Third Party Risk: Too Close for Comfort

The relationships that keep your business thriving can also make it vulnerable to a variety of threats and disruptions. Does your risk management go far enough?
Several years ago, social scientists Dr. Nicholas Christakis and Dr. James Fowler coined a phenomenon they call “three degrees of influence” — the idea that everything we do affects others in our network down the line. In a similar fashion, your business is subject to several degrees of influence with every relationship you forge. Suppliers, partners, franchisees, merchants — just about every business that touches your business, even indirectly, impacts your company in tangible and intangible ways.

There’s no doubt you have protocols for vetting and onboarding business relationships. But these procedures may not go far enough to account for the broad range of potential risks you may be exposed to.

**Risk management is often a “one-and-done” exercise with no formal provision to “spot check” risk over the life of these relationships.**

Not only that, risk management tends to focus heavily on supply chain disruptions as a consequence of quality issues, logistics problems and major events like natural disasters and geopolitical issues. However, there are many other types of risk to consider.

Financial risks, compliance risks and reputational risks can stifle your ability to meet your obligations to your end customer. Yet too often these risk factors aren’t given enough scrutiny due to resource constraints or lack of information.

Let’s take a closer look at each of these three types of risks and the potential influence on your enterprise.

**Third party risk management is complex:**

- Diversity of third parties (suppliers, partners, merchants, franchisees, and more)
- Number of third-party relationships, often geographically dispersed
- Volume of data and the velocity of change to keep up with and manage
- Patchwork of regulations specific to each department/industry sector/location touched
An auto manufacturer had a solid 15-year relationship with a supplier that provided a special component for wheels. Unexpectedly, the supplier filed bankruptcy, forcing the automotive company to halt production and suffered millions in lost revenue until a replacement supplier could be onboarded. The automaker lost dealer orders as a result, and also racked up unforeseen costs in sourcing new suppliers, penalties from missed contracts and expedited shipping fees.

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1 Administrative Office of the U.S. Courts
Clearly, a third party’s financial position is every bit your business. The challenge is getting accurate and timely information. Financial risk can be especially hard to assess when it comes to small businesses. And with small businesses comprising 99% of the U.S. and E.U. economies and over 90% of economies across most of the world, chances are most of your third-party partners fall into this category. Due diligence is hampered by a number of factors:

Only about 40% of small businesses in the U.S. have a traditional credit profile. Of those, many only have a single, low-limit credit card on file.

The link between the business and its owners/authorized representatives is much more direct in small businesses. Personal financial issues are more likely to have an impact.

While none of these factors may be cause to walk away, they illustrate the scope of potential risk you could be missing.

And keep in mind that the dearth of financial information may not provide an adequate picture of the businesses’ capacity to quickly pivot to fulfill unusually large order spikes or the fast turnarounds you might need. Access to capital is a huge question mark that needs to be answered.

How financially sound are your partner organizations?

- Any derogatory financial history?
- Delinquencies or other signs of impending trouble ahead?
- Signs of potential problems among the principals of the business?

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*Data compiled from the U.S. Small Business Administration; European Commission Directorate-General (DG) for Internal Market, Industry, Entrepreneurship and SMEs; Development Bank of Latin America; Asian Development Bank 2014 SME Finance Monitor*
In 2015, there were more than 50,000 updates to regulations and compliance mandates across the globe. They cover a wide range of concerns — financial reporting, anti-bribery and corruption, human rights, use of conflict minerals...a diverse scope that requires significant resources to monitor, manage and address. In fact, supply chain executives expect new laws and regulations to be the second most significant risk in the next five years.

Saying, “I didn’t know” doesn’t cut it. U.S. regulators are calling for a culture of compliance across industries — and putting the responsibility on companies to identify and control compliance risks of the third parties they engage. You’re expected to proactively identify potential risks and verify the compliance of not just your business partners but also your partners’ third parties.

Your responsibility extends to continuous monitoring for changes that might create new risks or compliance gaps and managing the investigation and remediation of incidents.

With so many types of third parties contributing to your business, each managed by a distinct department with its own set of KPIs and metrics, it’s too easy to overlook the compliance details that can cost your business dearly — both in fines and reputation.

The scope of compliance is ever-changing. Some of the evolving regulations and regulatory bodies in recent years include:

- SEC’s Bad Actor Provision
- UK Bribery Act and the US Foreign Corrupt Practices Act (FCPA)
- US Treasury’s Office of the Comptroller of the Currency (OCC)
- Dodd-Frank: Conflict Minerals
- California Transparency in Supply Chains Act
- UK Modern Slavery Act
- Consumer Financial Protection Bureau (CFPB)
In a classic example in which McDonald’s entered France in the 1970s, it was the job of licensee Raymond Dayan to introduce Parisians to American-style hamburgers and fries. But the relationship went south, and ultimately McDonald’s accused Dayan of running such poor quality restaurants that he was ruining the chain’s reputation. The company wound up in a multiyear legal battle with Dayan, costing millions.

