Risk Management in Next Generation Outsourcing
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Executive summary

Outsourcing is now a key business strategy for organisations throughout the world that shows no sign of diminishing in its popularity, despite some well-publicised setbacks and failures. As market and competitive pressures develop, outsourcing continues to be a preferred method of cutting costs and accessing specialist expertise. But increasingly firms are moving away from “first generation” outsourcing models, where cost cutting was often the only driver, services outsourced were clearly “non-core”, and a long-term relationship with a sole supplier was preferred, towards a more strategic outsourcing model that is more value driven, integrated with the business, and flexible. Importantly, companies are now outsourcing parts of the business that, until recently, would have been considered as a core business function and kept in-house. These “next generation” models often involve forming relationships with multiple “best of breed” suppliers, frequently across diverse geographical locations, or closer, risk-sharing partnerships with a single supplier.

Outsourcing, however, has always been a complex process that exposes businesses to considerable risk. Often, these risks are not properly identified or understood when the decision to outsource is made, or are simply off-loaded onto the service provider (vendor) without due consideration as to whether this is an appropriate and cost-effective way of allocating the risk. Under next generation arrangements, these risks can grow in terms of frequency and severity, particularly where companies have greater integration with and dependency on the service provider, or multiple partners are involved in different countries.

Implementing a risk management framework for each stage of the outsourcing lifecycle is a critical foundation for the success of an outsourcing arrangement. Indeed, the ability to look beyond the threats posed by a changing environment and to anticipate change, and treat it as opportunity, will create sustainable competitive advantage for forward-thinking organisations.

This paper explores established and emerging risks that may arise from next generation outsourcing models and highlights best practice techniques that can be employed to allow organisations to better mitigate and manage their risk exposures.
Moving up the value chain: Evolution of outsourcing models
Organisations may choose to outsource the management and execution of business functions and services to third party providers for many reasons, the most common being to:

- reduce and control operational costs;
- transfer fixed costs to variable costs on the balance sheet;
- enable the business to focus on its core competencies;
- gain access to world-class capabilities and specialist expertise; and
- unburden internal resources.

Whilst constituting valid reasons, in some respects these drivers are more retrospective than indicative of where outsourcing is headed. Traditionally, the primary driver of the outsourcing market has been cost management and reduction. Outsourcing reduces the capital tied up in non-core functions and allows the cost to become predictable through variable cost. Contracts have therefore traditionally been oriented towards defining a precise service with predictable costs - typically with only one major vendor. However, this has often resulted in inflexibility, as implementing change under these types of arrangement can be prohibitively expensive, stifling both business and technical innovation.

The inflexibility, and lack of sustained satisfaction with this generation of outsourcing has led to rethinking the approach, and more recent contracts have been based around a flexible partnership model that, in addition to reducing operational costs, allows organisations to achieve desired flexibility whilst gaining access to greater skills and optimising efficiency – often from multiple strategic partners.

Accordingly, outsourcing is evolving into a strategic tool for change - often described as "transformational outsourcing" - and this evolution is reflected in a change in the focus of the business functions outsourced. This has been evidenced by a dramatic shift in the type of activities outsourced, moving from back-office functions such as managing the IT infrastructure and data operations to intellectually-based service functions such as research, product development, human resources, marketing, accounting, and legal services.

However, the resulting contractual and commercial model is substantially more complex, as this must address issues such as the parties’ relationships, governance and cultural fit as much as service levels and cost savings. Models that therefore embrace close collaboration between the parties can facilitate improved understanding, and by sharing both risk and reward between the partners, efficiently fund investment in required infrastructure and motivate the commitment of all the outsourcing partners by aligning goals (see case studies 1, 2 and 3).

A key component of the next-generation outsourcing model involves accessing the skills and efficiencies of multiple service providers. For example, companies such as General Motors (see case study 4) and ABN Amro have recently taken their large outsourcing deals and split them up into smaller deals involving a larger number of suppliers. When a customer hands over to a single vendor all of its IT applications and processes, for example, there is a significant risk that any problems with that vendor’s ability to perform against the agreed service levels will have a major impact on the customer. In addition, a single vendor may not have all of the skills required by their customer. Hence, customers are increasingly looking to break-up such contracts to ensure they are getting the right vendor for the right level of service, whilst simultaneously reducing the risk associated with single provider dependency.

