Kieran Moynihan IS THE MANAGING PARTNER OF
BOARD EXCELLENCE

Many of us have experienced frustration when we stand in front of an ATM or try to access our online banking service at home and we realise the system is down due to a serious IT outage in our bank provider. Even worse was the severe disruption experienced by airline passengers in recent times being stranded at airports across the world due to severe IT outages in airlines that are taking, in a number of cases, days to fix. As customers, we understandably focus our frustration and disappointment on our direct provider but in many cases the root causes of these severe disruptions in our service are in third party providers, often in distant geographies and time-zones, which significantly impacts on our provider's ability to rapidly diagnose, fix and restore service to its customers.

Key Elements

Board teams across the world are increasingly realising that while outsourcing key services provides a lot of benefits in terms of cost and flexibility, there is a serious downside to this in terms of the special oversight needed and more importantly the ability to respond to a serious crisis impacting key services or a sudden realisation that, due to a series of ongoing crises with a particular third party provider, either the capability needs to be brought back in-house or moved to another outsource provider. In some cases, outsourcing to a specialist third party provider is the only way for organisations to access and bring complex technology and services to support both their own operations and that of their clients. However, outsourcing to third parties was driven by major cost reduction initiatives and very often board teams didn't fully appreciate the downside consequences of losing, for example, all of the critical expertise and deep experience of their own teams as well as the serious consequences of a major outage in service provision and the serious lack of control over the restoration of that service to their customers.

In reality many board directors today do not fully understand the scale of services outsourced to third parties, the special approach needed by the board to the oversight of these services and the implications for crisis management and business continuity if serious problems develop within the third parties. Many executives have commented to me that third party services are no different to internally provided services so they just come under normal operations reporting to the board. Ask any executive who recently has had to stand in front of a board to explain that they are struggling to get the attention of their third party provider who is prioritising other clients in restoring a critical service and they will explain very effectively

Outsourcing, particulary of IT services, has become a fundamental component of the operations model

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that there is a fundamental difference when it comes to downside scenarios.

One Direction

The scale of outsourcing in today's enterprises is very well illustrated by an excellent report from the Irish Central Bank in November 2018 which examined the critical outsourced provider dependencies for leading regulated firms in Ireland and the implications for governance, risk management and board oversight. Figure 1 below illustrates a very concerning insight into the extremely high level of dependency financial firms have on outsource providers. The following commentary from the report illustrates the depth of concern around outsourcing and the oversight by board teams: "The level of board awareness and quality of governance and risk management remains far from satisfactory. Significant and proactive action is still required by boards and senior management of regulated firms across all sectors to meet minimum supervisory expectations in relation to Outsource Provider (OSP) governance arrangements and risk management controls. Strong business continuity plans which incorporate the activities of OSPs, must also be maintained and managed to ensure outsourcing by a regulated firm of any activity does not compromise that firm's resilience. Findings from the Survey and our supervisory engagements suggest that this is not the case in many regulated firms".

This heavy dependency of financial services companies on third party outsource providers is mirrored in the UK and internationally. On 5 December 2019, the Bank of England Prudential Regulation Authority (PRA) launched a consultation process on 'Outsourcing and third party risk management'. The Financial Conduct Authority (FCA) in the UK has significantly strengthened its guidance on the oversight of outsource providers.

While the financial services sector is uniquely dependent on outsourced providers, I believe that outsourcing, particularly of IT and technology services, is embedded in the fabric of the majority of organisations and the level of outsourcing is only heading in one direction – upwards. I strongly believe, based on our board engagements, that the findings of this report mirror the findings of any similar report anywhere around the world and that outsourcing has become a major oversight blind spot for a significant number of board teams. Many board directors I have engaged with have indicated that they only realised the extent of third party outsourcing when something actually went wrong. Many other board directors would also admit that they struggled to fully understand the ramifications of IT outsourcing due to their own lack of IT and technology expertise.

