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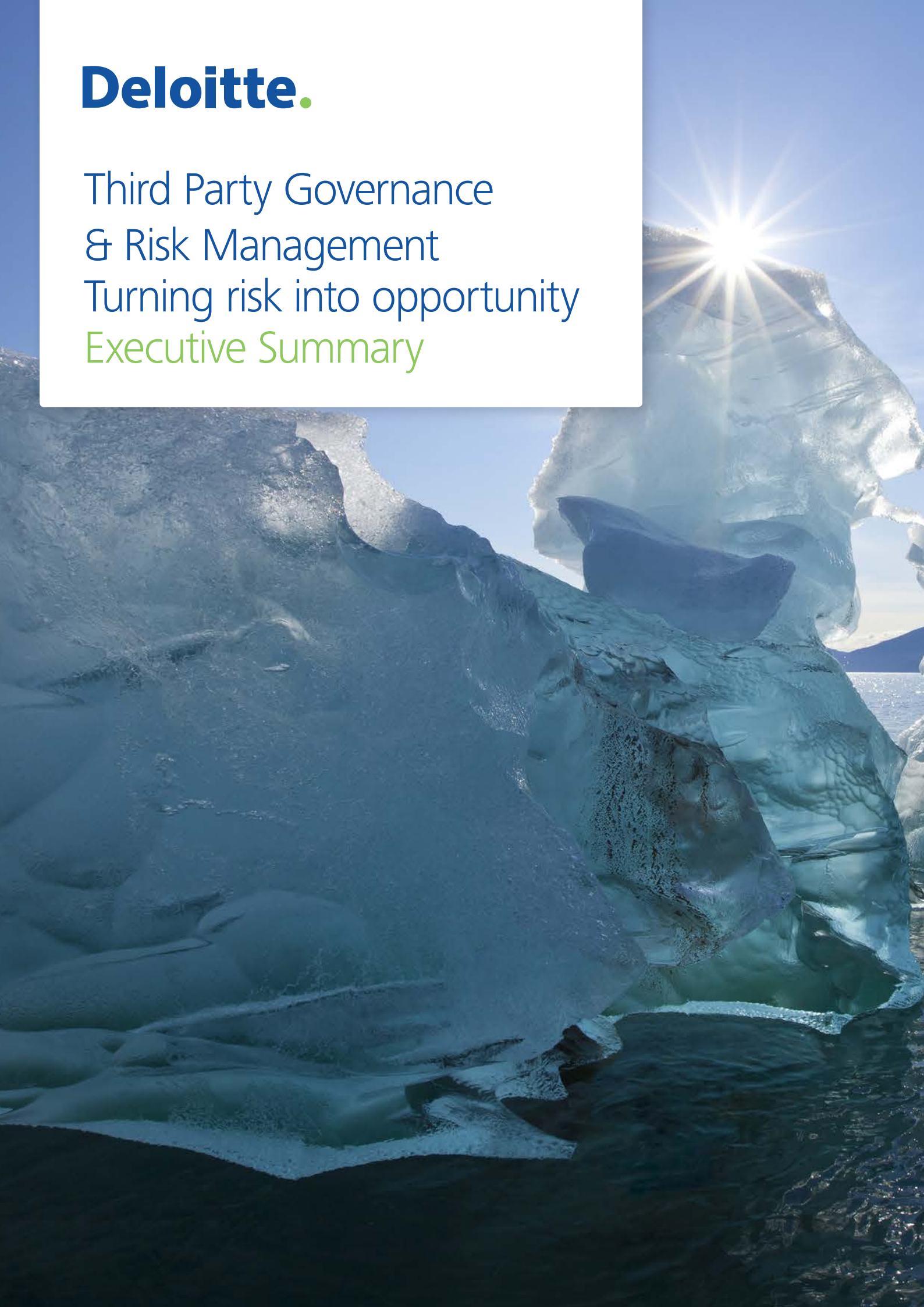