The fiasco was well publicized at the time and serves as a case study of what can happen when a company doesn’t have good oversight of a business partner it trusts with the brand.

Customers don’t differentiate between you and the licensees, partners, suppliers and every other third party that supports your business. You probably couldn’t name the suppliers who serve some of the world’s most recognized brands. But you could probably rattle off a few of these brands that have come under fire for contracting with suppliers that have a record of safety, quality or human rights violations.

Reputation matters—and not just in a PR sense.

Maintaining continuous visibility into how your third parties are behaving (screening for violations, negative news, etc.) enables you to detect problems and quickly intervene to:

• Mitigate disruption to your business and customers
• Reduce reputational impact on your brand
• And in some cases, protect human lives

Here’s another way to look at it: Businesses that prove they have robust supply chain visibility enjoy about a 50% savings in contingent business interruption insurance rates. There’s a reason they get a better deal on the insurance: lower risk.

Supply chain disruptions reduce shareholder value by 7% on average.10

ON AVERAGE, REPUTATION ACCOUNTS FOR 25% OF A COMPANY’S MARKET VALUE.8 AND A ONE-POINT DECREASE IN REPUTATION SCORE LEADS TO AN AVERAGE HIT OF -$5B IN MARKET VALUE.9

8World Economics survey, “The Impact of Reputation on Market Value,” Simon Cole, September 2012, as reported in Deloitte’s 2014 Global Survey on Reputation Risk
9CIRANO Burgundy Report, Corporate Reputation: Is your most strategic asset at risk?, 2012
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WIDEN THE SCOPE OF SUPPLY CHAIN VISIBILITY

It's evident that a 360° view of your third parties is critical to properly managing against risk. So, how do you accomplish this, given all that's already on your plate? A best practice approach looks like this:

- **Analyze your organization** and look at all the third-party dealings you have, and then determine the extent to which you should evaluate and monitor them. For instance, a formal Supplier Risk Management initiative in addition to other business due diligence processes may be appropriate for your specific organization.

- **Analyze your industry.** There is unfortunately no “gold standard” or framework for everyone to follow. Your best course of action is to take a look at your industry to determine which areas are most critical: financial, political, economic, social, technological, legal, environmental.

- **Segment your third parties.** Given the scale of third parties, the multitude of risk factors and the proliferation of data, it is not practical to implement a “one size fits all” approach to all your relationships. It is more important to segment your third parties by risk, set appropriate risk metrics for each segment, and assess organizations accordingly. Risk segmentation can be based on each party's role and importance to your organization, their industry, location — whatever aspects may impact your ability to maintain compliance and continued operations.

- **Tap into current, robust and accurate data sources.** During onboarding, it's critical that you confidently identify the businesses and individuals you're working with, and that you are able to conduct appropriate due diligence based on their determined level of risk. This requires not only the data supplied directly by your third parties — but also access to external data sources: identity verification sources, court filings, financial data, assets and transaction histories, watch lists, sanctions, negative news and more. For some industries, it may even make sense to monitor social media and customer feedback for signs of potential issues. This due diligence applies not only to the business itself but to the critical players connected to the business (histories of business owners, executives and employees).
CONCLUSION

WIDEN THE SCOPE OF SUPPLY CHAIN VISIBILITY

Monitor third parties on a continual basis. Change is constant. Assessing risk on the front end is not enough to protect you over the lifetime of your relationships. Ensure you’re monitoring for changes in derogatory information, screening for criminal or compliance violations and conducting additional due diligence as necessary. While there is no magic formula for how frequently you should be doing this, most organizations should be monitoring and reassessing their third parties at least every 6 months at a minimum.

Integrate your risk management workflows to help you with the full spectrum of business risk. Free tools and manual processes aren’t good enough. There are easy to implement, automated solutions available that draw on robust data sources to give you clear insight across the lifecycle of your third parties.

An experienced provider like LexisNexis® Risk Solutions can help you drive efficiencies into your screening processes—which will result in lower compliance costs, increased operational capacity and reduced cycle times.
Let’s continue the conversation
Get in touch with us to talk more about optimizing third party risk management amid the complexity of global commerce.

For more information, call 1.800.869.0751
or visit lexisnexis.com/SupplierRisk

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