EXTENDING ORGANIZATIONAL BOUNDARIES THROUGH OUTSOURCING: TOWARDS A DYNAMIC RISK MANAGEMENT CAPABILITY FRAMEWORK

Abstract

Pressure to maintain organizational profitability in an increasingly uncertain business environment is driving executives to seek competitive advantage by increasing their dependence on outsourcing, consciously taking on the additional risk this creates. While risk management around outsourcing is traditionally perceived as avoiding "bad things happening", this paper extends this view to align it closer to the board and executive leadership strategic agenda, enabling them to consider the full spectrum of potential opportunities that outsourcing could create for their organizations, particularly those that are more radical or transformational in nature. Building on insights from the dynamic capability theory and empirical data collected via survey and follow up interviews of top executives, we offer a framework that encompasses two new capabilities integral for vendor management activities: (a) the capability to have a broader perception of risk in outsourcing that recognizes opportunities that these risks present in addition to the threats and hazards; and (b) the "asset orchestration" capability to develop more mature risk management mechanisms that enable organizations to maximize the opportunity while addressing the risk. The framework provides multi-industry perspectives on gaining competitive advantage and risk-mitigation through a newer and more dynamic approach to outsourcing and related risk-management.

Keywords: Strategic outsourcing, Risk, Executives, Dynamic capability, Innovation

INTRODUCTION

As outsourcing[i] of information technology (ITO) and IT-enabled business processes (BPO) matures as a major trend in the global economy, it is increasingly becoming a strategic Board-level[ii] activity, which is driving competitive advantage and value-creation. In such a pursuit, organizations have progressively increased their levels of dependence on outsourcing to unprecedented levels (Forrester

Research, 2013; Gartner, 2014; Deloitte, 2015), exposing themselves to newer risks and hazards in the turbulent business environment (Starbuck, 2014; Oshri, Kotlarsky, & Willcocks, 2015; Deloitte, 2016). While most academic research to date examined risk management around outsourcing with the mindset of preventing "bad things happening", focusing primarily at the operational issues faced by middle managers such as contract or delivery managers (e.g., Oshri, Kotlarsky, & Willcocks, 2007; Gefen, Wyss, & Lichtenstein, 2008; Handley & Benton Jr., 2012; Mason, Oshri, & Leek, 2012), strategic perspective on managing outsourcing risks with a mindset of creating value for organizations has not been addressed. In this paper we extend the operational view on outsourcing risks to include strategic aspects that are key concerns for top executives who need to consider the full spectrum of potential opportunities that outsourcing could create for organizations, particularly those that are more radical or transformational in nature.

The increasingly uncertain and complex macro-economic and business environment since the last global financial crisis is putting pressure on Board-level executives and business leaders to think outside the box about ways to make their organizations more efficient, competitive and profitable (e.g., Okhmotovskiy & Shin, 2018; Hulsbeck, Meoli, & Vsimara, 2018). In his article "Why corporate governance deserves serious and creative thought" in the *Academy of Management Perspectives* in 2014, Starbuck makes a strong argument that risk management as part of corporate governance should continually consider technological and social changes such as networking and alliances, which are propelling corporations toward entirely new organizational forms. Further, citing the United Nations Global Outlook (2013), he comments that businesses will continue to face growing economic uncertainty and turbulence, requiring them to develop new capabilities to increase their maturity in risk management in this environment. It emerges as another important under-studied area, seeking researchers' attention.

Earlier studies (e.g., Beske, Land, & Seuring, 2014; McAdam, Humphreys, Galbraith, & Miller, 2017; Akbar, Baruch, & Tzlkas, 2017) have long recognized the generic vendor relationship management ability of organizations as a dynamic capability. Building on such earlier studies and drawing insights from the dynamic capabilities theory, we propose two new organizational capabilities for exploiting the full spectrum of opportunities from outsourcing in an uncertain and volatile environment:

- First, the capability to have a broader perception of risk in outsourcing that recognizes opportunities that these risks present in addition to the threats and hazards.
- Second, the capability to develop more mature risk management mechanisms that enable organizations to maximize the business opportunity created from outsourcing while mitigating the risk in this uncertain and complex environment.

This dual focus on exploiting the opportunities while managing the risk is referred to as "astute decision-making" in this paper. By integrating theory and research findings around the new capabilities described above, we offer a forward-looking framework that can enable organizations to understand their current positioning and select a possible trajectory going forward to emerge as astute decision-makers. We illustrate this by providing a four-pronged perspective, based on exemplar case studies from our empirical research, involving high profile industry players across multiple industry segments.

DATA COLLECTION

We carried out a survey of 113 senior executives of large global organizations to investigate current and emerging risk management practices in outsourcing amongst large global organizations, in collaboration with one of the top tier global consulting firms. The respondents to this survey were responsible for outsourcing risk management in their organizations, and included Chief Finance Officers (CFO), Heads of Procurement/Vendor Management, Chief Risk Officers (CRO), Heads of Internal Audit and those leading the Compliance and IT Risk function. They represented industries across all the major industry segments, though a substantial proportion of responses were obtained from organizations in Financial Services (FS) (34%), followed by Healthcare and Life Sciences (HLS) (26%), and Business and Professional Services (BAPS) (17%). Analysis of the survey results revealed clusters emerging around these three key industry segments, thus providing us the confidence to segment our case studies by industry. A potential fourth cluster was seen to emerge around Public Sector organizations together with Consumer Business (CB), Energy and Resources (E&R) and Technology, Media and Telecom (TMT), which accounted for about 9% of respondents. These organizations typically had a high public exposure (PE) and were therefore inherently risk averse, like their Public-Sector counterparts. The risk-averse mindset of these PE firms was reflected in their reluctance to adopt more innovative approaches to outsourcing due to their increased public accountability.

More than 70% of the sample firms had annual revenues in excess of US$1 billion and are based in Europe and North America. The questionnaire was split into four sections with an initial filtering question to identify and select those research organizations that were pursuing ITO/BPO: (a) Background/context of the respondent’s third-party or outsourcing ecosystem; (b) Mechanisms for managing risk; (c) Accountability and ownership; and (d) Technology, delivery models and other evolving issues/good practices.

The survey was followed by one-on-one detailed interviews with 23 of the survey respondents, available and willing to provide a deeper understanding of these areas, supported by illustrative examples and direct quotes.