A multisourcing strategy does however present some major challenges and time commitments for companies, namely:

- the more service providers, the greater the complexity;
- multisourcing is a route to breaking up deals via the notion of specialisation from outsourcing providers. However, this may reduce the attraction of the deal for larger outsourcing providers, who may be less interested in smaller transactions;
- companies are required to find qualified staff with financial and technical skills to help run a project management office, or some other body that can track all outsourcing agreements; and
- the time commitment to multisourcing can mean higher costs for the company undertaking the outsourcing.

1 Source: eweek.com
Next generation outsourcing structures will consequently raise a number of different challenges for companies, particularly in relation to management and performance measurement. For intellectually-based service functions, the task of co-ordination also becomes more complex as businesses adapt to dealing with best-in-world service providers of intellect as opposed to providers of physical products or conventional services. Similarly, whilst multisourcing offers an effective means of putting competitive pressures on service providers and reducing dependency risk, the internal management costs can be significant and need to be considered at the outset of the transaction.

Case Study 1
Xchanging’s Enterprise Partnership Model

The business processing services company Xchanging has used its Enterprise Partnership model to offer an innovative approach to business process outsourcing, involving the creation of a third entity, jointly owned by the customer and service provider.

The Enterprise Partnership is structured through the use of a shareholders’ agreement to govern the relationship between the customer and the service provider at a strategic level. Operational level governance is dealt with under an outsourcing agreement, which also describes the services to be provided. The service provider may also contribute know-how, management and specialist expertise to the joint venture company, in return for licence fees and personnel secondment fees.

The model is used to transform business process functions through the introduction of streamlined processes and new technology. This is typically structured so that the customer transfers relevant personnel to the joint venture and becomes its first customer, sharing in future profits realised through the joint venture providing services to third party customers.

Case Study 2
Business process outsourcing using a new model for Royal Philips Electronics

Infosys Technologies, a leading IT and BPO service provider, was engaged by Royal Philips Electronics to run their end-to-end Finance and Accounting (Accounts Payable, General Ledger, Financial Planning and Analysis) and Procurement transaction processing.

As part of a seven year US$250m contract, the deal has involved Infosys taking on c1400 staff located in centres in Poland (Lodz), India (Chennai) and Thailand (Bangkok), a rare move for an offshore vendor. In addition to their ability to meet client cost objectives and provide process excellence, this people focused approach, coupled with an informed understanding of risk, was a key differentiator. According to Gerard Ruizendaal, Chief Strategy Officer & Group Controller for Royal Philips Electronics, “Infosys clearly demonstrated a willingness to invest in people with a strong HR process, better solution quality, ability to leverage end-to-end process improvements and a robust risk mitigation and transition plan. Their leadership capabilities were clearly evident in all interactions and proposal submissions, with a strong focus on the customer.”

A key element in structuring the deal was the need to identify potential risks and put in place appropriate mitigation plans. This involved transparent and open information sharing during the due diligence stage, communication to Infosys on key brand perception influencers and reputational concerns, business continuity management planning, and strong focus on governance and compliance. In addition, emphasis was placed on joint development of communication plans for both internal stakeholders as well as the media.

As a result, a mutually beneficial model has been created for both the partners, including potential for Philips to further leverage their capabilities using the platform, and for Infosys additional capacity in Europe and significant potential growth for further BPO and IT services.
Case Study 3

Pearl Group's outsourcing to Diligenta

The IT services company TCS has formed Diligenta Limited as a subsidiary company in the UK to service the Pearl Group's closed book portfolio of 4 million policies, an arrangement expected to generate revenues of around £486 million over the next 12 years. Pearl's strategy was to consolidate its IT functions from 3 separate businesses running 11 different financial and administrative systems onto one platform and this cutting-edge outsourcing strategy was selected as a way of accessing the skills required for such a complex migration and business transformation.

