk and compliance officer at CalPERS (at the time of writing), says that the organisation has developed an integrated assurance approach, which in practice means that the reports from the internal auditors, risk managers and the compliance team are all brought to the board for discussion. This gives the organisation a forward-looking and comprehensive view of its entire risk universe on a regular basis and provides it with the ability to act or react quickly.

“We are continuously looking out onto the horizon, seeing what changes are happening in the environment, being sensitive to those changes, and then developing a plan to be responsive to those things,” Ms Webb says. This future-oriented approach has been good for innovation because CalPERS has been able to take some of the issues it has identified as potential problems and create solutions around them.

For example, confronted with spiralling health costs, it designed a programme that required its members to pay out of pocket all costs above a

“reference price” of US\$30,000 for orthopaedic surgery (joint replacements). A study by University of California researchers in 2014 found that the cost to members of such operations dropped by one-third as a direct result of the initiative.

“We don’t just think of our challenges, but we ask what challenges our members and employers are facing,” Ms Webb says. “Sometimes that can lead to process changes, sometimes to new products. You have to weigh the options, do the risk and return on value assessments. That has to be on the table as part of good risk management discussion.”

CalPERS was also one of the first major institutional investors to embrace shareholder activism. It scrutinises the companies in which it holds shares and if their corporate governance and risk management practices are not following best practice, CalPERS will engage with the board, even voting against it at annual general meetings if necessary. This has improved CalPERS’ portfolio returns, according to Wilshire Associates, the pension fund’s primary consultant. Wilshire Associates claims that while the companies CalPERS engaged with were underperforming their index peers by about 36%, after five years the same companies returned about 11% above the industry average. Whether all of this gain can be attributed to CalPERS’ pressure is not clear, but the organisation has had a strong influence on helping the businesses in which it invests in innovating their corporate governance.

“Ultimately, the role of risk management is to identify, assess and prioritise risks to protect the organisation,” Ms Webb says. “That is where you want to be as a programme—an advisor to boards and the executive team on those strategic aims and aspirations.”



## Conclusion

Hitched together, risk management and innovation are powerful teammates. They can make businesses more agile and responsive so that they can better cope with the downsides of risk but also exploit its upsides. However, when the risk function is reduced to a compliance-only role, its strategic benefits are lost.

Ensuring effective collaboration between risk and innovation is easier said than done. There are cultural barriers to overcome and old habits to break. Too many people still see risk in purely negative terms, a view that prevents them from understanding how the organisation's assurance functions can help to energise the business. Furthermore, too many risk managers and internal auditors are blinded by the compliance model of risk—a legacy of the corporate scandals from the turn of the century and of the more recent financial turmoil.

Stronger risk management frameworks that take a holistic approach to risk can help to bring down some of these barriers, as employees responsible for risk and those responsible for innovation are brought closer together and see the value that collaboration brings to the business.

But companies also need to make sure these frameworks are adaptable enough to foresee and guide the business through future challenges. To do this, innovative thinking needs to be applied to risk management processes, too. Doing so can give the firm competitive advantage in new products and services, as managers can predict future needs and issues, and so respond in a timely and effective manner.

There are innovators on this journey already. People such as Phil Tarling at Huawei, who is working hard to improve the risk culture at the business by proving the value his function can bring to the firm. And Margaret Junker and Kathleen Webb, who are constantly developing and adapting their more mature risk procedures to meet new and unexpected challenges ahead.

They are proving in their different ways that investment in risk management can also be an investment in innovation.





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LONDON

20 Cabot Square

London

E14 4QW

United Kingdom

Tel: (44.20) 7576 8000

Fax: (44.20) 7576 8500

E-mail: london@eiu.com

NEW YORK

750 Third Avenue

5th Floor

New York, NY 10017

United States

Tel: (1.212) 554 0600

Fax: (1.212) 586 1181/2

E-mail: newyork@eiu.com

HONG KONG

6001, Central Plaza

18 Harbour Road

Wanchai

Hong Kong

Tel: (852) 2585 3888

Fax: (852) 2802 7638

E-mail: hongkong@eiu.com

GENEVA

Rue de l'Athénée 32

1206 Geneva

Switzerland

Tel: (41) 22 566 2470

Fax: (41) 22 346 93 47

E-mail: geneva@eiu.com