INNOVATIVE APPROACH TO OUTSOURCING: MAXIMIZING OPPORTUNITIES, MITIGATING RISKS

Today, outsourcing is increasingly seen as a way to explore opportunities for innovative thinking (Oshri et al. 2015), beyond operational efficiencies that has been traditionally considered to be main outsourcing benefits. Murphy, Wu, Welsch, Heiser, Young, & Jiang (2012) define innovative or “entrepreneurial outsourcing” as the identification and exploitation of previously unexplored opportunities innovatively through outsourcing. Most of the emerging literature on innovation in this context has focused on processes, practices, and decisions (e.g., Damanpour, Sanchez-Henriquez, & Chiu, 2018) that have led to the development and delivery of innovative and new products/services through outsourcing (Ordóñez de Pablos, 2012). Won (2015), who attempts to theorize the influence of innovation and entrepreneurship in the determination of insourcing vs. outsourcing decisions, demonstrates how such considerations in sourcing decisions can increase organizational agility and flexibility through outsourcing. Innovative thinking also influences the choice of sourcing mechanisms in favor of those aiming to exploit the newly recognized opportunities to create a sustainable competitive advantage that would be challenging for competitors to imitate, as evidenced below.

Maximizing the Opportunities

Vagadia (2012) lists five pillars of potential competitive advantage through outsourcing in the era of globalization, despite the risks involved and no guarantee of success: *focus*, *efficiency*, *skills and knowledge*, *technology*, and *new products and markets*. The following examples provided by respondents during our follow-up interviews illustrate how the more progressive organizations are starting to innovatively extend their boundaries through outsourcing, along these five pillars.

Focus: redefining what business you are in, in convergence with business partners/long-term service providers that possess complementary skills.

Example: A European paper manufacturer reported how it reinvented itself as a bio-energy producer by implementing bio-refinery units in its existing pulping mills to process biomass into energy to generate new revenues. Having operated with in-house IT teams and a strong regional culture since inception, the organization's Board recognized the risks and debated extensively over multi-sourcing IT and business processes for its new energy business to three firms operating in India, Poland and the Philippines as their delivery centers. This, in the Board's view, was the only feasible alternative to facilitate a timely transition, expedite revenue inflows and secure competitive advantage.

Efficiency: seeking out cost and process efficiencies through lower-cost providers with core competencies in outsourced processes.

Example: Two of our survey respondents (new-generation challenger banks) reported having implemented a number of vested outsourcing contracts based on long-term partnering. They shared profits from innovative continuous improvement based on actual benefits-realization with vendors.

Skills and knowledge: seeking global skills and knowledge with a worldwide workforce across multiple time-zones to evolve as a 24-hour company.

Example: An interviewee from the HLS industry reported that they were exploring the concept of launching a "*Darty button*" to provide immediate response to their customers, irrespective of geographical location, enabled by a combination of outsourced service providers. The Wifi-enabled device (costing Euro 25) was pioneered by the French electronics chain Darty, and enables its customers get a call back from the nearest customer service representative within one minute, including items not covered by warranty or procured outside Darty (*The Times*, 2014). The company calls this "*prioritized personal support,*" developed and operated by outsourced providers.

Technology: using global technology capabilities to establish a connected ecosystem for enhancing collaboration opportunities across business partners.

Example: A large global financial services organization with over 10,000 third parties forming its outsourcing ecosystem reported how it had joined a community of large organizations working together to reduce duplication of effort in third-party pre-qualification and on-going assessment, based on pre-agreed common risk-management standards and performance data they had collected collaboratively. This collaboration was facilitated by an outsourced external intermediary. Using cloud-based and other agile technologies, this vendor provides access to a hub of validated data and analytics, helping organizations in the network manage outsourcing risks efficiently and cost-effectively.

New products and markets: offering new products and services, innovatively developed or operating in new markets through business partners and long-term providers.

Example: A global provider of IT and BPO services reported that it was partnering with a large European bank with operations in more than 20 countries to converge various internal finance functions (cost centers) of the bank into shared services utilities and eventually transform them into market utilities servicing other banks as revenue-generating profit centers. They aligned and simplified standardized risk, regulatory and financial reporting processes and modernized technology, reducing total cost of ownership by 32%.

Mitigating the Risks

The nature of the evolving threats to such innovative outsourcing is also compelling organizations to continuously focus on sensing and addressing risks dynamically. Davari & Rezazadeh (2015) recognize outsourcing decisions as one of the most complex organizational decisions, requiring a thorough evaluation of the benefits on one side and the barriers or challenges on the other from the perspective of fostering innovative thinking. Our interviewees, on a similar note, agree that the risks associated with outsourcing continue to increase in proportion to the rewards and that recent examples of high-profile business failures have demonstrated that third-party risk management has not always been given the strategic attention it deserves.

Inappropriate actions or failures of third parties have impaired the achievement of strategic objectives (e.g., a business model failing to achieve growth and profitability targets), compromised organizational reputation, impaired business continuity/resilience and attracted regulatory enforcement action. An interviewee gave us an example of an incident which acted as a change driver to stimulate rethinking in their organization. A major supermarket chain in the USA faced a cyber-attack (in November 2013) in which 70 million items of shoppers' personal data and 40 million credit card details were stolen. The initial intrusion was through network credentials stolen from a third-party vendor, followed by a malware-laced email phishing attack sent to employees of the vendor organization. The supermarket faced losses exceeding $400 million including costs of reissuing millions of cards by issuers; fines for Payment Card Industry non-compliance; and direct customer service costs, including legal fees for customers affected by the breach.

Many of our interviewees from the FS industry referred to recent cases of regulatory enforcement by the Financial Conduct Authority (FCA) in the United Kingdom that resulted in fines ranging from US$67 million to US$500 million on banks for failures caused by their outsourced providers, which compromised customer interest or impaired their ability to access banking services.

A 2016 global survey on outsourcing and third-party risk conducted by Deloitte[iii] mirrors our empirical evidence that enhanced regulation and concerns about cyber fraud, data security and privacy are expected to challenge organizations using outsourcing as part of a business model. Further, the lack of appropriate senior-level executives managing outsourcing in the retained organization[iv] may impair innovation intended to enhance value to the business.

Furthermore, empirical evidence from the survey demonstrates that organizations are going beyond traditional financial and compliance-related risks (McConnell, 2013; Marsh, 2014) to recognize the strategic impact of outsourcing. This supports arguments put forward by researchers that contract design and management of outsourcing should be recognized as a capability and a source of competitive advantage for a client firm (e.g., Harrison & McMillan, 2006), which in turn can enable better product or service innovation or provide access to skills and capabilities not available internally. Outsourcing service providers that bring in new knowledge and experience can thus be utilized as knowledgeable partners or trusted advisors, able to catalyze organizational innovation, provide strategic insights and even feature on organizational Advisory Boards (Deloitte, 2015).