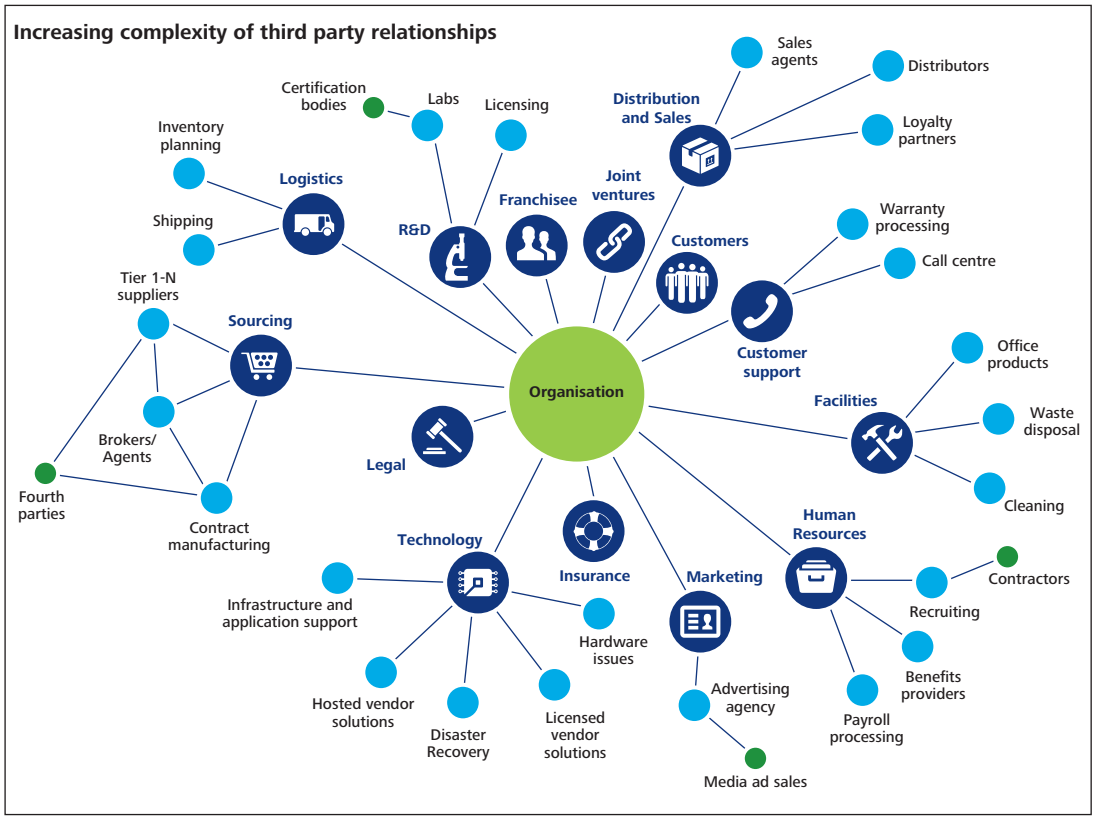
Third Party Governance & Risk Management
Turning risk into opportunity
Executive Summary



