Supply Chain Risk Management

Why does risk management matter?

We manage risk in order to maintain the delivery of essential goods, services, and works when things outside our control go wrong. This protects our customers or clients and maintains the reputation of our organisation, and in the private sector, profitability and shareholder value. Remember – reputational risk cannot be outsourced.

Supply chains present a particular risk to organisations over and above managing risk from internal delivery. Managing risks in supply chains includes managing the risks of suppliers going out of business in recessions, or having difficulty getting the right materials or staff during economic booms. In the latter quality, outcomes and financial factors can all be under strain and require prioritisation.

**Risk management is becoming more essential as a result of**

- Increasingly global markets
- Increasingly complex supply chains

These result in interdependency between suppliers and markets and additional complexity of data flows and information processing.

The UK Public Sector spends £221bn\(^1\) per annum with third party suppliers on goods and services to support delivery of government obligations and policy. Effective management of the risk associated with these supply chains is key to delivery of citizen services.

Many public sector organisations have instigated a risk management strategy to address risk across their sector e.g. Department of Health on behalf of the many contracting organisations within the health sector.

OGC’s remit is across government – there are thousands of public sector organisations buying goods and services. A coordinated, consistent, measurable and evidence-based approach to supplier risk management is essential to provide overview and at the same time be cost-effective.

In the private sector risk management is also of prime concern. Different organisations will apply a range of risk management strategies dependent on their size, sector and complexity of their business and / or supply chains.

**Principles**

Risk cannot be managed without being measured. As a starting point we need an analysis of what we deliver to our clients and customers, and how external suppliers support delivery. There is a need to understand how we are going to manage risk - there are many different aspects of risk - each needs to be addressed.

Risk can be complex, but need not be. The risk management approach adopted needs to reduce the complexity of the problem. There are approaches to address this.

We need to identify what risks (the possibilities of loss or misfortune) might prevent us delivering to our clients and customers. Each risk has an associated probability (likelihood) and impact - how badly each risk would hurt our service delivery. We need to establish a baseline and track changes against this.

Good risk management is proportional to the likelihood and expected impact of each risk. Managing risk is resource intensive. Good risk management balances the cost of preventing or dealing with (mitigating) a risk against the likely cost of doing nothing, of simply taking the risk. Some unlikely or low impact risks are not worth mitigating. We should spend more time and effort managing “critical” risks than managing “low” risks.

Eliminating all risk, even if it was possible, would be disproportionate, inefficient and expensive. Therefore there is a need to manage risk throughout the supply chain continually.

Risk changes over time – mechanisms are required to access information from a wide range of information sources and to analyse this to update the risk management process.

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\(^1\)Public Expenditure Statistical Analysis (PESA), May 2009
Risk management strategies will vary by spend category. Across government, the benefit of applying a consistent risk management process to each area of spend is becoming apparent. Consistent application will deliver improved outcomes. Given the additional risks posed by the economic downturn, including third parties delivering front-line services, OGC have implemented on behalf of the public sector a ‘Horizon Scan’ programme to provide early warning of emerging risks. The principles of this are shown diagrammatically in Figure 1.

You must have high quality information to effectively manage risk. For OGC, undertaking the Horizon Scan programme in a collaborative way across government helps to improve the timeliness and quality of management information on procurement, reduces duplication of effort and increases the effectiveness of the management of risk. This is consistent with best practice.

Figure 1: Business and Financial Risk Assessment

Access to timely information across the full range of dimensions including political, economic, financial, social and environmental is essential. Understanding what this means for each supplier and for our organisation is key to effective outcomes.

A factor of risk in all organisations is the complexity of the internal organisation structures and the aggregate impact on the overall organisation. For the UK public sector risk needs to be managed (kept under control by assessing, measuring and acting appropriately) across all public sector organisations – low impact for individual departments, could contribute to high impact across the sector. A similar dimension can impact on complex private sector organisations, depending on how their overall supply chains are managed. The OGC has a leadership and coordinating role for the UK public sector where many suppliers have multiple customers.

In supply chain terms it is important to understand in the contracting process where responsibility and ownership of specific risks will sit. This should be a clear aspect of the procurement strategy. Failure to do so will result in unmanaged risk and the potential for failure, or duplication of risk management with associated costs and inefficiencies.

An additional dimension to be considered in Supply Chain risk is depth – the number of layers of supply in which the risk is assessed and managed. There are numerous examples of the failure of a sub-contractor bringing failure to overall projects.

**Activities**

Identify the key supply arrangements for your organisation, driven by the key elements of your business strategy. Identify the key suppliers supporting these strands of activity through the development of a set of assessment criteria. These criteria will include the size and criticality of suppliers, the nature of the markets in which they operate, their ownership, funding and financial position, the level of mutual dependency and the length of the commitment. The difficulty of transferring supply to alternative arrangements, should the need arise, is also important. Effective contract and supplier management will identify suppliers that are at risk.
In many cases the key suppliers to an organisation may not be those that you expect – the larger suppliers may in some cases pose less of a risk, although for many this is counter intuitive. Applying a consistent, measured and evidence based approach will identify the correct suppliers to be managed rather than the largest. In many supply markets large suppliers are more resilient – able to raise finance, additional management capacity - than a small supplier without capacity or capability to respond to changing circumstances.