All of the above evidence demonstrates how organizations now need to refresh their approach to emerge more flexible, adaptable and innovative so that they may maximize the strategic opportunities while mitigating the risks. The need to develop this organizational ability therefore leads us to examine how the DC theory can be extended to address the emerging demands.

INSIGHTS FROM THE DYNAMIC CAPABILITIES THEORY

The dynamic capabilities (DC) theory emphasizes the flexibility and adaptability of organizations and their efforts to act strategically, embrace newer opportunities, and even shape the business environment (O'Reilly & Tushman, 2008; Teece, 2014). In this section, we discuss selected insights from the DC theory that can be related to developing the two specific capabilities around risk management that form the core of this paper and *define the two axes of our 2x2 framework:* (a) a broader perception of risk in outsourcing that continually recognizes the opportunities that these risks present in addition to the threats and hazards; and (b) mature risk-management mechanisms that enable organizations to mitigate the risks while maximizing the business opportunity from outsourcing.

Both these new capabilities require the organization to act strategically and with flexibility and adaptability in order to innovatively embrace the new opportunities by graduating from an ordinary capabilities mindset to a dynamic capabilities mindset. Accordingly, it is first important to differentiate between ordinary and dynamic forms of capabilities from a theoretical perspective.

Insight A: Difference between Ordinary and Dynamic Capabilities

The former involves the performance of administrative, operational, and governance-related functions that are necessary to the execution of current plans. They are embedded in some combination of (1) technical skills; (2) facilities and equipment; (3) processes and routines; and (4) the administrative coordination needed to get the job done (Teece, 2016). As a result, much of the knowledge required to acquire ordinary capabilities can be bought in through consultants who can help design processes or implement technologies or through investment in training (Bloom, Eifert, Mahajan, McKenzie, & Roberts, 2013). Although such capabilities are valuable for businesses, in a competitive business environment these typically get imitated by competition within relatively shorter periods of time (Bloom, Genakos, Sadun, & Van Reenen, 2012).

Dynamic capabilities on the other hand are more innovative in nature and can enable an enterprise to re-focus its attention towards pursuing novel opportunities which do not come with guaranteed success, develop new capabilities, and effectively coordinate (or "orchestrate") internal and external resources to address and shape shifting business environments (Teece, 2016). Strong DCs can allow an enterprise to generate superior profits by developing and producing differentiated products and services that address new markets, or existing markets in new ways (Teece & Pisano, 1994). The strength of a firm's dynamic capabilities determines the speed and degree to which the firm's resources can be aligned and realigned. To achieve this, organizations must be able to continuously sense and seize opportunities, and to periodically transform (Eisenhardt & Martin, 2000; Aktas, Adnreou, Karasamani, & Philip, 2018).

To summarize, ordinary capabilities are about being efficient; dynamic capabilities are about learning and improving and about being innovative. Strong DCs are vital for firms facing dynamic competition and, possibly, significant disruption from competitive behaviour (Sidak & Teece, 2009). According to Chatterji & Patro, (2014) these broad sets of activities have been called "asset orchestration." These scholars note that very few specific examples are available to demonstrate how this capability operates in practice. Our literature review leads us to concur with this view. However, we address this limitation of earlier research and demonstrate how it operates in practice in the context of outsourcing risk management by providing a direct linkage between the related criteria proposed by Teece (2016) on the two axes of our 2x2 framework (Figure 1).

Insight B: Dual-focus on Threats and Opportunities

In line with our proposed framework, the DC theory envisages the development of an over-arching ability to keep a dual focus on recognizing threats along with the opportunities presented by its dynamic and competitive business environment (Teece, 2016).

Insight C: Concurrence of Routinized and Independent Innovation

Dynamic capabilities scholars define innovation as creative ideas related to the generation and delivery of products or services that are new to the world or just new in a given context (Teece, 2016). These creative ideas can either:

- Extend existing activities in some way (improved risk management processes, proactively "sensing" risks in the business environment, using emerging technologies to process real time data such as cloud, predictive analytics, visualization of risks etc.) i.e. "*routinized innovation*"; or
- Be completely new and create a new market and revenue streams, satisfy a previously unrecognized customer need or develop and commercialize a new approach to technology, i.e. "*independent innovation"*) (Baumol, 2002).

How well a firm fosters both types of innovation (in this paper, through outsourcing) to simultaneously seek competitive advance is based on the strength of its dynamic capabilities (e.g., Beske, Land, & Seuring, 2014; Teece, 2007). Our earlier examples of innovative outsourcing, as well as the multi-industry perspectives that follow, demonstrate this concurrence in practice.

Insight D: Ownership and Accountability for Developing Dynamic Capabilities

Both our literature review and empirical research reflect similar views on ownership and accountability for implementing DCs in an organization compared to establishing risk-management mechanisms for outsourcing, which once again establishes a common foundation in relating the two. Although led by Boards and organizational leadership, the ownership and accountability for developing and leveraging dynamic capabilities in an organization resides, in part, with individual managers and the top management team (Adner & Helfat, 2003). The ability of board members and the top management team to have continued macro- and micro-level insight is important to reallocating resources to lead the firm forward. Teece (2016) is of the view that this is likely to be the most visible feature of the firm's DCs. At the same time, the dependence of DCs on the knowledge of individual managers and in idiosyncratic ("signature") organizational routines that have developed over time makes them hard for rivals to imitate (Gratton & Ghoshal, 2005).