The rise of the extended enterprise

Global third party ecosystems of organisations, also known as the extended enterprise (including suppliers, support service providers, sales agents/distributors and affiliated organisations, whether an alliance, joint venture or a subsidiary) are in recent years becoming stronger sources of strategic advantage. They enable cost reduction, access to scarce skills and knowledge, business agility and other innovative forms of enhanced business value. The scale on which this is now taking place is generally much larger than in the past. However, businesses are also facing new risks, such as the threat of high profile business failure, accountability for illegal third party action or regulatory enforcement action with punitive fines, leading to reputational damage and erosion of shareholder wealth.



The Financial Services sector has dominated industry-specific regulation around the world impacting the use of third parties, which is expected to get more severe, however similar regulation is being introduced in other industry sectors such as life sciences and healthcare, chemicals, food and retail etc.

Deloitte estimates that the failure by large multinational businesses to appropriately identify and manage third parties can lead to fines and direct compensation costs or other revenue losses in the range of US$ 2 – 50 million, while action under global legislation such as the US Foreign Corrupt Practices Act can be far higher, touching US$ 0.5 – 1 billion. This resonates with academic research which has established that punishment by regulators causes losses to shareholders that are, on average, 10 times the size of the fine itself and negatively impacts share prices, on an average by around 2.55% in the three days after the announcement, where direct harm to customers and investors is involved. This of course is in addition to the significant reputational damage that an organisation will incur.

Third Party Governance & Risk Management (TPGRM)

TPGRM is in its infancy. Focus on third party risk has traditionally been reactive and determined by who is driving the activity. Such a decentralised approach to risk has led to micro-focus on risk areas that interest certain parts of a business or certain functions (for example, operational performance from a supply chain perspective or information security from a corporate security angle).

Organisations are only now starting to depart from this myopia and take a Board and leadership-led holistic and proactive approach to risk as a source of organisational value, covering all categories of third parties and all areas of risk, considering *operational risk* factors (e.g. performance, quality standards, delivery times, KPI/SLA measurement) with *reputational/financial risk* factors (e.g. labour practices, an understanding of financial health, appropriate charging mechanisms and adherence to these) and *legal/regulatory risks* (e.g. compliance with bribery regulations, awareness of global industry standards as they apply to third parties, Environment and Health & Safety compliance).

The Opportunity in the Risk

It is easy to focus exclusively on the risk and forget the potential opportunity. Deloitte experience indicates that effectively governed third party relationships can be a significant source of organisational value arising, for example, from product or service innovation, expansion to new markets and access to skills and capabilities not available internally. Some organisations are now also able to effectively benefit from third parties as their knowledge partners or even as trusted advisors who are able to catalyse organisational innovation, provide strategic insights and feature on organisational Advisory Boards.

Deloitte believes those organisations that have a good handle on their third party business partners, can not only avoid the punitive costs and reputational damage, but stand to gain competitive advantage over their peers out performing them by an additional 4-5% ROE, which, in the case of Fortune 500 or FT500 companies can mean additional EBITA in the range of US$ 25-500 million. Academic researchers concur with this view. When stakeholders can appreciate improvements in governance, controls and risk management that upgrade their long term expectations, equity values will rise.

Undergoing a Value-Focused Transformation around TPGRM

A step-by-step guide for global organisations desiring to undergo a value-focused transformation to adopt best-in-class practices in leveraging the extended enterprise as a source of opportunity is summarised below:

Changing the position of risk and governance	Understanding risk appetite and the Three Lines of Defence	Establishing a TPGRM framework
Recognising the strategic nature of risk as an organisational value driver. Repositioning governance as Board and leadership-level strategic activity.	Establishing a consistent understanding of risk appetite. Reinvigorating the Three Lines of Defence.	Establishing a TPGRM framework that considers business objectives to guide boards and senior management thinking for a structured approach to third party risk management

Step 1: Changing the position of risk and governance:
Risk management has long been associated with mitigating adverse financial consequences of "bad things happening", which has historically positioned governance-related activities to avoid or mitigate risk. The first step in undergoing this transformation is to recognise that good governance and risk management around third parties is not about eliminating risk, but rather managing it appropriately. Such governance and risk management mechanisms should not stifle the business; it should raise organisational awareness and competencies, remain simple and proportional to the overall risk to the organisation, whilst providing the right management information to the key stakeholders.

Whilst risk mitigation will continue to remain a focus area, organisations should also see risks as a source of opportunity. Governance, a higher level process involving directing and managing risk management and related activities to address stakeholder expectations, therefore needs to reinvent itself to focus on maximising the opportunity, while also managing compliance requirements and the downside of risk. In this new thinking, the explicit linkage of risk and strategy, starting at the Board and C-suite level is considered an integral part of the organisational strategy-setting process.

