Third Party Risk: Exposing the Gaps

An independent survey discussing how organizations today are managing the risks associated with their third party business relationships

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FOREWORD

by Shaun Sibley, Managing Director, Supply Chain and Commodities, Thomson Reuters

It seems that hardly a day goes by without a company being dragged into the media or regulatory spotlight because of actions within their supply chain or from their third parties.

These actions, such as the use of forced labor or a bribe being given to secure a government contract, are not only damaging to society but also to organizations in terms of their reputation and profits.

We at Thomson Reuters decided to examine the scale of the problem and find out how much organizations really know about the risks related to doing business with suppliers, distributors and partners. We also wanted to understand what organizations are doing to manage these risks and if the benefits and implications of having robust due diligence processes in place outweigh the consequences of not having an established risk-based approach.

At times, the results are surprising but overall they highlight that organizations recognize the need to conduct due diligence on third parties. However, there are still large gaps in knowledge, resources and information to properly address all the risks.

We hope you enjoy reading the report and find it a useful tool to benchmark your organization against current practices, and to help identify areas that require improvement.

ABOUT THE SURVEY

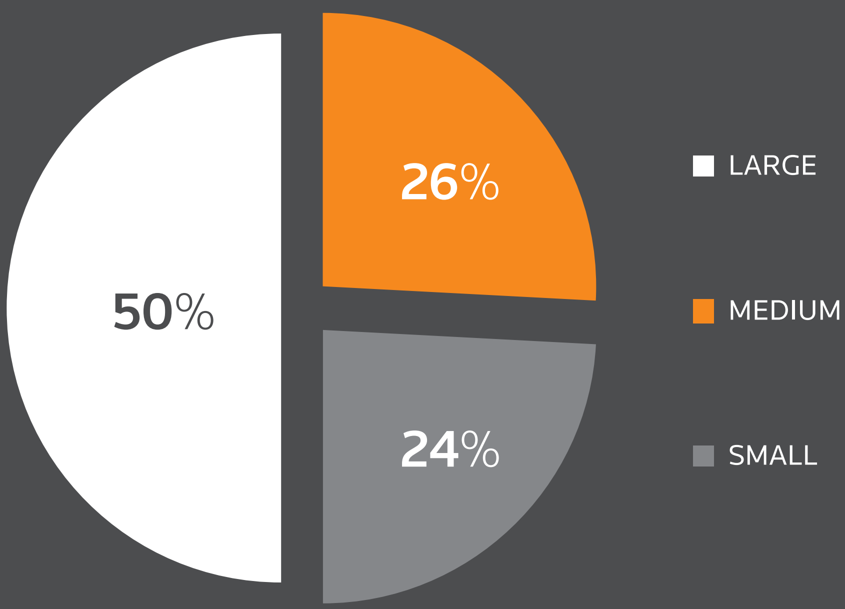
This report is based on research commissioned by Thomson Reuters and conducted by an independent agency in late summer 2016. A total of 1,132 professionals completed the survey, all of whom were involved in global third party relationships or third party risk management within their organizations including procurement, compliance and legal professionals.*

Respondents by country

Survey respondents worked for organizations consisting of **2.7 million employees** and **9.4 million third party relationships** in total, spanning the continents of the globe.

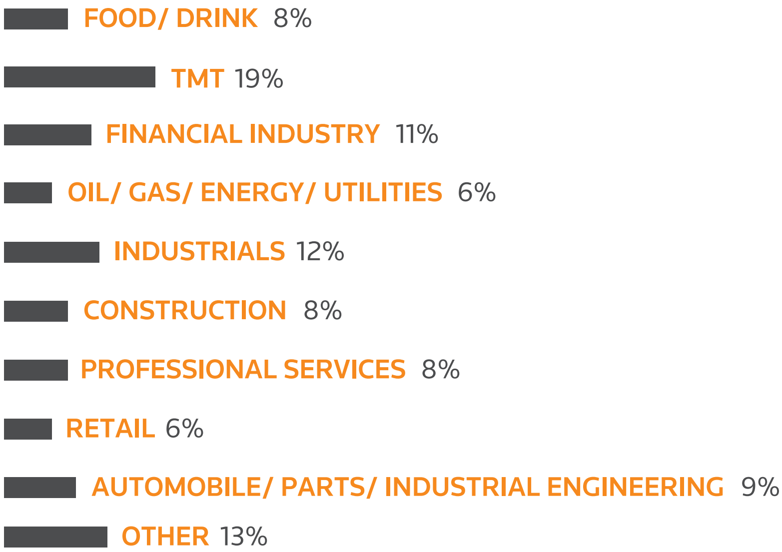
Professionals completed this survey from Australia, Brazil, China, France, Germany, India, Singapore, UK and USA

Organization type

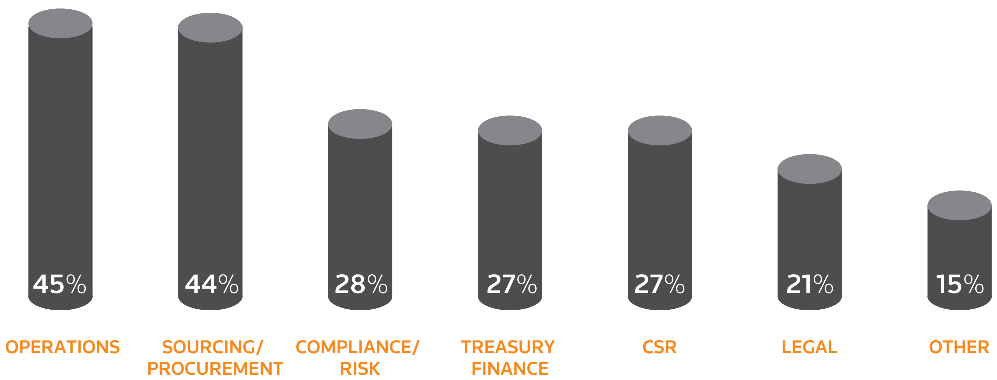


* *The general convention for rounding percentages has been undertaken, so not all sums will add up to 100% where applicable.*

Industry



Job functions*



* *Respondents selected all that applied*

Definitions

For the purpose of this report we have defined a 'third party' as any person or organization that is connected to a supply chain or is executing business on an organization's behalf such as a supplier, distributor, agent and/or partner.

The report has defined the term 'third party risk' to include anything that could expose a company to threats and risks through engagement with third parties including Bribery and Corruption, Modern Slavery, Environmental Crime or Conflict Minerals.

The term third party due diligence refers to assessment of the third party at the onboarding and ongoing monitoring stage to determine the risk profile.

