Making the Business Case for Managing Strategic Third Party Risk

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TABLE OF CONTENTS

Making the Business Case for Managing Strategic Third Party Risk..............................2
What is “Strategic Third Party Risk”? ...........................................................................2
Why Has Third Party Risk Management Become So Important? .................................3
Third Party Risk: What is Strategic and What Not – Some Guidelines .......................5
Level: Is the Third Party Risk that has been Identified Related to the Business Strategy or Business Plan?................................................................................................................7
Context: What is the Geographical and Structural Context of the Third Party Risk?........7
Materiality: How Well Known and How Material is the Third Party Risk to the Organization?......................................................................................................................7
Timing: When and How is the Third Party Risk Unfolding? ....................................8
Resources: Who Must Be Deployed to Address the Third Party Risk? .........................8
Reporting: Who Needs to Know about the Third Party Risk? .......................................8
Conclusion ....................................................................................................................8
About the author ........................................................................................................9
Making the Business Case for Managing Strategic Third Party Risk

As third party risk has moved its way up the risk priority agenda for both the c-suite and the board, it has become increasingly important for leaders to understand its characteristics and nuances more fully. Most importantly, leaders need to understand when third party risk is no longer an operational or tactical issue but a more material and perhaps even strategic risk in need of their attention and company resources.

This is especially the case in connection with the fight against corruption and related matters such as anti-money laundering and fraud. Governments and regulators, not only in the United States but in many other nations, are increasingly pursuing enforcement and compliance and know that the third party risk component of such risks is great.

In this white paper, we provide some guidance on what might constitute “third party strategic risk”, and when issues of this nature should be elevated to the c-suite and the board’s attention for their information or for further action.

What is “Strategic Third Party Risk”?

To understand strategic third party risk, we must first understand what strategic risk is. The following definitions provide excellent guidance:

The Conference Board defines Strategic Risk as follows:¹

“Strategic risks” are those risks that are most consequential to the organization’s ability to execute its strategies and achieve its business objectives. These are the risk exposures that can ultimately affect shareholder value or the viability of the organization.”

Hans W. Decker, CEO and Vice Chair of Siemens USA (Retired), considers third party strategic risk in the following context:²

“Strategy is the way a corporation positions itself in the market. So it (third party risks) depends on what the market competition is, who the suppliers are, who the customers are, what resources are needed. Strategy comes in when that positioning could be threatened or endangered in any way. That’s where we have to make the distinction between strategy and the normal course of business.”

Likewise, it is important to understand who might be within a company’s universe of third parties. As Marie Patterson, VP of Hiperos, has stated:³

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“When we say “third party”, we’re talking about everything from your vendors, suppliers, contractors, manufacturers on the cost side of the balance sheet through to your brokers, distributors, third-party channels on the revenue side; so all of the third parties that make up your extended enterprise.”

Thus, third party strategic risk would appear to be any type of risk involving one or more of an organization’s universe of third parties that, based on a series of increasingly important and relevant criteria, may pose a risk to the organization’s strategy.

Before we delve into these criteria, let's turn for a moment to an understanding of why third party risk management has suddenly become so important.

**Why Has Third Party Risk Management Become So Important?**

Organizations increasingly rely on third parties to do business on their behalf but, ultimately, engaging a third party does not absolve a company from the risk that third party may expose them to. Over the past two decades we witnessed the globalization of corporate ethics, compliance, and risk management. We have also witnessed a material increase in investigation, enforcement and cooperation by government agencies like the Department of Justice (DOJ) and Securities and Exchange Commission (SEC) in the United States and equivalent agencies in other countries such as the Serious Fraud Office in the UK. These investigations have focused heavily on key issues like anti-corruption, anti-fraud, and anti-money laundering, all of which often involve third parties.

This trend includes non-governmental entities like Transparency International (TI) and the Organization for Economic Cooperation and Development (OECD) that over the past two decades have developed deep and broad expertise, guidance and data on all manner of anti-corruption, anti-fraud, anti-money laundering and other criminal, civil and unethical behaviors.

Add to all these developments the latest trend: the slow but steady realization by boards of directors of their critical risk oversight role. With boards’ heightened awareness comes greater scrutiny of the c-suite and the CEO on all manner of corporate risk, including strategic risk and third party risk.

Recent risk surveys of boards of directors demonstrate their increased sensitivity and concern over certain key risks – including reputation risk, cyber-security and corruption. In all three cases, third parties are often, if not always, inextricably linked to these risks.