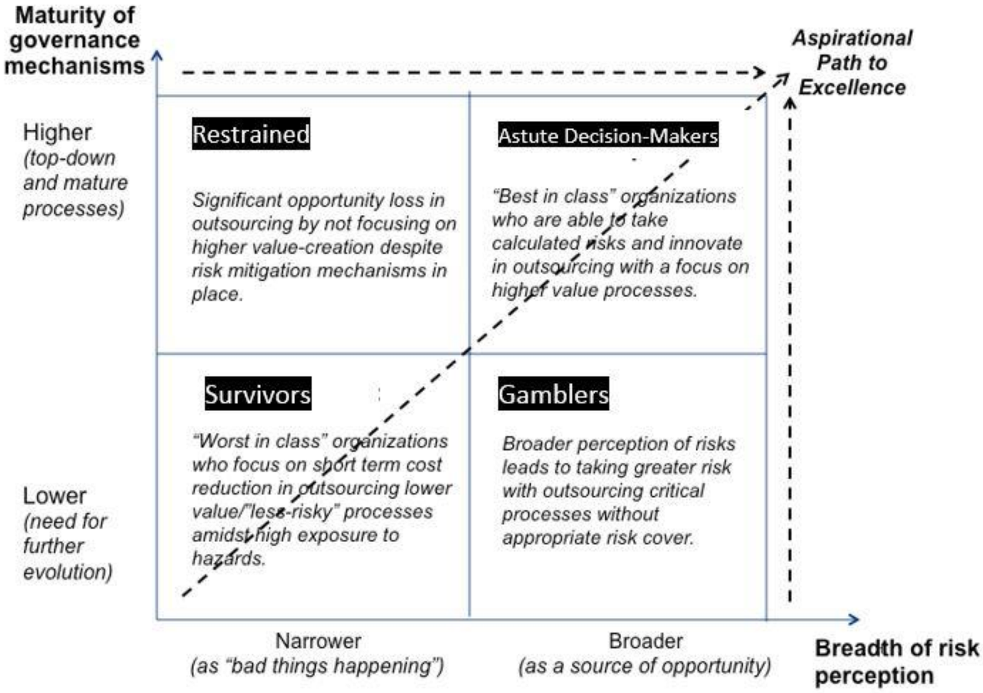
A FRAMEWORK FOR ASSESING ORGANIZATIONAL POSITIONING FOR INNOVATIVE OUTSOURCING

Our findings, based on the primary data, indicate that outsourcing organizations are at different stages of evolution and maturity with regard to developing an organizational capability to (a) enhance their perception of risk, and (b) optimize the maturity of the related risk-management processes along a continuum, the combination of which impacts their ability to be more strategic and innovative in their approach to outsourcing.

Organizational Positioning for Innovative Outsourcing

Based on the breadth of risk perception and maturity of risk-management processes, organizations can be mapped to a two-by-two framework set out in Figure 1. Multi-industry perspectives that follow illustrate each element of the proposed taxonomy in Figure 1 subsequent to our analysis of organizational attributes for both the horizontal and vertical axes below.

Figure 1: Framework to Assess Organizational Positioning for Innovative Outsourcing



Enhancing the Breadth of Risk Perception (Horizontal Axis)

The review of literature and empirical evidence gathered through our survey enables us to offer key characteristics of organizations that demonstrate a *higher breadth of risk perception*, aligned to the DCs framework, evidenced in the case studies that follow.

- First, these research firms appear to have graduated from an ordinary capabilities mind-set to a DC mind-set, to be more strategic/innovative in outsourcing. They execute this through a continuous alignment of strategic decision-making considerations around outsourcing with the related risks. This is in contrast to those with a lower breadth of risk perception that still retain an ordinary capabilities mind-set to address current needs, with a primarily focus on avoiding current consequences of "bad things happening" such as breach of data privacy or business interruption caused by the provider of outsourcing services. The latter has been the traditional focus of risk management (Law, 2006; Dionne, 2013).

- Second, research firms with a higher breadth of risk perception establish a continuous mechanism for sensing opportunities and threats, enabled by the Board and accountable leadership teams (e.g. selected members of top and middle management, business unit heads/representatives etc.). This equips them to create value through both routinized and independent innovation while having a holistic view of risks and ensuring this is within their overall risk-taking capacity. This, in turn, enables them to sense, seize and transform such opportunities where expected returns are commensurate with the risks taken (Funston & Wagner, 2010; Kaplan & Mikes, 2012; Elahi, 2013).
- Third, such organizations establish actionable data points to continually monitor performance, using analytical and predictive tools and technology, guided by a top-level independent risk-management function that works with the Board through all the stages of the outsourcing process. This represents a significant shift from post-mortem based compliance auditing (Slywotzky & Drzik, 2005) that encouraged consistency rather than dynamic considerations. (Funston & Wagner, 2010).

Progress in developing all these capabilities has generally been slow, except where triggered by drivers such as regulatory action (e.g., in the FS industry) or extremely high levels of uncertainty/disruptive change (e.g., in HLS businesses).

Increasing Maturity of Governance and Risk-management Processes (Vertical Axis)

Our review of the literature and research data indicates that organizations with a higher level of maturity in outsourcing risk management are better able to continuously align organizational behaviors, structures, processes, and infrastructures to the changing risk spectrum to elevate their standard of risk management. Specifically, we identify the following key attributes of such organizations, demonstrated through the case studies that follow:

- Corporate governance and risk management is a Board and top management-led initiative (e.g., McConnell, 2013; McNulty, Zattoni, & Douglas, 2013). This is supported by other top and middle management teams. It is implemented through a dynamic organizational framework focused on extending the frontline (boundaries) of ongoing organizational risk management beyond the enterprise itself to also cover risks (and opportunities) related to third parties, including outsourced service providers forming the "extended enterprise."

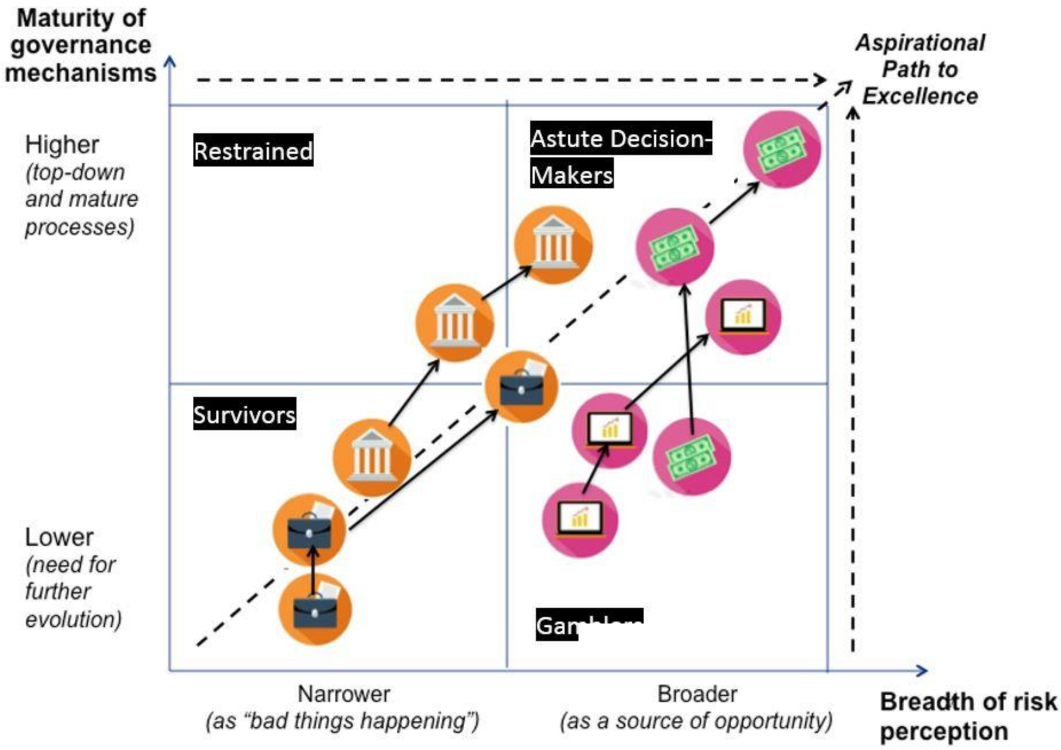
- Being a dynamic framework, this is continually refreshed by having third party/outsourcing risk as a regular Board agenda item (Deloitte, 2017).
- Risk management policies and tactical action plans are continually revisited, refreshed and embedded in revised processes and technology relevant to the organizational macro-environment and business context. Accountability exists not just for achieving results today but also for revisiting these continually in the light of changing business circumstances (Deloitte, 2015).
- The organization is focused on ongoing risk training and competency development, supported by knowledge sharing on risks across various outsourcing projects.