KEY FINDINGS

1. SETTING THE SCENE 7

The current business environment is increasing both the benefits and risks of third party relationships.

- 74% say that third party relationships have enabled their company to be more flexible and competitive
- 65% think that the current economic climate is encouraging organizations to take risks in relation to regulations to win new business

2. THE THIRD PARTY RISK LANDSCAPE 9

Companies are not as knowledgeable about current risk and regulation as they would like to be.

- Nearly half feel they are not sufficiently knowledgeable about the risks they face
- 14% of third party risk management professionals do not use the Foreign Corrupt Practices Act (FCPA) to inform their decisions and 13% are not even aware of this legislation

3. PREPARATION, PERCEPTION AND PUNISHMENT 13

Perceptions about third party risk and its consequences do not always match the reality.

- Due diligence is conducted on approximately 62% of third parties
- 56% feel that they are unlikely to be prosecuted if they breach regulations
- 92% increased spending on compliance after experiencing an enforcement action

Respondents to the survey are using a range of risk management strategies.

- The main drivers for due diligence are compliance with regulation and managing reputational risk
- Only 36% are fully monitoring for ongoing risks

Organizations are working hard to address risk, but there are obstacles to overcome.

- Nearly two-thirds know where risks may occur but struggle to detect them
- A lack of budget, time and data is the main challenge

Third party risks will continue to rise, but they can be successfully mitigated.

- 77% expect the time and resources spent on third party due diligence to rise next year
- 80% of compliance professionals believe their personal liability will increase

1. SETTING THE SCENE

Balancing the rewards with the risks.

In a highly competitive environment, businesses are under pressure to do more with less and at greater speed. This has led to the outsourcing of non-core activities and the expansion of operations and supply chains into unfamiliar territories.

For example, a business headquartered in the US may manage back-office functions from lower cost countries such as India or Indonesia, oversee manufacturing in Vietnam or Mexico and deliver finished products to customers anywhere in the world. Or a UK high street supermarket may sell food sourced from small suppliers thousands of miles away.

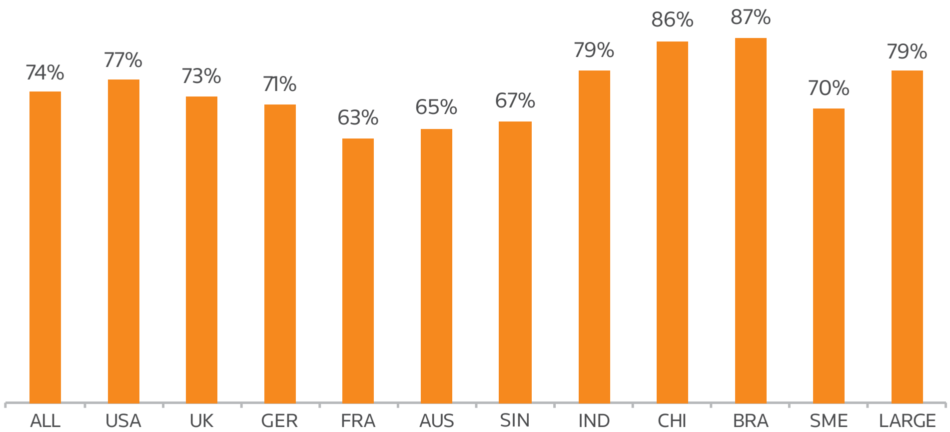
Inevitably, this environment is putting more responsibility on third parties operating in remote markets that may have very different operating standards and understanding of risks.

SETTING THE SCENE

Enjoying the benefits

Our survey shows respondents are well aware of the benefits of these arrangements, with 74% saying that third party relationships have allowed their company to be more flexible and competitive. This figure was even higher in some regions with 86% of China-based respondents endorsing this view and 87% in Brazil. Industrials, Professional Services and Technology Media and Telecommunications (TMT) were the leading industries in which respondents saw the benefits of third party relationships with 83%, 78% and 77% respondents in agreement, respectively.

THIRD PARTY RELATIONSHIPS HAVE ALLOWED COMPANIES TO BE MORE FLEXIBLE AND COMPETITIVE



Underplaying the risks?

Some organizations, eager to grasp the benefits, may not be paying enough attention to the risks. Nearly two-thirds (65%) of those surveyed agreed that the current economic climate is encouraging organizations to take risks, in relation to regulations, in order to win new business. Yet, our respondents have a strong sense of where the most geographical risk lies. Sub-Saharan Africa was identified as the riskiest location with 54% of all respondents describing it as high risk. This percentage rose to 65% among respondents with relationships in this region. Interestingly, there appear to be no safe havens as every region was identified as either high or medium risk by at least 49% of respondents.

Looking ahead

As more companies seek to improve efficiency and profitability through relationships with third parties, risk exposure is set to rise in the future, accelerated by growing regulation and greater public awareness. In the supply chain alone, Thomson Reuters has calculated that organizations currently lose $200 billion every year by not managing their risks effectively – and this figure looks set to rise.

2. THE THIRD PARTY RISK LANDSCAPE

More regulation, more risks.

The regulations that govern third party relationships are not only growing in number but also in severity and complexity. Simultaneously, globalization is taking companies into new relationships and territories, increasing their exposure to third party risk.

Evidence of the size of the challenge can be seen in the finding that less than half of respondents felt that they had sufficient knowledge about the risks they face. Although the percentage is worryingly low, it could also demonstrate a lack of complacency as respondents acknowledge the ever-changing landscape and need to constantly update.

The Foreign Corrupt Practices Act (FCPA)

This is top of the agenda for many companies managing third party relationships and with good reason – all ten of the biggest FCPA settlements involved the use of third parties. In the first quarter of 2016 alone, there were eight corporate FCPA enforcement actions and three individual resolutions, with companies paying nearly $500m in fines, penalties and settlements[1].

In addition, the UK Bribery Act, the Modern Day Slavery Act in the UK and the Dodd-Frank Act Section 1502 in the US, plus a host of other global regulations, provide a further complex regulatory landscape, with mitigating third party relationships being a key factor.

[1] *Cassin, R.L. (2016) FCPA enforcement report for Q1 2016 - the FCPA Blog.*

Available at: http://www.fcpablog.com/blog/2016/4/1/fcpa-enforcement-report-for-q1-2016.html

(Accessed: 29 September 2016).

Reputational damage

Companies can face reputational risk, often accelerated by social media 'naming and shaming' those perceived to have transgressed, whether regulations have been breached or not. On average, more than 25% of a company's market value is directly attributable to its reputation, according to the World Economic Forum. This means that taking all necessary steps to identify who you're doing business with is now more critical than ever before.