Step 2a: Understanding Risk Appetite
Risk appetite is one of the essential concepts that must be understood and consistently applied to be able to reap the strategic benefits out of this emerging perspective on governance and risk management. Simply stated, risk appetite is the type and extent of risk that an organisation is willing to accept in its pursuit of value. Establishing risk appetite is thus about establishing the strategic boundary between the extent of risk that a business is willing and able to take as an integral part of its business model/profitability (risk seeking) on the one hand and the level at which it wants to expose itself to "bad things happening" on the other (risk aversion).

Let us take the example of a consumer products company that aspires to grow and increase market share by expanding to the new MINT countries through strategic alliances, leveraging newer sources of global supply for raw materials.

- Such as company may clearly articulate that it has absolutely *no risk appetite* for any reputational damage or erosion to shareholder wealth as a result of this aspiration.
- However it may have a *high risk appetite* with regard to new markets and franchisee networks and willing to accept higher losses in the pursuit of higher returns. The Board may define an expectation of say an 18% return on investment in each of these growth initiatives over a 1-3 year horizon, but not willing to take more than a 25% chance that the investment leads to a loss of more than 50% of the capital investment in any new initiative.
- With regard to its new sources of supply of raw materials, the Board may recognise the need for aggressive pricing to maintain its competitiveness, and in keeping with market expectations on similarly priced products, may also set a *higher risk appetite* relating to product defects in accepting the cost savings from lower-quality raw materials. For instance, it may set a target for production defects of say, one flaw per 1,000 units and articulate that production staff may accept defect rates up to 50% above this target (i.e., 1.5 flaws per 1,000 units) if the cost savings from using lower-cost materials is at least 10%.

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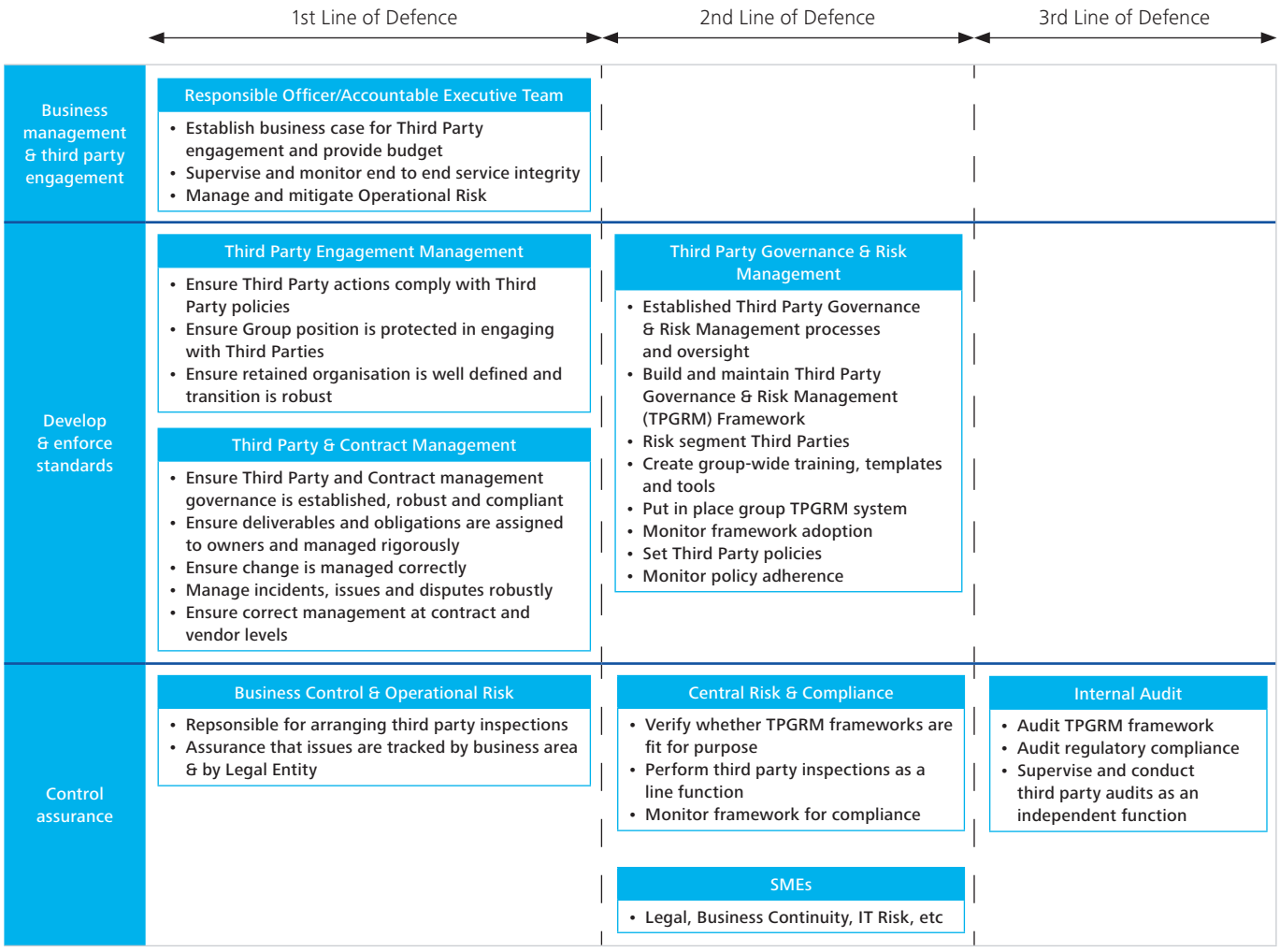
Step 2b: Leveraging the Three Lines of Defence