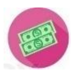
THE ASPIRATIONAL PATH TO EXCELLENCE: MULTI-INDUSTRY PERSPECTIVES

Figure 2 illustrates how each of the four industry sectors are evolving over time, from post-financial crisis to their current positioning, and their future aspirations. It is interesting to note that despite the variances in positioning, a consistent path towards excellence is evident across organizations as all four categories aspire to evolve over time into astute decision-makers, as shown in Figure 2.

This framework can be used by organizations to understand their current positioning, as a first step towards developing plans for reinventing themselves as "astute decision-makers" (upper right-hand quadrant). As explained below, they are able to maximize the opportunities by being more innovative in their behavior, while managing the risks with outsourcing-related management initiatives.

Figure 2: Treading the Aspirational Path to Excellence: Past, Present and Future[v]



Perspective 1: The Astute Decision-Makers: Financial Services 

Astute decision-makers are best positioned to maximize the opportunities arising from outsourcing and innovate in outsourcing (Oshri et al., 2015). They are likely to have a dual focus on routinized and independent innovation, outsource higher-value processes (e.g., combining new technology such as the cloud or social media, and leveraging their industry with functional knowledge to reinvent processes), while managing a greater level of risks in a dynamic, agile and innovative way in their pursuit of business value through a DC mindset.

Breadth of Risk Perception

Our research data indicates that the FS industry is currently the most advanced across all the key industry segments in its breadth of risk perception and ability to intertwine the pursuit of value in its strategic and tactical decision-making with the related risks. A key trigger for this appears to be the global regulatory focus in this area[vi]. As summarized by one of our interviewees:

> *"Our regulators have pushed us to establish a strong linkage between risk and strategy by clearly articulating our "risk appetite" – a phrase that none of us in the management team understood even five years ago."* [Chief Internal Auditor, European Bank]

Risk appetite reflects the amount and type of risk that an organization is willing and able to accept in its pursuit of strategic goals. In November 2013, the Financial Stability Board (FSB) set out the key elements for establishing and implementing an effective risk-appetite framework, underscoring the roles and responsibilities of the Board of Directors and senior management.

> *"In keeping with the principles for an effective risk-appetite framework, the breadth of risk perception managed through such frameworks has emerged as the primary lens through which FS organizations' quality of risk management and governance are evaluated."* [Regulatory Compliance Officer, Global Investment Bank]
>
> As a pre-requisite to achieving this effectively, most FS organizations have repositioned their risk-management function as an independent but integrated top-management function, headed by a Chief Risk Officer (CRO), typically reporting to the Chief Executive Officer (CEO) or to the Board. To ensure wider stakeholder buy-in and engagement (see earlier discussion on ownership and accountability for developing DC), some of the FS organizations covered by the survey hosted ongoing risk-articulation workshops.
>
> *"Our risk-articulation workshops on outsourcing (also referred to as the "curry club," given the dominance of service providers from India) included staff and even leadership from our critical service providers in addition to our own employees and continually revisited existing perceptions and definitions of risk to establish a shared understanding on risk, as a first step to being able to articulate risks and participate in risk conversations."* [Head of Global Business Services, US-based Insurance Company]

The next step was then to align these integrated organization-wide risk-management initiatives to outsourcing strategy to ensure that conscious risk-taking was enabled through a greater focus on areas of higher risk, enabled through a greater sophistication of real-time tools and technologies.

"We are currently implementing continuous monitoring and real-time risk sensing for outsourcing providers classified as critical suppliers, with ongoing technology investments and collaboration with providers of market utilities for subscription-based services in this area." [Chief Risk Officer, UK High Street Bank]

One of the organizations surveyed and interviewed had initiated a pilot project to evaluate the power of cognitive risk-management technology to enhance their "real-time" capabilities. This aimed to transform and consolidate unstructured data related to suppliers of critical services into actionable intelligence with real-time alerts of notable supplier-related events (e.g. cyber incidents) and customized reports for critical suppliers.

Maturity of Governance Mechanisms

Our survey reveals that FS industries are once again in a leading position, compared to other industry segments, with regard to their maturity of governance mechanisms. Survey respondents and interviewees attribute this high level of maturity to Board and top-management leadership of risk-management initiatives. These are enabled by a dynamic suite of policies, processes, supporting infrastructure, training and talent that are frequently revisited and refreshed to realign to the ever-changing business and operating environment.

"The ultimate responsibility of the Chief Executive Officer (CEO) or a member of the Board (typically supported by the CRO) in FS industries can clearly be attributed to pressure from the regulators." [Member of audit committee, Global Fintech Company]

Key financial regulators now agree that the Board's central role in approving and monitoring strategy cannot be appropriately fulfilled unless the Board understands the risks that strategic changes bring about and ensures appropriate risk management to strike a better balance between risk oversight, growth, performance, and strategy.

This is further evidenced in our research data around the increasing frequency and importance with which outsourcing risk discussions feature on the Board agenda (or the Risk Committee of the Board in US-based organizations).