Non-governmental organizations are playing an increasingly important role in making public the practices of corporates' third parties – for example The Corporate Human Rights Benchmark is a multi-stakeholder initiative that will provide the first-ever ranking of the world's largest publicly listed companies on their human rights performance. This is reflected in the survey, with respondents highlighting fear of reputational damage as the second most important reason to conduct due diligence on third parties. The number one reason was compliance with regulations.

What does the survey tell us?

Companies are not as knowledgeable about current regulation as they want to be or need to be. Despite the FCPA being the best known and most powerful anti-bribery and corruption legislation currently in place, a significant 14% of those involved in third party risk management said they did not use it to inform their decisions, including 6% of US respondents. Respondents in Australia and Brazil were the least aware when it came to the FCPA, and Retail stood out in terms of sectors. It was a similar story with the UK Bribery Act, with 24% of those involved in third party risk management saying they did not use it to inform their decisions, including 25% of UK-based respondents. Again, Brazil and Australia stood out in term of reporting a lack of awareness, as did Retail (19% unaware).

India and China were two of the countries apparently leading the way in using legislation to inform decisions with 52% and 34% respectively, saying they used FCPA to inform all decisions. However, this may reflect some regional differences, as Duncan Jepson, Director and Founder of Liberty Asia, explains. "Management culture in India and China tends towards conformity and being seen as doing the right thing when the reality could be quite different."

What does the survey tell us?

(Continued)

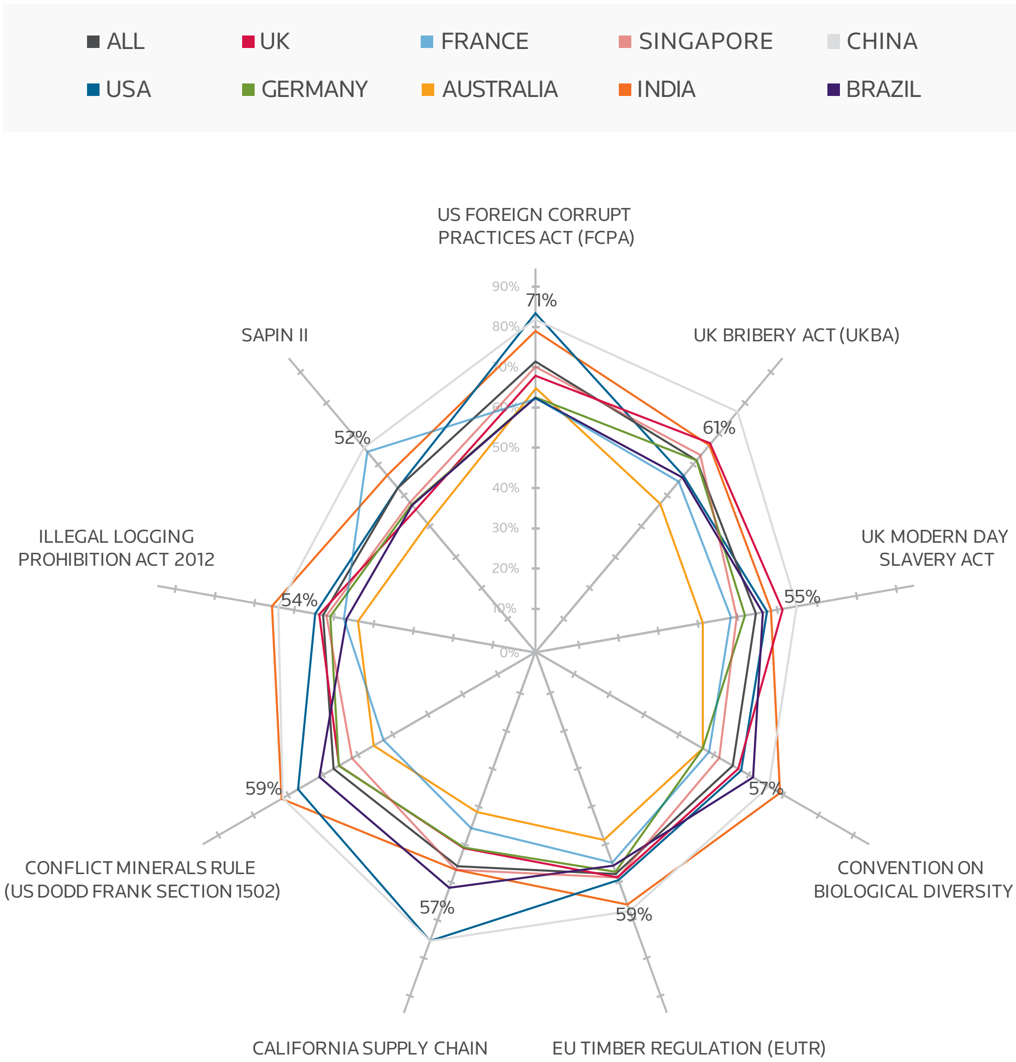
The level of corruption in these two countries (China ranks 83 and India 76 out of 168 on the Transparency International corruption perceptions index[2]) would suggest that the survey respondents may not be enacting the legislation properly nor fully understand its reach. Organizations need to factor into their due diligence processes that there might be a difference in what a third party are saying they are doing and what is actually happening in reality. Looking at the UK Modern Slavery Act, 22% of those from large companies did not use it to inform their decision-making, including 29% of UK-based respondents. This is a concern as its far-reaching powers include the obligation for companies with operations in the UK and a turnover of £36 million or more to show the steps taken to ensure slavery and human trafficking are not taking place either in their own business or any of their supply chains.

[2] *T.I. Transparency international - country profiles.*

Available at: https://www.transparency.org/country

(Accessed: 29 September 2016).

WHICH OF THE FOLLOWING GUIDELINES, LEGISLATIONS, FRAMEWORKS AND STANDARDS DO ORGANIZATIONS USE TO INFORM DECISIONS ON THIRD PARTY RISK MANAGEMENT?



Percentages represent ALL results

Risk awareness

Moving away from specific regulation, our survey examined whether those completing the survey felt sufficiently knowledgeable about a range of specific risks. Bribery and Corruption scored highest, with 58% of compliance/risk professionals feeling sufficiently knowledgeable, while those in sourcing and procurement registered 54%.

Just 16% overall felt sufficiently knowledgeable about Slavery and Forced Labour, rising to 24% of those in compliance/risk roles. This low figure may reflect a lack of understanding of its impact and reach as Jepson explains, "In truth no one really fully understands the problem yet as it is complicated and interconnected with many other risks, however by having access to more information companies can start to get a better understanding of the issue and tackle the problem."