In order to successfully manage third party risk, including strategic third party risk, senior management first needs to fully understand, manage and mitigate these risks. But their work does not end there – executives need to know when these risks should be presented to the
board of directors both on a regular or periodic reporting basis and during critical times when such issues have become material or are part of a crisis.

In the Hiperos Webinar, “Making the Strategic Business Case for Managing Third Party Risk” (March 2015), the author and three panelists pictured below discussed the strategic implications of the three case studies depicted below. To listen to the recording: http://promotions.hiperos.com/making_the_strategic_business_case_third_party_risk_management

Expert Panelists

Hans W. Decker  
Retired CEO & Vice Chairman of the Board  
Siemens USA

Linda Toth  
Vice President Global Ethics & Compliance  
Harsco

Marie Patterson  
Vice President of Marketing  
Hiperos

Andrea Bonime-Blanc  
CEO  
Moderator  
GEC Risk Advisory LLC

CASE STUDY

# 1:  
DUE DILIGENCE RED FLAGS – HOW FAR UP THE FLAGPOLE?

- Is the issue operational or strategic?  
- Is the issue one only for management to decide?  
- Does the Issue require board information?  
- Does the issue require board involvement?

THE INVESTMENT THAT WAS TOO GOOD TO BE TRUE

- A major global equipment company makes a presentation to the business development team for the Latin American region of Company Y  
- In the course of the presentation, the equipment company makes references to possible financial upsides that do not seem to be specifically referenced in the PowerPoint deck  
- At the end of the presentation, the equipment company states that the financial results are better than what is stated in the deck  
- The investment opportunity (as a 25% minority equity shareholder in a private project finance) is extremely attractive regardless of the extraneous comments made by the global company representative
CASE STUDY

# 2:
THIRD PARTY DUE DILIGENCE & THE ROLE OF THE C-SUITE & BOARD

- Is the issue operational or strategic?
- Is the issue one only for management to decide?
- Does the issue require board information?
- Does the issue require board involvement?

THE CASE OF THE CROOKED CEO
- A water infrastructure development company has entered into a JV with two partners (one an established public company, the other a two-man consulting company) in a new market for the company

  - Substantial project investment is contemplated in the $50-$100M range
  - The background due diligence report reveals:
    - 2 brothers are clean
    - Established public company CEO convicted of bribery, conviction on appeal

CASE STUDY

# 3:
SUPPLY CHAIN HAVOC: THE ROLE OF THE C-SUITE & THE BOARD

- Is the issue operational or strategic?
- Is the issue one only for management to decide?
- Does the issue require board information?
- Does the issue require board involvement?

THE CASE OF THE TAINTED PHARMACEUTICAL TRANSACTION
- A global pharmaceutical company has a complex and sensitive third party supply chain including distributors and wholesalers

  - In this case, a cancer product that requires continuous cold-chain protection, is available at the wholesaler
  - The local business unit of the company, the distributor and the wholesaler decide to sell this product into an Asian market that does not appear on the company’s business plan
  - An anonymous whistleblower reveals that these sales are taking place, without a business plan, without the supply chain quality environment needed and without the local and national licenses and approvals needed for the safe and legal sale of these products in to this Asian market.

  - What is the role of the CEO and Board, if any in this scenario?
**Third Party Risk:**

**What is Strategic and What is Not – Some Guidelines**

Different challenges require different responses. In some cases a third party risk event may require a tactical or operational response that is confined in time, location, resources and response. In other instances, the strategic context in which a third party risk issue might emerge may determine a different response – a more coordinated, regional, global or even crisis management response depending on its characteristics.

As Linda Toth, Vice President, Global Ethics and Compliance, Harsco, stated:

> “In a situation when a very serious (third party) allegation is made, companies should have a process to escalate such allegations right away to the most senior level in the company, even to the board, especially when the issue goes to an element of the business strategy or against the business plan, and could damage not only the company reputation but also truly its basic license to operate. To me, a situation like this right away becomes a matter for critical incident management.”

In order to understand where a particular third party risk may fall, it is useful to think of third party risk on a continuum or spectrum of key criteria from mostly tactical to mostly strategic or even critical. See picture below.

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The following is a series of criteria management and the board should consider to determine whether a third party issue is or has become strategic:

**LEVEL: IS THE THIRD PARTY RISK THAT HAS BEEN IDENTIFIED RELATED TO THE BUSINESS STRATEGY OR BUSINESS PLAN?**

The more tactical and contained the third party issue, the least likely it is to rise to the level of the c-suite and the board. The more it is related to the business plan or strategy and the broader its operational impact, the more likely it needs to be brought to the attention of the highest levels of the organization.