"Discussions on third party risk management now feature consistently on our Risk Committee as a matter of high priority – a significant change from the earlier reactive mode in which the Risk Committee engaged in these discussions, typically in response to specific third-party related disruptive incidents." [Chief Finance Officer, US Asset Management Company]

To support this elevation of responsibility, FS organizations have made significant progress in establishing dynamic policies that need to be supported by processes, technology, and infrastructure. Such policies encompass the entire life-cycle of the outsourcing relationship and include, for instance, policies related to establishing a business case for outsourcing, pre-contracting and due diligence, knowledge transfer and on-boarding through to ongoing monitoring, assurance and contract termination. As one of our interviewees commented, *"the chain of risk management processes is only as strong as the weakest link!"*

These procedures, in turn, require appropriate real-time tools and technology (e.g., risk-management software packages such as RSA Archer or Open Pages; Third-Party Management software such as Hiperos, etc.), in addition to the technology infrastructure, to ensure secure connectivity with the provider organization.

IT infrastructure and risk-management processes need to be further supported by clear roles and responsibilities that are communicated and understood by those accountable throughout the organization. These individuals must have the skills, experience, and seniority appropriate to discharge their roles effectively. The organization should take responsibility for their competency development to be able to address current and future business and risk-management needs.

"The introduction of the Senior Managers Regime (SMR) by the FCA in the UK in April 2016 has significantly enhanced the focus on having full clarity on allocating prescribed responsibilities to Senior Management Functions (SMF), supported by Management Responsibilities Maps to document key governance arrangements and Statement of Responsibilities for each SMF (to be revisited periodically)." [Senior Regulator, Financial Conduct Authority]

Our research data reveals that investment in such risk management technology and skills is also heralding a unified and consistent approach to managing outsourcing arrangements across multiple contracts, functions and departments of large global FS organizations, some of whom may have 10,000 – 50,000 outsourcing contracts.

Treading the aspirational path to excellence

Based on our survey data, we believe that FS organizations are likely to move diagonally towards the upper-right corner (Figure 2) as they continue to refine themselves as astute decision-makers in outsourcing risk management.

Perspective 2: The Gamblers: Life Sciences and Healthcare

Organizations that perceive risk as a source of opportunity, but without the requisite maturity in risk management mechanisms as they embark on outsourcing, can be called the *gamblers*. This typically leads to greater risk-taking, typically by outsourcing critical and high-value processes (e.g., supporting key managerial decisions such as advanced analytics or critical customer-facing processes) but without appropriate risk-mitigation cover.

Breadth of Risk Perception

The HLS industry has made significant progress in broadening its outlook to risk, not in response to regulation but to address the challenge of managing high levels of uncertainty and disruptive change. The survey reveals that organizations in this industry have an imminent need to evaluate the exposure to risk that strategic decisions bring about in an environment of significant uncertainty, caused by changing demography (e.g., the ageing population in Western countries and related healthcare issues), complexity of increasing lifestyle-related diseases, financial factors (e.g., escalating pricing pressures and eroding profit margins) and increasing innovation (e.g., patient self-care), amid increasing regulation and the need to be more patient-centric through greater use of technology. Our survey respondents and interviewees clearly recognize this development:

"The changes that we are facing in the business and macro-economic environment give rise to new risks, but also open the doors to new opportunities." [Head of Risk, US Healthcare Services Provider]

"To seize these opportunities, it is not enough to be able to avoid the risks but manage them to adopt new technology-enabled ways of working and improving patient services, while increasing revenues and managing costs." [Chief Technology Officer, US Healthcare Services Provider]

In pursuing this view on risks, the explicit link between risk and strategy is increasingly being considered as an integral part of the organizational strategy-setting process.

"We expect our risk-management function to not only address damage-prevention but also help top leadership in making informed business and strategic decisions about growth and expansion, operational challenges and opportunities, and technology adoption and implementation." [Chief Finance Officer, Global Life Sciences Company]

For instance, with the shift in thinking from fee-for-service to value-based care, survey informants explained how healthcare companies are now using their enhanced perception of risk to evaluate the benefits of adopting new capabilities such as those related to emerging technologies, including the "Internet of Things," that could radically transform healthcare delivery. They are also contemplating both risks and opportunities in merging with or acquiring other entities in the supply chain, such as contract research organizations, that augment current capabilities in healthcare delivery.

Leveraging data innovatively, supported by advanced analytical tools and technologies, is increasingly enabling organizational leadership to translate such risk to opportunity.

One respondent organization, for example, operates multiple hospitals and has recently initiated a significant transformational initiative to integrate clinical treatment data with cost data in healthcare service delivery, which earlier resided in separate data pools and was utilized by a completely different set of stakeholders representing lower management teams:

> *"The integration of these internal data pools, together with additional external data related to patient finances and behaviors (e.g., retail purchase history) now enables our risk-management team to segment patients and match the profiles and preferences of patients to care providers (physicians, nurses, etc.) and healthcare delivery choices in each segment. This has established an evidence-based mechanism to ensure that the right provider is providing care under an appropriate setting, to deliver the intended clinical impact."* [Risk Analyst, Global Hospital Chain and Provider of Premium Healthcare]

Traditionally, IT-based transformation projects in this global hospital chain had been delivered by in-house IT and business teams. However, in this case, the organizational leadership chose to take what they considered higher risks by outsourcing the project to an overseas provider to bring in specialized knowledge and skills, innovation and process improvement.

Maturity of Governance Mechanisms

Despite increased risk-taking in the HLS sector, the maturity of risk-management mechanisms in these organizations continue to be relatively lower in proportion to the risks involved. Our survey and follow-up interviews reveal that organizational attitude towards managing outsourcing risk in the HLS sector has traditionally been reactive and determined by who is driving the activity. In some HLS organizations, this has been the responsibility of a procurement team focused on compliance with payment terms for suppliers. In other organizations, it is the brand and intellectual property (IP) protection function that is managing outsourcing risks, focusing on counterfeit drugs and medical products in outsourced distribution channels. Such a decentralized approach to risk has led to a micro-focus on risk areas that interest certain parts of a business, or certain functions (e.g., operational performance from a supply-chain perspective or information security from a corporate security angle), rather than a holistic and integrated approach aligned to strategy or innovation with wider benefits for the organization.