Awareness of Environmental Crime and Conflict Minerals risks falls somewhere between the two extremes, registering 28% and 23% respectively in terms of sufficient knowledge.

Ultimate Beneficial Ownership

Our survey shows that only 11% of respondents have sufficient knowledge about Ultimate Beneficial Ownership (UBO) – with China performing best (19%) and the US and Singapore joint worst (7%). While this is worrying at a time when regulatory requirements around UBO are rising, it also reflects what James Swenson, Global Head of Proposition – Risk Managed Services, Thomson Reuters describes as, "The onerous task of identifying UBO. In fact only 45% of all jurisdictions provide director information online and only 36% disclose shareholders. This lack of transparency is a real challenge for companies, who often need specialized support."

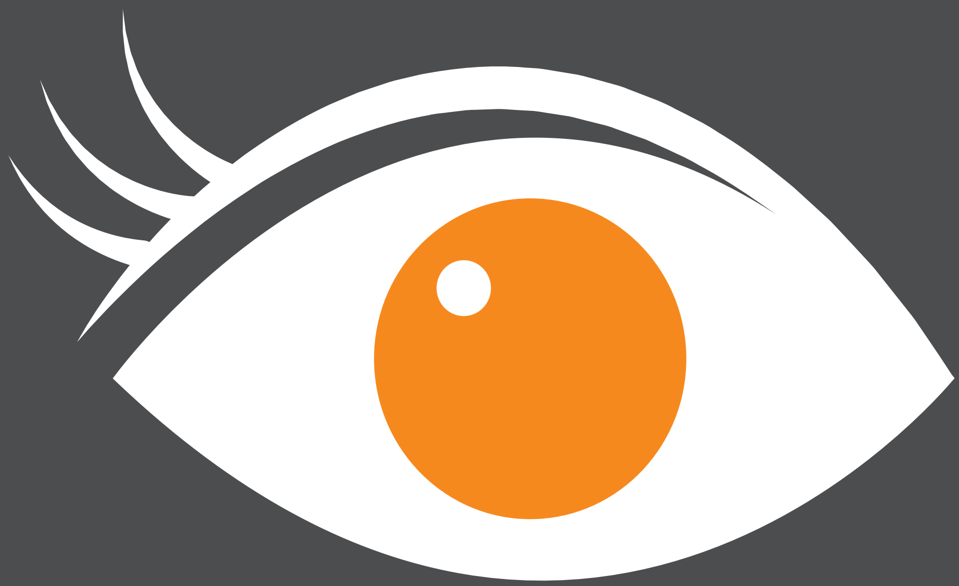
LANDMARKS ON THE LANDSCAPE

Six pressures shaping the risk environment:

- Increased supply chain and third party risk regulation, aimed at improving sustainability
- More and higher fines for non-compliance
- Proof required to demonstrate due diligence
- Consumer ethics driving the agenda
- Shareholder value and investor satisfaction
- Civil society and NGO pressure

3. PREPARATION, PERCEPTION AND PUNISHMENT

How well are companies doing in terms of due diligence, what is their perception of risk and the impact of enforcement action?



PREPARATION, PERCEPTION AND PUNISHMENT

Being prepared – due diligence

Knowledge is the first line of defence. The more companies know about who they are doing business with, the better they can manage the risks, ensure compliance and avoid reputational damage. Due diligence is the frontline in this battle. Yet survey respondents reported their organizations had carried out due diligence on just 62% of third parties. This rose to 74% for US-based respondents.

Knowing if your third parties are outsourcing to other suppliers is also vital in managing the risk to your business, but 61% of respondents were unaware of the extent to which this was happening. This is backed up by the fact that 62% of respondents say they only carry out due diligence on tier 1 third party relationships.

Taking a risk

It may not simply be a lack of knowledge; it could be judged a risk worth taking. 63% of all respondents agreed that winning new business is a priority and, as a consequence, they might breach regulations, rising to 79% in USA and falling to 47% in France.

A lack of deterrence may also be a factor, with 56% agreeing that 'there is a perception that we're unlikely to be prosecuted if we did breach regulations'. 61% in the USA and 56% in the UK agreed with this statement, which is surprising as these two countries are heavily regulated and have tough regulatory enforcement. In terms of the actions taken by companies when they find that a third party has breached regulations, the most likely outcome (66%) is that it will be reported internally. There were some significant differences between countries, the highest being China at 82%, while just over half (51%) in the USA said they would report internally. In terms of sectors, Professional Services was most likely to report in-house (75%), while Food and Drink registered a much lower 51%. Of the other options, 11% of all respondents said they would report a breach externally and 15% would record but not report it, highlighting there could be incidents organizations are not aware of happening. Worryingly, 4% said they would do nothing.