For example, a third party IT services consultant at a local office who is terminated for cause (improper invoicing) does not rise to a strategic issue. However, a third party business partner who is accused or convicted of bribery and corruption can have a potentially strategic impact on a company’s business plan.

**CONTEXT: WHAT IS THE GEOGRAPHICAL AND STRUCTURAL CONTEXT OF THE THIRD PARTY RISK?**

If a risk is strictly local and its impact contained, it may not grow to be strategic. However, the greater its impact geographically or systemically within the company, the more likely it will become strategic in its implications.

For example, a virus inadvertently deposited by a third party consultant on a local laptop is not a strategic risk; a concerted third party cyber-attack on a company’s servers is strategic.

**MATERIALITY: HOW WELL KNOWN AND HOW MATERIAL IS THE THIRD PARTY RISK TO THE ORGANIZATION?**

The better known and addressed the risk, the less likely it will become strategic and critical. However, if a risk is not known and/or not properly addressed by the organization, the more material it can become and thereby the more strategic or critical its potential negative impact.

For example, an energy company knows that it has environmental exposure and risks and ensures compliance with local laws by working with a well-regarded environmental firm. If the firm turns out to be incompetent and irresponsible and the consequences to the company are the loss of a license to operate in the country, it could have strategic implications.
TIMING: WHEN AND HOW IS THE THIRD PARTY RISK UNFOLDING?
The more one-off and short-lived a risk, the less likely it is to become strategic. However, if it has further reverberations and/or is not handled in a timely manner, the risk can become increasingly problematic to the organization and eventually even become a strategic challenge or crisis.

For example, one incident of not conducting proper due diligence on a third party may not rise to a strategic risk. However, a systemically irresponsible approach to conducting third party due diligence can lead to multiple incidents or a material one with strategic risk implications to the company.

RESOURCES: WHO MUST BE DEPLOYED TO ADDRESS THE THIRD PARTY RISK?
The more layers of local, national and international company resources, including cross-functional experts, that need to be deployed to properly address a specific third party issue, the more likely the issue will become potentially material and even strategic.

For example, a proposed strategic partner in a new market will require not only the deployment of local resources for due diligence purposes, it is likely to require national, international and senior management attention as well for both vetting and approval. If such vetting does not take place or something else goes wrong (the party turns out to have been convicted of corruption in the past, for example), such third party issue will become strategic and subject to crisis management.

REPORTING: WHO NEEDS TO KNOW ABOUT THE THIRD PARTY RISK?
The higher up one must go on the corporate echelon, the more likely the risk is strategic. Additionally, if reporting to outside authorities is part of the consideration, this risk issue poses even greater potential strategic implications. The Table on Page 6 is meant to provide guidance to risk managers and others who are analyzing whether a third party issue constitutes a strategic third party issue requiring the attention of (and potentially resources from) the highest levels of the organization.

Conclusion
Third party risk in today’s increasingly challenging global business environment is inevitable. Companies that understand when third party risk becomes strategic and know when to raise it to their c-suite and board are companies that are more resilient and prepared to deal with the complex conundrums of the age of hyper-transparency.
About Hiperos

Hiperos is an Opus Global company. We were founded with a single focus – to help our customers get more value from their third parties and third party relationships. Today, Hiperos customers engage with their third parties in 182 countries worldwide, and depend on the Hiperos 3PM™ platform to control the risks and optimize the value of their third party relationships.

We are fortunate to have earned the business of some of the greatest brands in the world who leverage the Hiperos Network and the power of Hiperos 3PM™ to protect their organizations against reputational impact, regulatory exposure, and revenue loss. Our customers include many of the world’s leading companies such as Aetna, Alcoa, AON, Arrow Electronics, Astra Zeneca, AXA, Bank of Montreal, CA Technologies, Charles Schwab, Halliburton, Huntington Bank, Kraft Foods, Mondelez, Microsoft, News Corporation, Peabody, PNC Bank, Rockwell Automation, Sun Life Financial, State Street, TD Bank, and United Technologies.

We recognize the ever-increasing pressure on organizations to do more with less in an environment where the number of third parties, third party relationships, regulations, elements of risk, and costs continue to increase, with no signs of a slowdown. Our dedication to optimize the user experience and create innovative ways for our customers to take control and has led to the highest user adoption rates, and the lowest total cost of ownership.

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About the Author

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