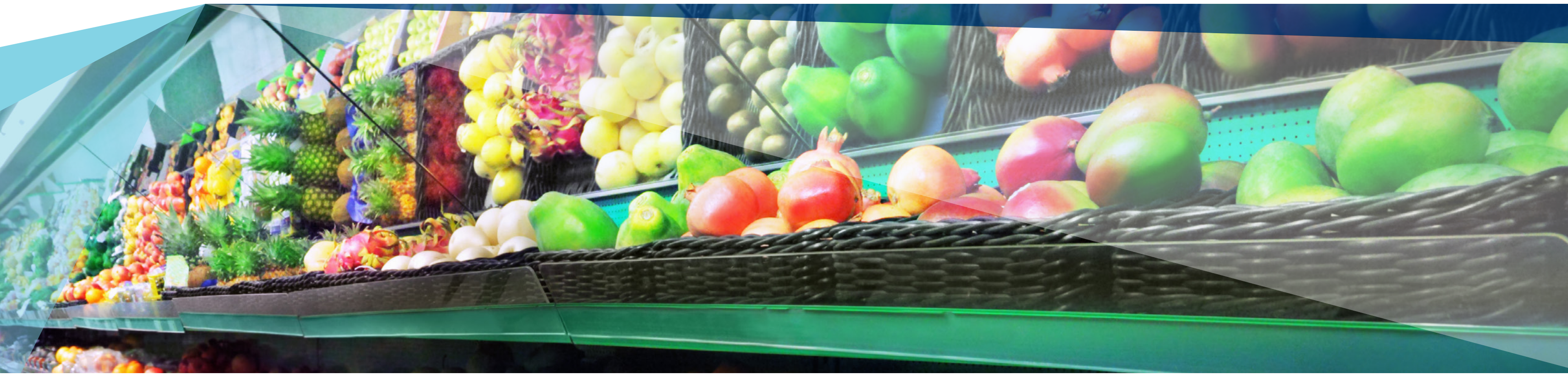
TAKING STOCK

TRUST, BUT VERIFY — MANAGING VENDOR AND SUPPLIER RISK



As the risk professional at a large grocery chain, you're always on the lookout for risk exposures that could affect your company's bottom line and reputation. You have instituted risk mitigation strategies in all of your stores, but when one of your suppliers has to recall their peanut butter product, you're reminded that there's some risk on your shelves that you don't have control over.

A product recall is just one example of a third-party risk that can arise from vendor or supplier relationships. Knowing the right questions to ask when first establishing the relationship can save you untold money and time when a problem crops up.

QUALITATIVE AND QUANTITATIVE RISKS

When establishing your approach to handling risk exposures that could be created by vendors and suppliers, your first step should be to look at your risk bearing capacity. How big a loss can you absorb?

In the retail, wholesale, food, and beverage space for example, there are thousands of suppliers — it's impossible to review every single product or supplier. Instead, consider employing a risk scorecard methodology to group products by the level of risk they pose — high, medium, and low. From there, it's simply a process of working on the highest risks first, and those typically get reviewed with greater frequency.

Digging a bit deeper, there are two types of risk to evaluate, one of which is quantitative. This evaluation includes looking at your risk tolerance, appetite, and risk-bearing capacity. This is a financial calculation that involves the development of tenable loss scenarios, where historic loss activity is identified — what did those losses look like; how often did they occur?

The other type of risk is qualitative; this refers to things like brand name and reputation. For a company that has built its name around a specific principle, damage to qualitative exposures can be catastrophic. For example, a company that prides itself on being authentic, and committed to being a steward of nature and the outdoors, would suffer damage to its brand if one of its suppliers was found to be polluting rivers and streams. This is something that could drive away consumers and take years to rebuild trust.

Qualitative risks added to quantitative risks equal your total risk. Companies' boards of directors typically have discussions around risk appetite annually, but the actual risk assessment is usually done every three to five years, unless there's a big change in the risk profile.

WHAT PRODUCTS ARE CONSIDERED HIGHER RISK?*

FOOD/PHARMACEUTICALS:

- Pharmaceuticals/nutraceuticals.
- Leafy greens.
- Raw eggs and egg-based products.
- Pet food.

DURABLES:

- Trampolines.
- Children's products, furniture and clothing.
- Anything with flame or fire.
- Window shades and blinds.
- Tree stands.
- Guns, ammunition.