PREPARATION, PERCEPTION AND PUNISHMENT

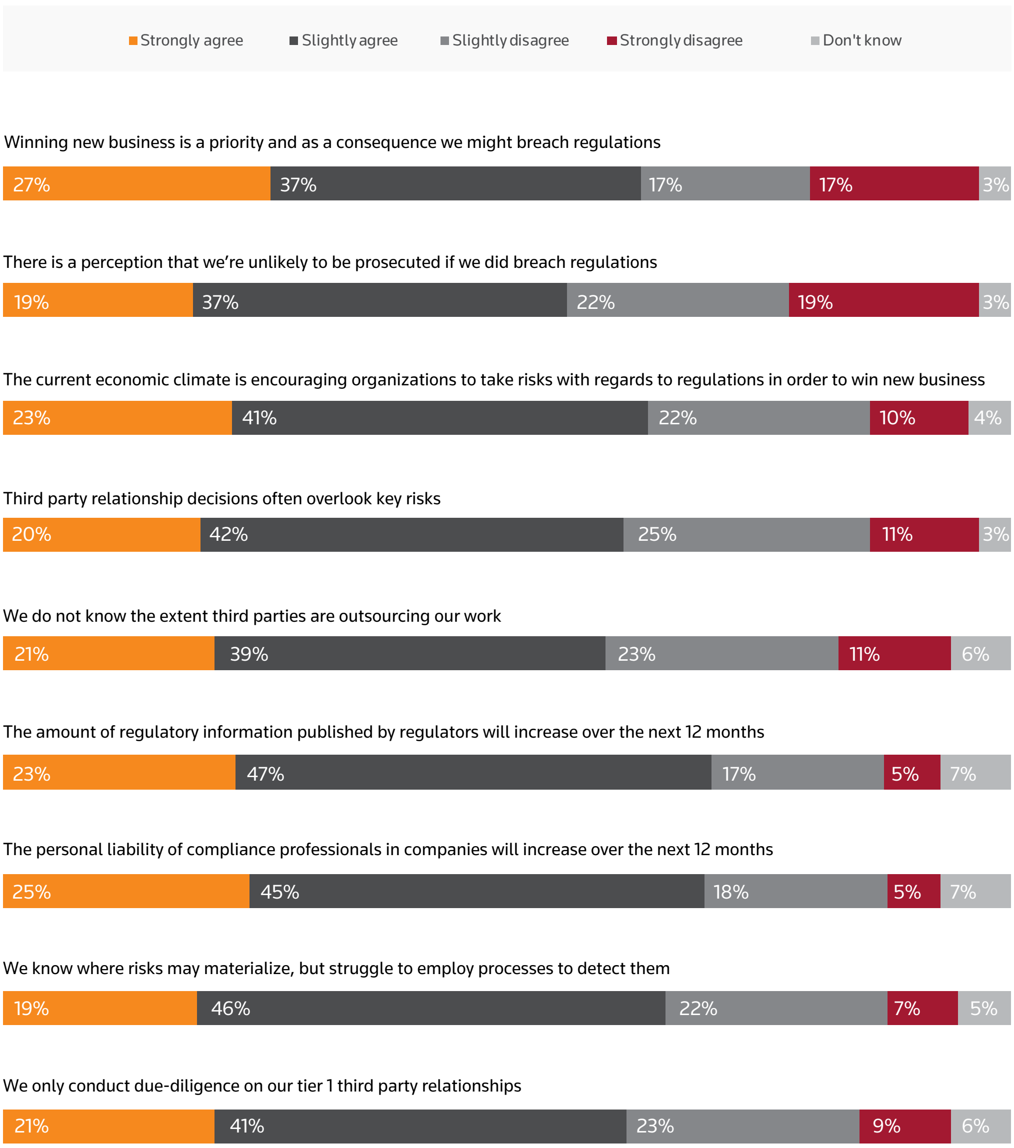
IF AN ORGANIZATION CAME ACROSS A THIRD PARTY THEY ARE WORKING WITH THAT BREACHED REGULATIONS, WHAT WOULD THEY MOST LIKELY DO?

PREPARATION, PERCEPTION AND PUNISHMENT

After the event – experience of enforcement

In contrast to the relatively low priority or understanding assigned to third party risk by some survey respondents, those who have had enforcement actions taken against their organization were quick to act: 92% increased the amount their organization spends on compliance after experiencing an enforcement action. This suggests it's not that organizations are reluctant to take action on third party risk, but that they need to understand the impact first. This invisible nature of much third party risk means that unless actively sought out, companies may only see it when it's too late.

HOW STRONGLY DO ORGANIZATIONS AGREE OR DISAGREE WITH THE FOLLOWING STATEMENTS?



4. CURRENT PROCESSES

In this section we look at the factors influencing third party risk management and the methods currently used.

CURRENT PROCESSES

The drivers for due diligence – stick or carrot?

Overall, 55% of respondents chose compliance with regulators as the main motivation for due diligence and it was higher still in the US (64%) and Brazil (63%), perhaps illustrating the impact of legislation in those countries. Nearly an equally as important reason to conduct third party due diligence was protecting a company's reputation (53%), with the UK, Singapore and Brazil the most sensitive to this issue. It's perhaps not surprising that these two reasons came out on top as they can both have a big impact on the bottom line. "Large corporations have missed their annual numbers because of reputational damage", says Nick Wildgoose, Global Supply Chain Product Leader, Zurich Global Corporate. This can be seen with a luxury car manufacturer whose shares dropped by 3% following a SFO investigation into possible Bribery and Corruption in China and Indonesia.

More positive drivers, such as ensuring a sustainable supply chain was only chosen by 31% which is interesting because by managing and seeking to improve environmental, social and economic performance and good governance throughout supply chains, it can also benefit companies at large. In fact Novo Nordisk CEO Lars Sørensen, recently ranked Harvard Business Review's best-performing CEO in their annual ranking to identify CEOs delivering "enduring success," has previously said: "Corporate social responsibility is nothing but maximizing the value of your company over a long period." "In the long term, social and environmental issues become financial issues[3]."

[3] *Ignatius, A. (2015) The best-performing CEOs in the world.*

Available at: https://hbr.org/2015/11/the-best-performing-ceos-in-the-world

(Accessed: 29 October 2016).

Due diligence methodology

While the majority (60%) of organizations say they would conduct due diligence on a third party at company level, this drops to just 46% conducting due diligence on the parent company and 33% on the subsidiaries.

When asked what determined if further due diligence needed to be conducted on a third party, the most popular driver (chosen by 44% of respondents) was if the third party was a high value supplier to the organization. The next two most popular triggers for extending due diligence were if so-called 'traffic light systems' highlighted jurisdiction/country risk (37%) and industry/product risk (35%).

The nature of risk is that it constantly changes, so ongoing monitoring is vital to identify new risks, for example, a third party might make changes to their ownership structure or working practices. In our survey, however, only 36% say they are fully monitoring for all ongoing risks.