**Suppliers and supply chain**

As stated previously, if things go wrong, customers and clients blame the organisation they can see, not the suppliers to that organisation. Organisations cannot transfer reputational risk, but they can, and should, manage the risk that is inherent in external sourcing. Risk management strategy should be included in the sourcing strategy, reflecting the overall needs of the organisation. Risk management is required throughout the full lifecycle of a contract.

Risk does not stop at first tier suppliers. Arguably visibility of risk with those further down the supply chain is of equal importance – failure to manage effectively at this lower level can result in the same negative outcome as an issue with a prime supplier.

For each of the key suppliers there are a number of areas against which we must establish baseline information and a process to maintain an up-to-date position.

**USEFUL LINKS:**

- **A formula for success**
- **Risk Management guidance**
- **Financial appraisal guidance**
- **Management framework good practice**
- **Risk Management**
  http://www.cips.org/professionalresources/knowledgeworks/knowledgesummary/
- **Supply Chain Vulnerability**
  http://www.cips.org/professionalresources/knowledgeworks/knowledgeinsight/
- **Risk Assessment Template**
  http://www.cips.org/professionalresources/toolsresources/toolstemplates/
- **Risk and Reward**
  http://www.cips.org/professionalresources/toolsresources/toolstemplates/
- **Opening the way... risk management in the supply chain report, Author Dr Helen Peck**
  http://www.cips.org/professionalresources/research/

**This should include:-**

- Is the industry competitive or monopolistic?
- Are the business goals of the supplier compatible with ours?
- Does the supplier have the appropriate resources - capacity, financing, staff, management, leadership and governance?
- What proportion of their business do we account for - are we a risk to them?
- What is the nature of our relationship with them – combative, partnership?

**In addition, for the further levels of the supply chain, we also need to know**

- How does the supplier manage risk - how well do they manage their suppliers – across a similar range of criteria on a rigorous programmed basis?
- Are the goals of our contracts with them cascaded?
- Do we formally have visibility of their risk management?
We need a strategy to control each risk. The strategies should include:

Avoid – do not undertake the activity. If the activity is essential the risk must be accepted and managed.

Minimise – reduce either the impact or the probability (or both) e.g. where appropriate requiring parent company guarantees and link financial distress provisions to the parent company’s financial performance.

Spread – develop ‘insurance’. For example, source from more than one supplier, although lowest price point may not be achieved. To be effective multiple sourcing requires knowledge of any supplier interdependencies e.g. second or third tier supply.

Accept – best overall strategy, particularly if low impact/probability and alternative strategies are not deemed effective or efficient. An example might be where organisations no longer insure low value capital goods, but replace these as they wear out or suffer accidents. Overall, this saves money compared to the cost of insurance.

The economic benefits of active risk management

Active risk management can have economic benefit. Management of risk is not only about certainty of supply – it can also directly result in economic benefit. A public sector example is the collaborative procurement of energy. All public sector organisations use energy. Until a few years ago, many bought it themselves. The first stage of the work performed by the OGC led Collaborative Procurement Category team for Energy was to understand how energy was bought right across the public sector – from Local Authorities to major, centralised departments such as the Ministry of Defence. There was a wide variety in the pricing achieved by different buying methods – often more than 50 per cent – and also of the associated risk profile linked with the volatile commodity market.

Through extensive research and benchmarking the team was able to demonstrate that taking a flexible approach to energy procurement was the best way to balance risks with attaining the best value for money. Working with public sector bodies has reduced the overall risk to supply problems whilst at the same time reducing prices.

Capacity and capability

Managing risk requires both capacity and capability. In government, one of the objectives of the Government Procurement Service is to ensure that procurement professionals are trained, including having the right skills to manage risk in their jobs.

Summary

Risk management is always essential when we depend on suppliers for capability or capacity. We need to consider what the risks are that might prevent our organisation delivering essential services, goods and works. We also need to consider the collective risks our wider organisation (e.g. the whole of government, or a multi-division company or group) faces.

A rigorous programme of information gathering, monitoring and action is required to effectively manage risk. Appropriate management, governance and escalation must be in place.

Effective risk management is not about elimination of risk. It is about providing time to assess, plan and react to changing circumstances. We cannot eliminate risk, but we can mitigate it through effective management.

Checklist

You must ensure that your strategy:

> Addresses all risks and is proportional to the level of risk
> Details the escalation triggers and activities
> Addresses in a timely manner the impact of economic, political, technological and social changes
> Includes governance and appropriate resourcing and capability.