> *"Our Group has a decentralized Contracts & Procurement function responsible for risk management over outsourcing, with teams in various locations. There is an element of*

> *confusion over who the relevant line managers are and, in some cases, only a dotted line back to central team, resulting in less knowledge sharing, too much independence of the team in one location etc.- e.g. they take orders from local senior management who do not always comply with group strategy. This increases the exposure to third party related incidents, potentially resulting in disruption to business, reputation damage and regulatory action. We have now initiated a project to have full clarity on who exactly has accountability for doing exactly what at the corporate centre and at the business unit level, including subsequent ratification of anything that the local team has to do to respond to immediate market opportunities or threats."* [Internal Audit Head (Pharma), Diversified Life Sciences and Healthcare Company]

As HLS organizations struggle to cope with the heightened uncertainty, their outsourcing decisions, together with the related risks, are now starting to feature more regularly on the Board agenda with a high level of urgency. However, while Board and leadership awareness is increasing, our survey reveals that, in practice, risk-management decisions still continue to largely remain vested in the more static operational responsibilities. For instance, one of the HLS organizations included in our survey acknowledged the ultimate responsibility of the Board in outsourcing governance, yet relatively junior staff within the procurement or finance teams were taking key decisions in an isolated manner, based on individual contract considerations rather than holistic perspective: *"Board's involvement in these decisions was largely reactive and typically driven by the need to respond to critical incidents resulting from outsourcing."*

With regard to policies, procedures, and supporting infrastructure, whilst HLS organizations are trying to move in the same direction as their FS counterparts, the survey indicates three primary differences, resulting in the related maturity levels being lower than FS.

- Firstly, outsourcing risk-management mechanisms still continue to be focused at the functional level as discussed above rather than at the organizational level, despite the emerging leadership vision for change.

“Risk-management is driven by the priorities of the functional group leading the assessment. Our procurement teams have a greater focus on operational risks; financial teams emphasize compliance with financial terms, and this undermines the broader organizational focus required on strategic risks (i.e. an issue related to the fundamental business model), regulatory risks (i.e. those driving adverse regulatory action) or reputational risks (that negatively impacts share prices).” [Internal Audit Head (Pharma), Diversified Life Sciences and Healthcare Company]

- Secondly, the focus is on the individual contractual arrangements rather than a holistic and consistent approach that a more mature risk-assessment capability entails, e.g., grouping multiple contracts by supplier under a single suppler relationship manager across all departments, recognizing critical vendors and dependencies for greater focus selectively etc.

- Thirdly, the survey reveals significant gaps between leadership intention and the ability of the supporting processes, tools, and technologies to achieve the intended results. For instance, an integrated set of more dynamic and responsive organizational processes, supported by common real-time technology underpinning outsourcing risk management across the entire organization, was absent in most HLS organizations.

At the same time, the threat of global regulation such as the Foreign Corrupt Practices Act (FCPA), the Global Data Privacy Regulations (GDPR), the Health Insurance Portability and Accountability Act (HIPAA) or the UK Bribery Act (which hold the principal or user organization responsible for the acts of its agents or providers) is compelling HLS organizations to invest in enhancing their maturity of governance processes. This is however, a relatively recent trend and it will take some time for HLS industries to reach the higher levels of maturity that are comparable with the levels attained by FS organizations. Survey respondents also felt that cost and profitability pressures faced by HLS organizations, together with headcount reduction initiatives, may come in the way of investing in personnel competent to focus on risk.

Treading the aspirational path to excellence

Future aspirations captured in our survey indicate that HLS organizations will have a longer-term balanced view and a more deliberate strategic approach to maximizing the outsourcing opportunity, rather than just responding reactively in an isolated, short-term way to the compelling forces described above. Specifically, we expect to see HLS organizations moving more horizontally towards the right-hand side of the grid (Figure 2) than moving vertically upwards, evolving from gamblers to become astute decision-makers, as they continue to face significant changes in their operating environment.

Perspective 3: The Survivors: Business and Professional Services

Diametrically opposite the astute decision-makers are the *survivors* that continue to have a narrower perception of risk and have also not matured in their implementation of risk management mechanisms. Such organizations are yet to fully develop a DC mindset and lucky to be surviving in the future with a focus on present needs only (ordinary capabilities mindset) with potential erosion of organizational value. For such organizations, it is likely that any outsourcing initiatives are focused on lower-value generating and less risky activities (e.g., basic transaction processing or accounting) and they may still face several threats and hazards, even in these limited pursuits of organizational value.

Breadth of Risk Perception

This industry segment has the lowest focus on exploiting the upside or opportunities that risks create for business. Survey respondents believe that this behavior has its roots in traditional partnership-based legal structures, many of which continue to exist even today in the large global BAPS organizations. These structures are managed by the peer control of partners (co-owners) rather than the hierarchical control observed in publicly listed corporate structures. These attributes are reflected in the following quotes from our interviews:

“The professional autonomy of partners in our firm has resulted in the extreme decentralization of operational control, typically driven by the need to address specific client requirements and circumstances.” [Chief Operating Officer, European Law Firm]

“Our financial incentives are primarily driven by the ability to apply professional knowledge to complex client problems measured by client satisfaction with any incentive for profitable risk-taking being adverse, absent or opaque.” [Head of HR and Administration, US Accounting Firm]

The primary focus of risk management thus continues to be on minimizing the downside of risk, traditionally centering on the mitigation of risks resulting from professional liability to clients or other third parties impacted by services rendered. This has typically resulted from errors, omissions, or negligence in discharging professional responsibilities, misunderstanding over the scope of work, and other issues. Such professional liability can be significant and can threaten the very existence of these businesses. Although this fundamentally remains unchanged over the years, additional risks to professional liability continue to emerge:

“For instance, a firm of accountants or lawyers can now be held liable for risks such as breaches of computer security or data privacy related to their clients. A professional services business can be similarly held liable for bodily injury or property damage as a result of its acts or omissions, or even economic damages including delays, lost productivity and remedial costs.’’ [Internal Audit Director, Legal Compliance Solutions Provider]

Maturity of Governance Mechanisms

As risk management is considered to be an individual responsibility of client-facing staff and partners, our research findings indicate that BAPS organizations have typically not elevated the risk-management function to more strategic levels and have little motivation to do so.

Our survey reconfirms that risk-management capability for such organizations is primarily anchored on static rather than more dynamic capabilities administered typically by engagement partners and professional staff in the silos of their respective client engagements. These are facilitated by information (typically unavailable on a real-time basis) from core operational IT systems such as those related to client acceptance, time accounting, billing and work-in-progress, rather than specialized on-line real-time analytical systems that capture, articulate, assess, and report on organization-wide risks in a holistic and integrated manner.

> *"At the same time, the threat of global regulation, such as the Global Data Protection Directives (GDPR) in the EU, which holds the principal/user organization responsible for acts of its agents/providers, is compelling us to start making fragmented investments that address individual legislation on a piecemeal basis."* [Risk and Quality Director, UK Accounting and Tax Consulting Firm]

This lack of strategic focus has impaired investments in best-of-breed risk-management policies, processes and technologies.