We are also starting to see an increasing number of fourth party problems whereby a serious outage in the service provision by a third party provider to an enterprise is actually due to an outage in a fourth party to whom they outsource a key part of their service. In some cases, the fourth party may be a small provider that was never visible in the SLA negotiations with the main third party provider. This starts a very serious compounding problem in times of crisis as the enterprise can really struggle and be powerless to control the timing and prioritisation of
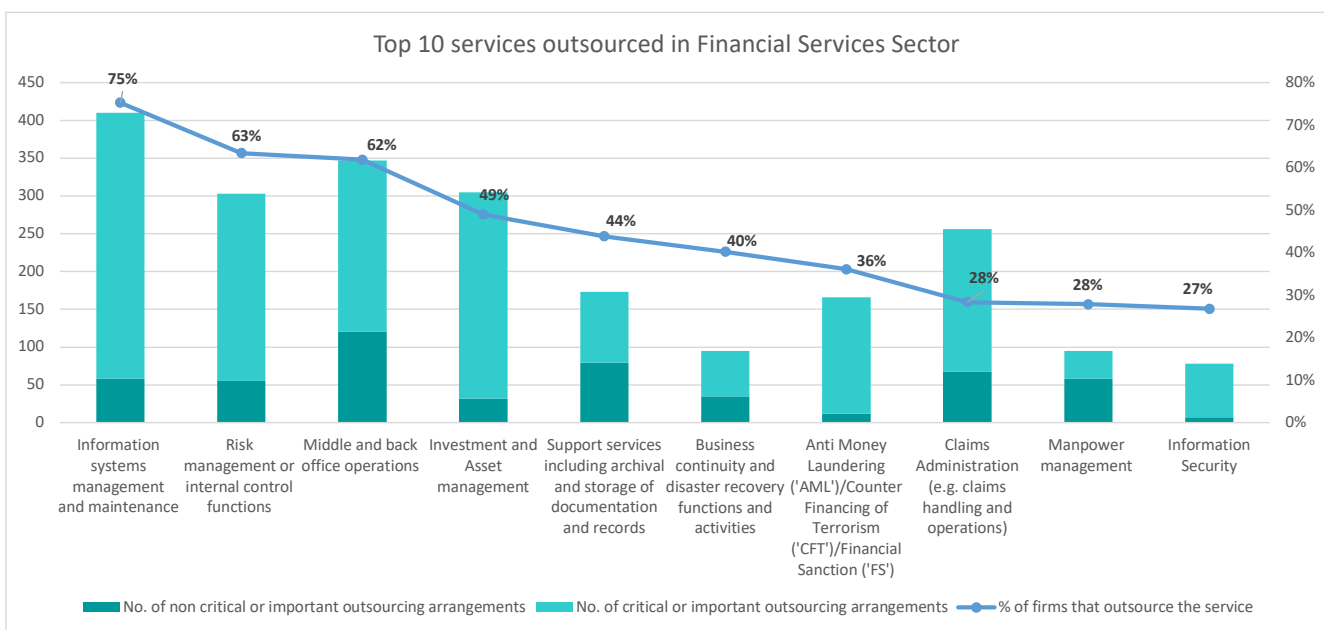

Figure 1 - Central Bank of Ireland Outsourcing report, Nov. 2018

the chain of outsource providers who themselves have multiple clients who may also be experiencing an outage.

Best Practices

So what are the best practices that strong board teams use to ensure that they have the proper levels and approaches to oversight when it comes to outsource providers?

Governance

Board Awareness and Control – ensuring the board is fully aware of the scale of outsourcing dependencies and associated risks.

Outsourcing strategy and policy – ensuring that the executive team have a clear strategy and policies in place to enable the board to understand, approve and monitor the performance of the outsourcing arrangements

Responsibility and oversight – ensuring that the executive team have a coordinated risk management approach to the responsibility for and oversight of outsourcing arrangements

Contractual arrangements – ensuring the board is fully briefed and signs off on key contractual outsource arrangements with the appropriate robust SLAs in place and serious downside scenarios properly explained to the board prior to SLA signing

Risk management

Risk assessment – ensuring the executive team implement comprehensive initial outsourcing risk assessments and ongoing periodic risk assessments

Due diligence – ensuring that the executive team conduct and refresh periodically, appropriate due diligence, both financial and operational, in respect of third party OSPs

Assessment of Criticality or Importance of Outsourced Functions - ensuring the executive team determine and track the criticality or importance of proposed arrangements.

Monitoring and Management – ensuring the executive team devote appropriate resources to suitable monitoring, management and on-site inspection arrangements relating to outsourced activities

Skills and Knowledge – ensuring the executive team retain appropriate skills in house for oversight of outsourcing arrangements and/or repatriation or substitution of services, if required

> ## Levels of outsourcing continue to increase across all sectors and with that come additional challenges

Business Continuity Management

Business continuity testing – ensuring the board is fully aware of the structures in place to test and periodically re-test business continuity arrangements

Follow-up on business continuity deficiencies – ensuring that the executive team follow up and address key issues identified in business continuity testing

Exit strategies – ensuring the executive team devise, document and test effective 'exit strategies' or repatriation contingency plans

Flag serious outsourcing issues early – due to the additional complexity of a serious crisis involving third parties (and potential fourth parties), ensuring that the executive team flag serious issues early to the board.

Conclusion

Outsourcing is a fundamental component of many enterprises and organisations today, particularly in the IT area. Levels of outsourcing continue to increase across all sectors and with that come additional challenges for executive and board teams in overseeing the outsourced function and relationship from initial negotiations, due diligence and signing an SLA agreement right through to handling a serious crisis and, in some extreme cases, the enterprise having to take the radical step of either moving the service back in-house or switching to another service provider. There are plenty of cases of high-quality outsource partnerships where there is high-quality oversight, monitoring and strong, well-thought out SLAs underpinned by a proven ability of the outsourced provider to handle unforeseen crises. There are, however, an alarming increase in the number of board teams left flatfooted by a serious outage impacting customers that is caused by an external third party over which the enterprise has very little control. Shareholders and stakeholders have entrusted a critical oversight responsibility to boards. Both from their vantage point and, importantly, from the vantage point of the customers, blaming a third party provider either directly or indirectly for a serious outage or degradation of service, both externally to customers and internally, rings very hollow as an excuse for a poor level of oversight by the board. n