To be able to position governance and risk management as an overarching strategic issue aligned to business strategy and operations drilling down to individual business units, it is important to establish how stakeholders at various levels will have a role to play across three groups:

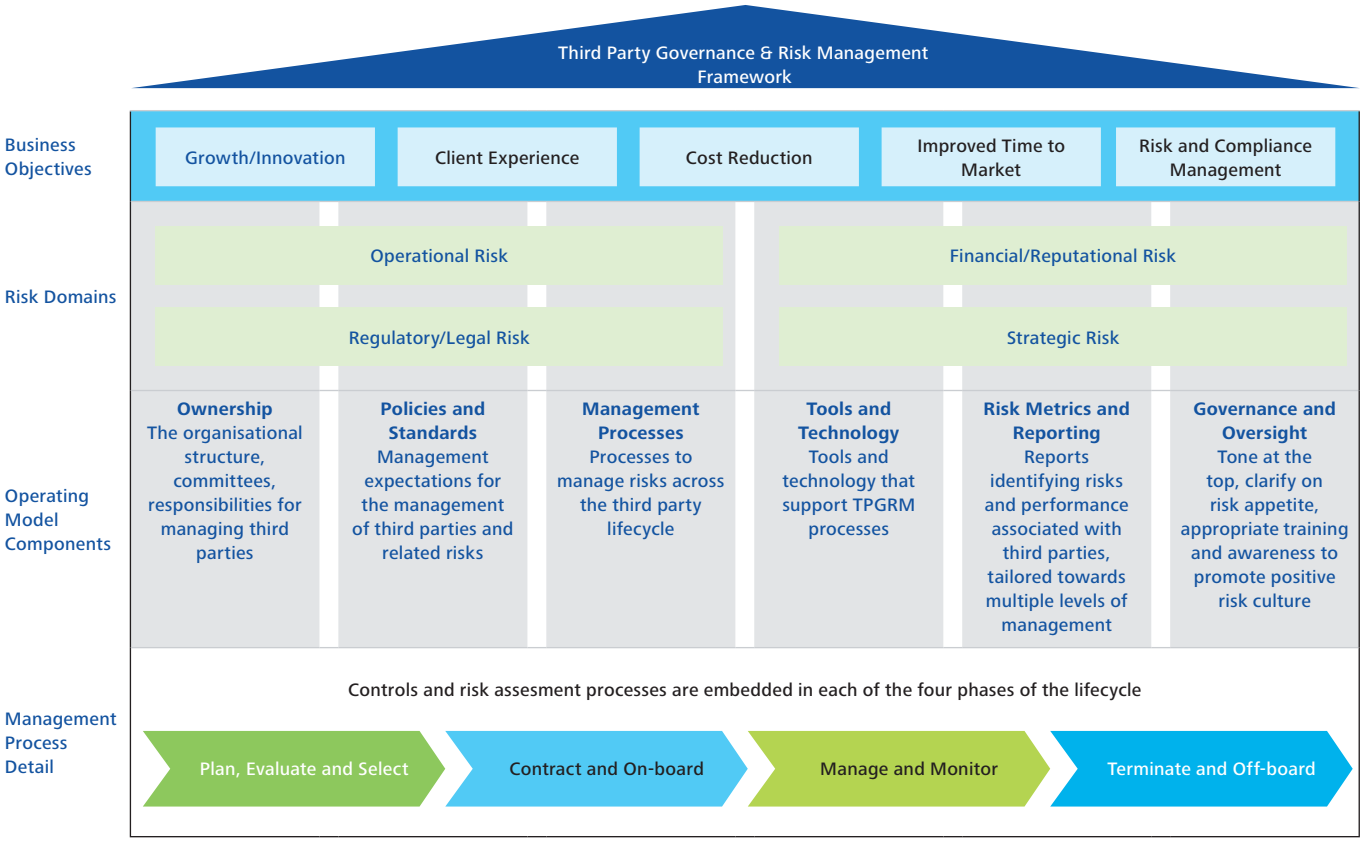
- First Line of Defence: represents functions that own, manage and take corrective action for risks in their respective functional areas, reporting up to executive leadership.
- Second Line of Defence: represents functions that oversee and guide common risk management processes as a common organisational function, such as risk management or compliance, reporting to executive leadership.
- Third Line of Defence provides independent assurance on risk management, typically represented by Internal Audit functions and teams, reporting typically to an independent Audit Committee.

Set out below is an example of how the Three Lines of Defence could operate in case of third party risk management – this principle should be applied to each category of third party in the organisation to ensure good governance.



Step 3: Establishing a TPGRM Framework

To assist Boards and senior management in the area of TPGRM, Deloitte has developed a framework, set out below. The framework is intended to guide management thinking for designing a structured approach, considering business objectives for using third parties, clearly identifying the associated risks, the required operating model components for end-to-end management and detailed management processes for enabling a sustainable, effective programme supported by business heads, procurement, legal, risk management, information technology, compliance and other functions.



A Maturity Model to Assess Your Extended Enterprise

We provide a maturity model to assess your extended enterprise, covering the key elements that, in our experience, are key to implementing a best-in-class TPGRM system.

These key elements are summarise d below and include strategy and governance-related matters, which underpin the establishment of a mature TPGRM system, supported by appropriate technology, process and people.

Strategy and Governance:

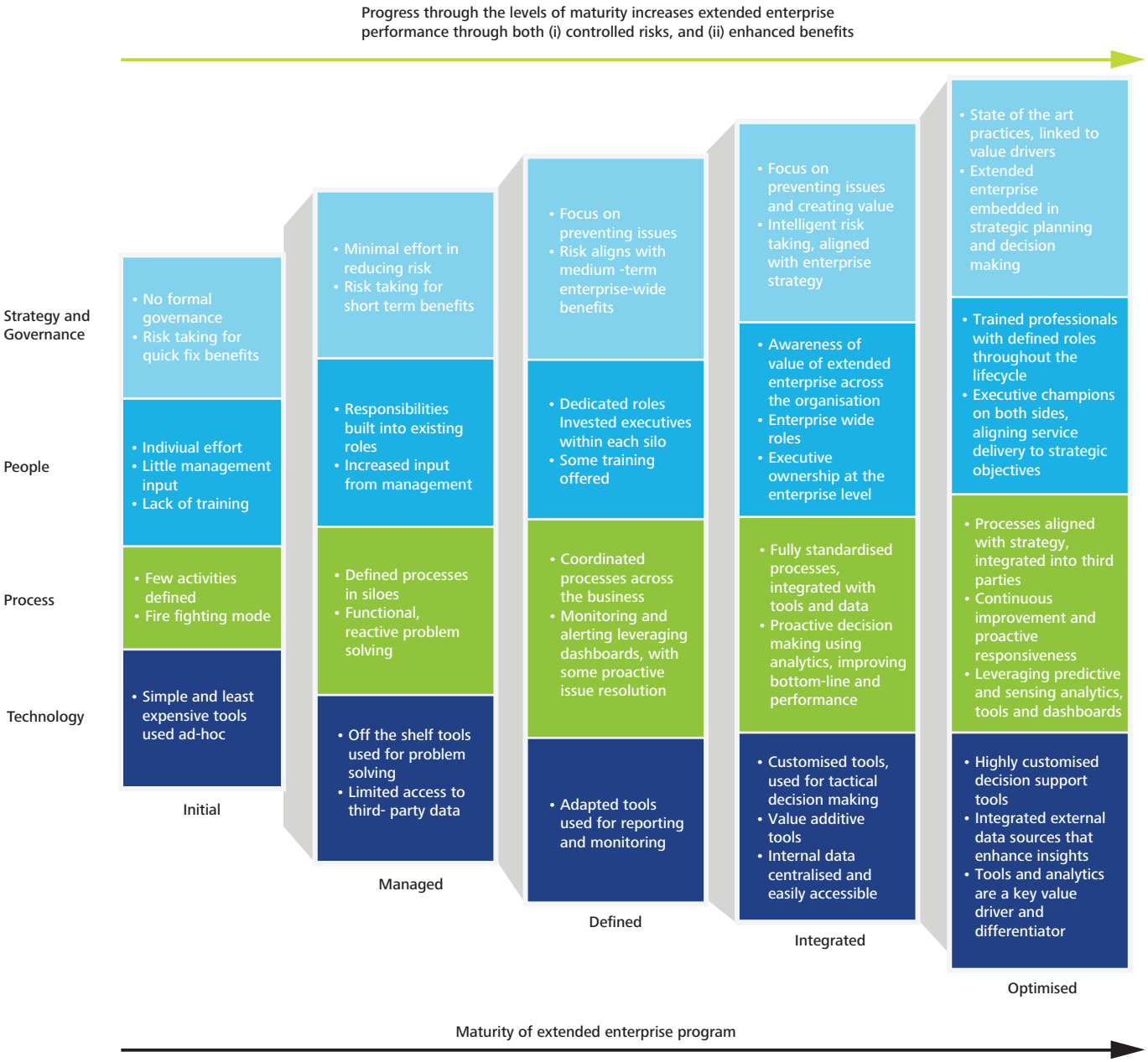
- Governance Structures to manage third party risk at an enterprise wide level.
- Ownership (Clarity of Roles and Responsibilities) of activities related to TPGRM.
- Stakeholder Engagement (Awareness and Commitment) related to TPGRM processes, including 'back-end monitoring' to determine internal compliance with TPGRM policies.
- Capability of individuals and decision-making authority at both a transactional and framework level.

People and Skills needed to resource TPGRM governance strucures.

Processes in place for TPGRM, evaluated in terms of robustness, clarity, practicality and alignment to risk appetite.

Technology to facilitate the performance of the framework seamlessly from inception to exit of a third party relationship.

In our experience, organisations enhance their performance byexploiting the opportunities arising from the extended enterprise as well as managing risks better as they mature over the five stages of evolution mentioned below:



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For further information, please refer to the complete white paper, available on **www.deloitte.com**

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