Treading the aspirational path to excellence

Based on our empirical research related to future aspirations captured in our survey, we believe that, BAPS organizations are likely to move diagonally to the right in the lower left-hand quadrangle (Figure 2) away from being survivors, as they embrace changes far more slowly than others.

Perspective 4: The Restrained: Organizations with Higher Degree of Public Exposure (PE)

The final category can be referred to as *restrained* organizations that have limited perceptions of risk despite maturing in governance mechanisms, and practices are perpetually facing significant opportunity loss, leading eventually to threats of value erosion and survival challenges**.** In such organizations, the inability to perceive risks as a source of organizational value typically leads to significant opportunity loss in outsourcing by focusing on less critical or lower-value processes (e.g., fundamental accounting processes) despite significant investment in risk mitigation.

This fourth and final category of organizations completes the picture of our four-box framework (see Figure 1). We have not compiled a more detailed case study, due to a fundamental lack of a risk-averse or mindset restraining strategic or innovative thinking, which results from high levels of public accountability or exposure. As mentioned earlier, this fourth cluster was seen to emerge around Public Sector (PS), together with some other organizations from Consumer Business (CB), Energy and Resources (E&R) and Technology, Media and Telecom (TMT) representing about 9% of respondents, many of which had their roots in erstwhile PS enterprises.

This seems to be driving organizational decision-makers to “play safe” while continuing to invest in risk management focused on managing any adverse consequences of risks, with limited effort to integrate risk management more directly with strategy or be innovative with a “big picture” mindset. Academic researchers concur that in some cases, risk management in these industries continues to serve the purpose of the proverbial “fig-leaf” for blame-avoidance, or as an excuse for sticking to procedural rules that may be ill adapted to particular problems (Hood, Rothstein, & Baldwin, 2001).

Treading the aspirational path to excellence

Based on our empirical research related to future aspirations captured in our survey, we believe that, going forward, PS/PE organizations are likely to move more vertically upwards in the grid (Figure 2) than horizontally to the right from being restrained towards astute decision-makers, as they continue to invest in governance while still “playing safe” and taking limited risks.

CONCLUSION AND CONTRIBUTIONS

In this paper we have used existing literature as well as evidence from our own empirical investigation to develop multi-industry perspectives on gaining competitive advantage and risk-mitigation through a newer and more dynamic approach to outsourcing and related risk-management.

This paper extends the operational view on outsourcing risks to include strategic aspects that are key concerns for top executives who needs to consider the full spectrum of potential opportunities that outsourcing could create for organizations, particularly those that are more radical or transformational in nature. This paper builds upon earlier studies that have long recognized overall vendor relationship management ability of organizations as a dynamic capability and offers two new dynamic capabilities that are playing an integral part in such overarching vendor relationship management activities: (a) the capability to have a broader perception of risk in outsourcing that recognizes opportunities that these risks present in addition to the threats and hazards; and (b) the "asset orchestration" capability to develop more mature risk management mechanisms that enable organizations to maximize the opportunity while addressing the risk.

Addressing a comment made in an earlier paper in the *Academy of Management Perspectives* that very few specific examples have been offered to demonstrate how this "asset orchestration" operates in practice (Chatterji & Patro, 2014), we illustrate it using a four-pronged multi-industry perspective with exemplar case studies and offer a framework that is intended to assist organizations to align risk management with innovation and organizational strategy. Specifically, the framework motivates thought leaders and top executives in organizations to answer two key questions. First, "Where are you today?" to assess the maturity of their current strategic governance over outsourcing vis-à-vis their breadth of risk perception, which drives their appetite to take higher risks. Second, "Which way should you be going next?" to determine a possible trajectory going forward that enables them not just to manage risks but also fully exploit the opportunities that outsourcing can create.

As illustrated by the exemplar case studies, there are different paths that organizations can pursue (e.g., horizontal, vertical, or diagonal) in their attempt to develop into astute decision-makers, depending on their current positioning. For example, the restrained organizations need to invest in broadening their risk perception, while the gamblers need to ensure that strategic governance is driven by the Board as a dynamic organizational initiative, rather than project-level activity. The survivors, on the other hand, need to develop both aspects, and this is more likely to be successful if made gradually – from engaging the Board and leadership through to the rest of the organization, towards broadening risk perception. Practitioners, such as members of the Board and top management in outsourcing organizations and outsourcing consultants, can apply our proposed framework to evaluate their maturity and devise ways forward towards the suggested trajectory.

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[i] Outsourcing implies contracting with a third party (vendor) to accomplish some work for a specified length of time, cost, and level of service. Offshore outsourcing refers to scenarios where the third party is based at an offshore location, which usually means in a developing country and separated from the client by an ocean (Oshri, Kotlarsky, & Willcocks, 2015).

[ii] This paper recognizes the role of the Board of Directors in large publicly-listed global organizations to be in keeping with fiduciary duties to shareholders. This includes providing strategic direction and monitoring organizational goals, together with related strategies and policies. The role of executive leadership, led by the Chief Executive Officer (CEO), is to run the organization in line with the Board's direction by making operational decisions, keeping the Board informed, and providing information and recommendations to support the Board in policy-making, decision-making, and oversight. Accordingly, the term "Board-level activity" in this paper refers to an activity of a strategic nature that is directed and monitored by the Board, while being implemented by executive leadership including the CEO and other members of top management, under direct Board oversight.

[iii] One author was playing an active role in this survey, and one author provided academic advice on survey design and questions.

[iv] "Retained organization" refers to capabilities that the outsourcing firm should retain in-house to ensure that it can exploit business advantages of technology over time (including technology-enabled services outsourced to third parties) (Oshri, Kotlarsky, & Willcocks, 2015).

[v] The past (post-financial crisis), present and future positioning of the four industries is supported by the findings from the survey and interviews we conducted with key informants across industries. Arrows between same industry icons show the movement from the positioning in the past, to present positioning, and then aspiration towards future positioning.

[vi] Following the last global financial crisis, financial regulators around the world, including the Financial Stability Board (FSB), the US Federal Reserve (Fed), the Basel Committee for Banking Supervision (BCBS), the Prudential Regulatory Authority (PRA), and the Financial Conduct Authority (FCA) in the UK have continually enforced as well as provided guidance on the need to link risk closely and continuously with strategic and tactical decision-making, with a specific focus on risks related to third parties to whom critical organizational processes have been outsourced.