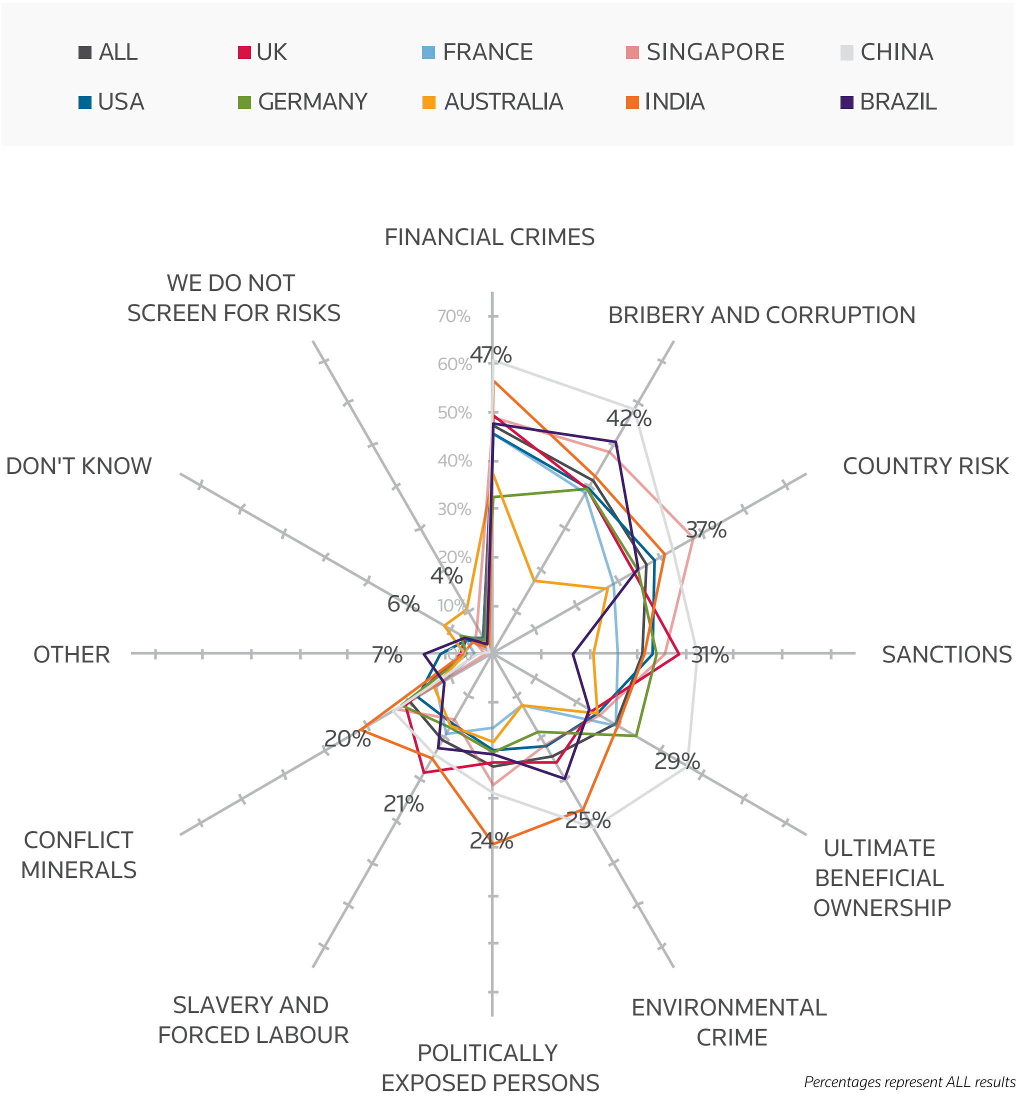
CURRENT PROCESSES

Screening strategies

A key time to identify risk is when third parties are first onboarded. Financial Crime was screened for by 47% of all companies surveyed, followed by Bribery and Corruption at 42%. Only 29% screened for UBO, which is of concern as by not knowing who you are ultimately doing business with could open organizations up to unforeseen risks, as the UBO could be a sanctioned individual or politically exposed person. Overall, the least likely risks to be screened for were Slavery and Forced Labour and Conflict Minerals. Looking at this from an industry perspective, Construction led the way, scoring highest in screening for Bribery and Corruption, Forced Labour, and Conflict Minerals. As might be expected, Financials were ahead when it came to screening for Financial Crime and UBO.

These statistics are in tune with the views of Alison Taylor, Director, Business for Social Responsibility, who says, "Where there is more clarity and guidance from the regulators, and regulations are most established, there is more understanding of what organizations should do and what risks to look out for."

WHAT COMPLIANCE RISKS DO ORGANIZATIONS SCREEN FOR AT THE INITIAL THIRD PARTY ONBOARDING STAGE?



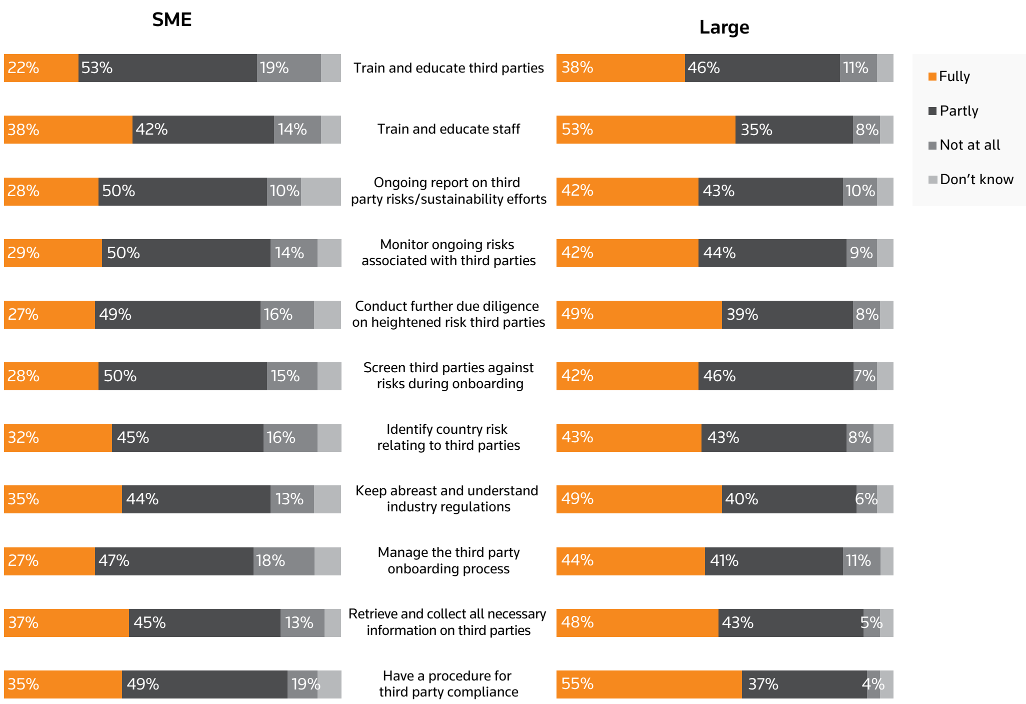
Percentages represent ALL results

CURRENT PROCESSES

Bigger companies are doing more than smaller ones

When it comes to the steps companies take to manage third party risks in their supply chain, training tops the list, in terms of educating both corporate staff and third parties. But there's a notable difference according to company size. Training programmes for third parties are almost twice as likely to have been fully implemented at large corporates than at SMEs. This difference is mirrored when it comes to the monitoring of the changing risks associated with third parties: 42% of large companies say they have fully implemented ongoing monitoring, compared to just 29% of SMEs.

WHAT STEPS DO COMPANIES CURRENTLY TAKE IN REGARDS TO MANAGING RISK WITH THIRD PARTIES IN THEIR SUPPLY CHAIN?



Who manages risk management?

Just over two-thirds of those who took part in our survey said their company's third party risk compliance program was managed by headquarters, compared to just 42% who reported it was managed locally (some companies combine both approaches). The danger with a centralized risk management program is that it may overlook significant region-specific risks as there is no on-the-ground presence.