*Only a partial list

In completing a risk assessment, consider how your company would answer the following questions:

- How is the balance sheet protected?
- How is compliance with regulations enforced?
- Ultimately, how is the brand protected?

Within the qualitative and quantitative risk groups, you have events surrounding safety — like food or product recalls initiated by the vendor, but which you may be sued for by the consumer. Additionally, it may be the vendors or suppliers themselves that have problems, which you suffer the effects of. For example, during Hurricane Irma, many grocery stores sold out of almost every product because the supply chain was so disrupted.

INVESTING IN RISK MITIGATION STRATEGIES

Both brick and mortar and e-commerce companies face risk exposures and adverse company experiences – which can damage their brand and reputation – as a result of the actions of their vendors and suppliers. For example, a grocery store might hire a company to fix the freezers in its frozen food section, but if it isn't done correctly and creates a hazardous situation, a customer could be harmed. An e-tailer may lose revenue and customers in the event of a data breach resulting from a vendor's access to their systems or a system interruption through the accidental insertion of malware from a supplier's logistics interface with the e-tailer.

So how do you protect yourself when entering into a new relationship with a vendor or supplier?

- First, ask yourself a basic question: is this organization capable, qualified and do they have the financial resources to deliver the goods or services you have contracted for with them?
- Second, make sure any company under consideration aligns to your values, and get specific information. Sound risk mitigation requires going beyond "handshake agreements" where a vendor says it will "take care of everything" if there's a problem. You want to have your supplier/vendor agreements in writing, with indemnification wording in favor of your organization.
- Third, find out if the company you're going to do business with is public or private. If it's public, it should be easy to determine whether or not it has the financial assets to back you in the event of a problem. Additionally, you want to make sure it has the right type and amount of insurance and all the proper documentation. Most importantly, require suppliers to sign a certificate of indemnification and to list your company as a named insured on the their liability policies.
- Leverage risk metrics to prioritize programs and tasks.
- For owned brands, integrate safety compliance into the product lifecycle.

Risk mitigation experts can also improve overall risk assessment — including identifying areas where a company may be creating hazards by being too risk averse. For example, when company leaders rely on personal beliefs or experiences, and urban myths, they can't make fact-based decisions and may be holding back the company's own growth.

Insurance placements are also part of the risk mitigation conversation. Limit of liability is a very common question. In the grocery space, typically commercial general liability should be between $2 and $10 million, with higher risk products getting higher limits.

MANAGING THE PAPER TRAIL

A retailer may have 50 thousand vendors and suppliers doing everything from selling a soft drink brand, to replacing windshields. There are documents for each, so a claim presents a potentially giant paper trail to follow; at each company. When considering buyers, logistics, supply chain and procurement, there might be two thousand people to manage over 15 thousand contracts. While many retail companies still manage their vendor/supplier contracts manually and via paper, some are using technology based systems to manage this process.

The following is recommended to augment existing product liability risk assessment & management systems:

- Identification and management of risks in central library. For example, design hazard risk analysis and a failure mode analysis for both design and production.
- Performance of regular risk assessments on products and suppliers.
- Risk-based desktop and field audits and "stress" tests.

RISK TRANSFER CONSIDERATIONS

In the event of a loss, it is important for a sound insurance program to be in place to help mitigate potential financial losses. Some US insurance carriers have policies specifically designed for vendors/suppliers of retailers with minimum premium as low as $50,000 for US coverage. Below are some typical features of such policies:

- Domestic US Primary and Excess Coverage.
- International Coverage.
- Third Party Administered Claim and Risk Control Services.
- US coverage: primary limits up to $5 million occurrence/$10 million aggregate with excess limits available.
- Foreign coverage option: primary up to $2 million per occurrence/$4 million aggregate.
- General aggregates available on a per supplier basis subject to underwriting review.

As with most risks, despite best efforts and implementation of best practices, there is always the chance of a problem arising. By implementing sound best practices and ensuring the vendors and suppliers you work with provide appropriate indemnification wording and have adequate insurance coverage, retailers can minimize the financial impacts in the event of a loss.

MARSH

This briefing was prepared by Marsh's Retail/Wholesale Practice, in conjunction with Marsh Risk Consulting with contributions from risk management professionals from a national outdoor sports retailer and a national grocery store chain.

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