THE RISK-BASED APPROACH TO THIRD PARTIES

1. Understand the risks companies are most vulnerable to
2. Define the risk criteria according to the risks they face
3. Have appropriate tools and processes in place to identify, assess and mitigate those risks

5. IDENTIFYING THE GAPS

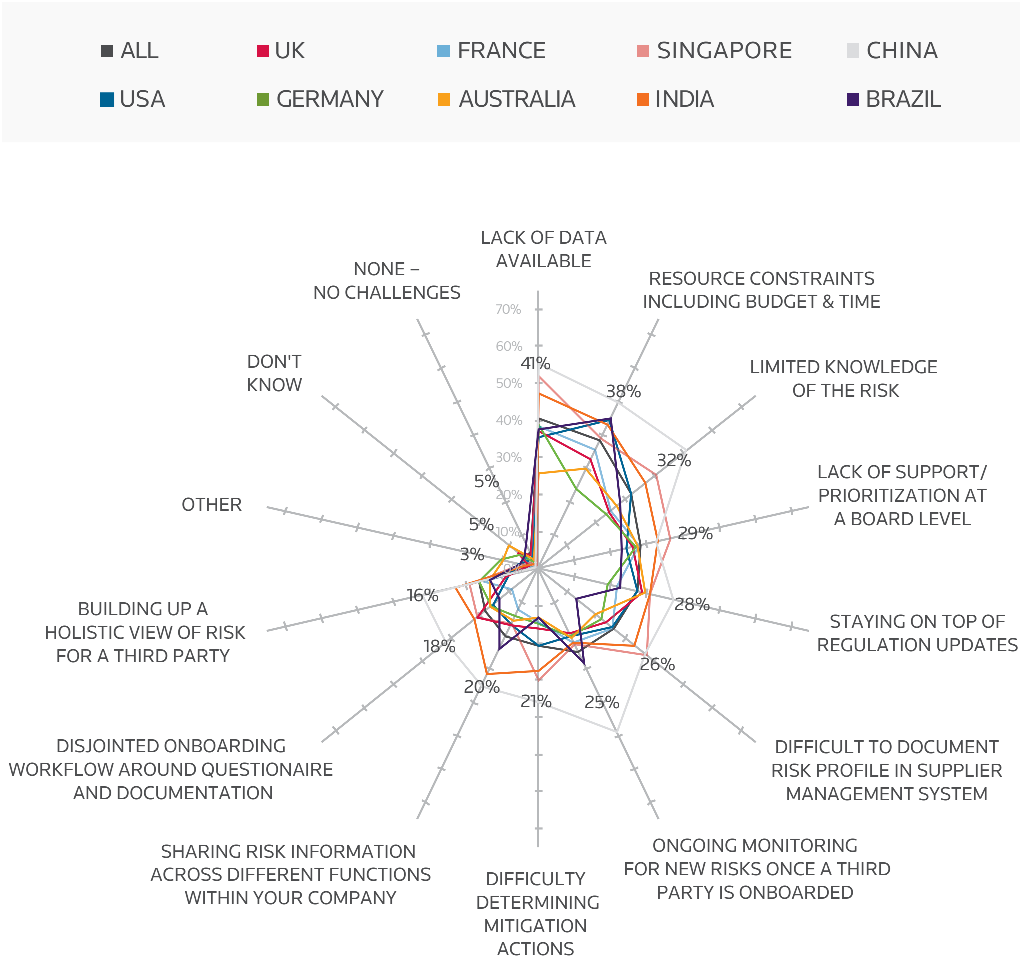
Companies are working hard to manage third party risk, but remain vulnerable.

IDENTIFYING THE GAPS

Just under two-thirds (66%) said that although they know where risks may materialize, they struggle to employ processes to detect them. This may reflect the range of challenges they face, the main two being a lack of data (41%) and resource constraints (38%). Resource constraints, including budget and time, were even more pressing for survey respondents working in compliance and risk, sourcing and procurement and CSR (44%). Only 5% of all respondents reported no challenges at all.

This lack of resources may be a result of what Wildgoose argues is perhaps the biggest challenge facing many companies: a lack of board-level support. "Without c-suite support, third party risk will not get the prioritization, investment and resource needed to put an effective management program in place", he says. This sentiment is supported by Suzanne Snively, Chair of Transparency International New Zealand: "A culture of fighting and preventing Corruption has to be entrenched within an organization and this can only come when there is active leadership from the top."

WHAT CHALLENGES DO ORGANIZATIONS CURRENTLY FACE IN IMPLEMENTING THE RIGHT APPROACH TO IDENTIFYING RISK WITHIN THEIR SUPPLY CHAIN?



Percentages represent ALL results

HOW TO HARNESS THE POWER OF DATA TO ADDRESS THIRD PARTY RISK CHALLENGES

Global supply chains are complex and the most critical issues usually appear deeper within the supply chain – further from customer reach and influence. This is why it's critical that organizations have access to data and solutions that can enable them to detect and assess such risks.

Oversight of third parties is still one of the greatest challenges in managing compliance programs, yet our survey reveals that 62% of respondents only screen tier 1 suppliers, resulting in a lack of data on all business relationships for effective risk management.

This is why it's critical that organizations have access to technology-driven intelligence and solutions such as Thomson Reuters World-Check risk intelligence. Using more than 230+ research analysts to search for hard-to-reach information, World-Check risk intelligence provides structured profiles on individuals and entities to enable organizations to identify who they are really doing business with and understand how the various risks intersect.

For heightened risk individuals and entities, Thomson Reuters Enhanced Due Diligence, provides organizations with customizable detailed background reports that includes information on adverse media, connections and relationships and ultimate beneficial ownership.

Companies that have a holistic and systematic approach to third party due diligence and work with key solution partners will be well prepared for future challenges and empowered to build more sustainable supply chains.

Miles Hobart
Head of Proposition, Third Party Risk, Thomson Reuters

Confidence is an issue

When respondents were asked what areas relating to third party risk management they are confident their companies are executing well, nearly a third were 'extremely confident' about their training and education of third parties, and a quarter were 'extremely confident' about their ability to conduct further due diligence on third parties. Spreading the net wider to include those who were 'very confident', we find the figures rise to two-thirds or above. This does, however, leave a significant minority with 'little or no confidence' in key areas such as ongoing monitoring (32%) and ongoing reporting (33%) of their third party risk/sustainability efforts. In addition just under 40% are fully taking all the steps needed with regards to managing risk with third parties in their supply chain and worrying approximately 10% don't have any steps at all.

Getting beneath the surface

The nature of third party risk is that much of it remains hidden until thorough processes are in place. It can be vital, for example, to go beyond tier 1 suppliers and screen those lower down the supply chain.

Similarly, when it comes to ownership structures it may not be sufficient to screen only the third party company, but to look beyond to their parent company, UBO, subsidiaries and directors. Our survey results presented a steady fall off from 60% screening the third party company to 38% screening for UBO and 27% directors.

6. BUILDING A SAFER FUTURE

Risks will rise, but the right approach can unlock valuable benefits.

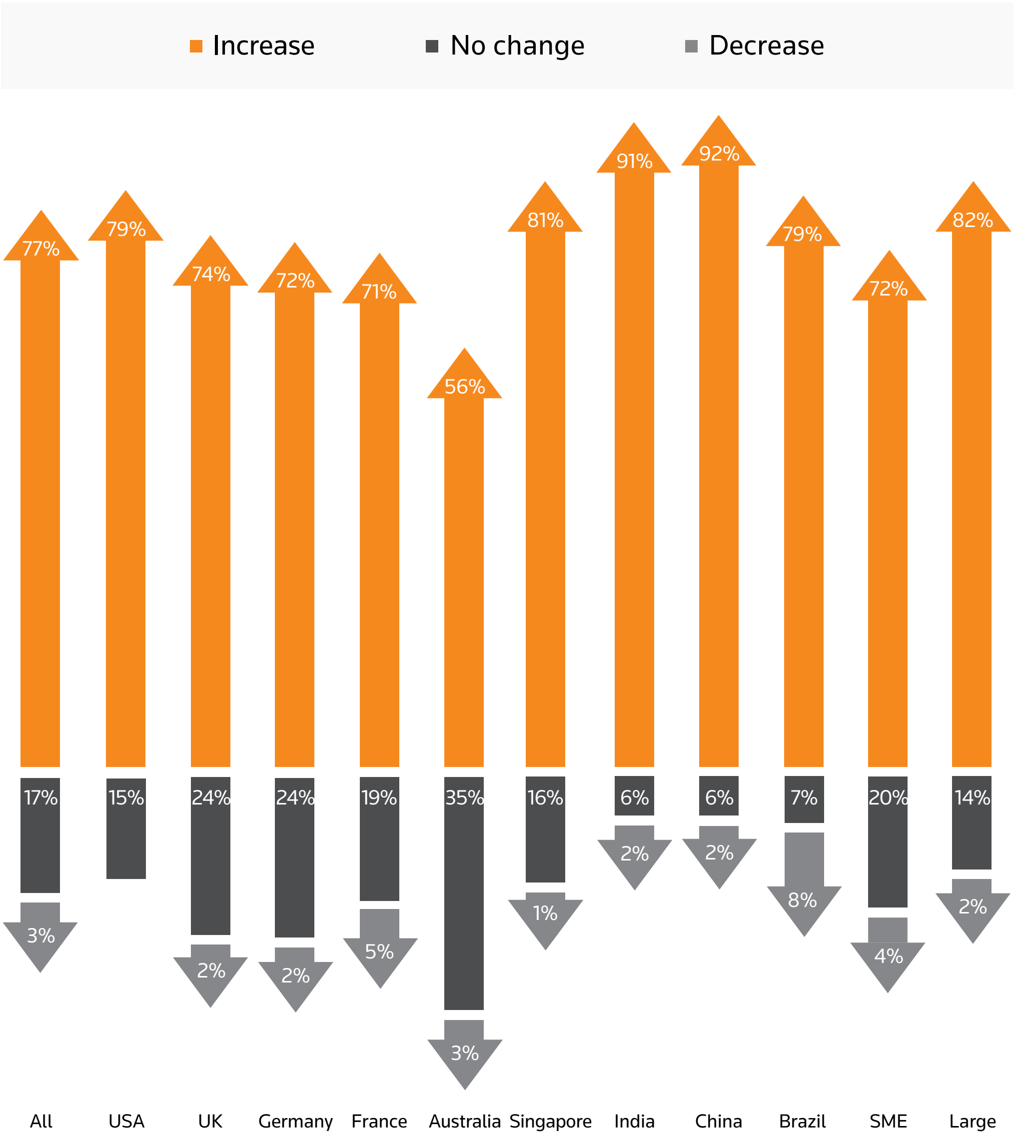
Third party relationships play a key role in the success of many businesses, helping to meet growth objectives, reduce costs and optimize resources. But they can also introduce substantial risks and, as the regulatory environment demands increasing scrutiny and control, these risks look set to increase.

This is backed up by our survey, with more than two-thirds of respondents believing the personal liability of compliance professionals will rise over the next 12 months. Just keeping up could also be a challenge, with over two-thirds (71%) saying the amount of information published by regulators will increase over the next 12 months.

Rising to the challenge

The positive news is that organizations are investing in better risk management processes. In our survey, three-quarters of respondents expect to increase the time and resources spent on conducting due diligence over the next 12 months. Key partners like Thomson Reuters can provide valuable support in implementing a comprehensive risk-based approach, using data and techniques that are proven, effective and easy to access.

DO ORGANIZATIONS EXPECT THE TIME & RESOURCES SPENT CONDUCTING DUE DILIGENCE ON THIRD PARTY RELATIONSHIPS TO CHANGE IN THE NEXT 12 MONTHS?



Seizing the opportunity

With the right processes, expertise and intelligence companies can not only better manage their risks, but unlock valuable benefits: cutting compliance costs, building reputation and shareholder value, and being better able to retain customers and key staff. Far from being something to fear, risk can provide opportunities to outperform peers and build a sustainable future for your business.

HOW THOMSON REUTERS CAN HELP

At Thomson Reuters, our Third Party Risk solutions help you detect, assess and minimize potential risks associated with your suppliers, distributors and partners, and regularly monitor them for any change in status.

We enable clients to:

- Evaluate the level of risk when working with third parties in a given country using Thomson Reuters Country Risk Ranking
- Screen and monitor third parties against millions of profiles using Thomson Reuters World-Check risk intelligence to raise red flags around potential risks, such as sanctioned entities, politically exposed persons (PEPs), bribery and corruption, environmental crime, slavery and human rights abuse
- Research deeper into heightened risk entities and individuals with Thomson Reuters Enhanced Due Diligence
- Provide online training for staff and third parties to help prevent risks from entering your business with Thomson Reuters Compliance Learning

Our solutions combine intelligence, technology and human expertise to help your organization identify the different risks you might face in a complex global environment.

With Thomson Reuters you get answers you can trust to increase efficiency and growth in your business and supply chain.

For more information, visit
risk.tr.com/thirdpartyrisk

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