Diligenta acquired the Pearl group's back office processing capabilities, including the claims administration business and assets, for a sum of £55 million. As part of the arrangement, which commenced on 01 April 2006, TCS will carry out the transformation of the Pearl group's existing systems in order to service the policies through TCS's proprietary integrated insurance management system platform. S. Ramadorai, CEO and Managing Director of TCS commented that “this deal validates our strategy of pioneering the next generation of business processing outsourcing opportunities”.

Diligenta will also focus on offering similar services to other life assurance and pensions companies to increase revenues and returns. In Pearl's case, operating in a heavily regulated industry, the utility model has the added advantage of transferring part of the risk of changes in pensions legislation and the costs of complying with those changes to the outsourced service provider. Through a utility platform, Diligenta is able to implement the changes necessary to comply with revised legislation on a single operating system and effectively share the costs of these changes across its client base.

Case Study 4

General Motors multi sourcing strategy

In 2006 General Motors (GM) became one of the first major global companies to re-shape the way in which it outsourced services. Traditionally, GM had outsourced the bulk of its IT work to US company EDS, though in reality used around 18 companies for work of various types and value - requiring significant resources for contract management. When it’s contract with EDS came up for renewal, GM decided to use a new, more strategic multi-vendor strategy to carve up the work, increasing competition among a core group of suppliers, reducing overall costs, and spreading risk.

As a result, approximately $7.5 billion in five-year contracts were awarded, with a further $7.5 billion in contracts to be parcelled out as new projects arise. EDS, which formerly had around two-thirds of GM’s outsourcing business, still retains the majority share of contracts worth $3.8 billion – or about half of the business, with the remainder spread across another 5 vendors. To further simplify matters, each supplier was awarded a contract on a worldwide basis, contributing to the development of globally standardised work processes.

GM's strategy for managing outsourcing has become a model for other major corporations looking to carve up large outsourcing arrangements. The package has five-year contracts instead of the more traditional 10-year pacts and splits the work up among several suppliers instead of relying predominantly on one. Risk is therefore spread across different suppliers, and GM now has consistent standards across its global operations.

4 Source: www.telegraphindia.com
5 Source: www.thehindubusinessline.com
6 Source: www.baselinemag.com
Strategies for risk management throughout the outsourcing lifecycle
Successful outsourcing requires successful risk management. As outsourcing models evolve so do the risks and their management needs. The shift away from major single vendor, long-term outsourcing deals, towards a more segmented, multi-vendor approach coupled with closer collaboration between the parties adds new complexities to the arrangement, and these need to be taken into account in the risk analysis of any proposed model. The multi-vendor structure, for example, may be less attractive than it first appears when the increased costs of due diligence and ongoing management resource commitment are taken into account.

Next generation models that offer greater flexibility, transparency and communication may help avoid many of the pitfalls that have plagued traditional approaches as the parties are more equally committed to ensuring the relationship is successful, and the ability to respond to and manage problems more quickly is enhanced. However, there are also new and expanded risks that need to be considered with these models and regardless of the structure used it is essential that an objective evaluation of the lifecycle risks is carried out before any contract is signed. This becomes ever more relevant as the strategic importance of functions outsourced increases, meaning that problems with delivery are more likely to threaten the reputation or even financial viability of the organisation. Risk management strategy must therefore consider each key stage of the outsourcing process including the decision to outsource, service provider selection, operational phase and termination and exit management.

Decision to outsource
When deciding to outsource a business function, it is important that the cost/benefit analysis takes into account both internal and external risk exposures, and potential gaps in risk management. The analysis should be reflective of corporate risk appetite and tolerance thresholds to determine what an acceptable risk to the business is and what is not. Areas for consideration will commonly include:

- how valuable is the function to be outsourced to the core business in terms of top and bottom line, reputation, growth strategy and interdependencies with other operations?
- if the service is interrupted how rapid and severe will the impacts be?
- how can the risks that can lead to poor service provision and service disruption be avoided or mitigated and what is the cost to achieve this?
- is there insurance protection available to lessen the financial consequences of a service disruption? What is the cost?
- is there a service provider in the market that is capable of working with the business to provide the required level of service whilst not increasing the potential for exposure to new or greater levels of risk?
- in a multisourcing strategy, is one service provider well placed to manage the responsibilities of the other service providers under a master agreement?
Answers to these questions can be provided with comprehensive risk assessment. For each outsource structure that is considered, whether they be next generation or traditional, onshore, nearshore or offshore, single or multi-vendor, the risks that are unique to each arrangement at each stage of the deal need to be identified and quantified as far as is practicable in advance. This analysis will then inform evaluation of the suitability and cost-effectiveness of mitigation, management and protection strategies for addressing the exposures. A robust risk assessment process should include elements of the following:

- consideration of risks associated with the initial and longer term impact on the internal functionality to be outsourced;
- risk analysis of all proposed structural options, including understanding of risks inherent in foreign geographies when offshoring;
- risk-intelligent design of a service provider qualification and selection strategy;
- contractual service parameters and service levels, including remedies for non-performance;
- structure and implementation of operational risk management; and
- development of contingency and exit management plans.

The assessment should be holistic, encompassing not just the risks that may cause actual interruption to supply of the outsourced services such as logistical breakdowns, or that affect the vendor’s ability to deliver, but also risks that could, for example, cause reputational damage to the organisation if the service provider acts unethically or fraudulently.

The assessment process should also involve communication with all relevant stakeholders within the function to be outsourced as well as other parts of the business that can contribute valuable management know-how and input, such as risk, finance, legal, compliance, procurement and logistics. Obtaining the advice of experienced advisors, particularly at an early stage of the evaluation, will also be critical. This will facilitate a broader understanding of some of the pitfalls that could arise from proposed outsourcing structures and how these could be mitigated.

For example, in relation to multi-sourcing strategies, there will also be a need to properly structure the relationship to avoid undue risk to the outsourcing company. Where there is a single prime contractor, the customer has the advantage of knowing that only one supplier will have end-to-end responsibility. However, in multisource environments the customer will often enter into a number of contracts, which may be as part of a hierarchy or in parallel, for distinct sets of services. Ensuring the parties have a detailed understanding of their responsibilities is paramount - if a dispute should arise identifying blame can be difficult.

To alleviate this risk, customers can, for example, appoint one master service provider to manage the responsibilities of the other vendors and be liable for the integration and management of the multisourcing arrangement, while the service providers remain directly liable to the customer for their services. It will, however, be critical to ensure a robust governance framework is implemented to manage the interaction between the various parties and to enable the quick resolution of problems as and when they arise.

Taking a structured approach to assessment therefore allows businesses to make informed decisions as to the right type of outsource arrangement for them, in line with strategic and operational objectives and corporate risk parameters, as opposed to purely financial levers.
Service provider selection

A key feature of next generation models is a shift towards a more closely integrated and jointly accountable and incentivised working relationship. In practice this means that choosing the right partner and structuring a well balanced outsourcing agreement (which may often be closer to a joint venture in structure) is now more critical than ever.

But from a risk perspective what are the key exposures that could negatively impact performance and what standards and degree of management sophistication is required at the vendor for it to be an acceptable partner? How will this be accurately determined and validated? If the risk/reward profile is fully equitable, in that the customer will suffer equally with the vendor for non-performance on the vendor’s part, is the customer satisfied that the vendor has full contingency and business continuity management plans to ensure integrity of supply?

When developing the selection process, the desired risk profile of the relationship and vendor needs to be clearly articulated and prospective candidates benchmarked against these criteria. A good starting point to determine this is the description of services and expectations of the vendor as set out in the RFP or tender documentation, together with the vendor’s current risk management practices. This will allow insight into the minimum requirements necessary for a vendor to be approved. It is therefore important that risk management standards are additionally incorporated into the contractual documentation. It may also be appropriate for the agreement to prescribe more robust contingency planning for remedying scenarios where the service provider(s) fail to provide service to the agreed levels.

The due diligence and risk assessment process for evaluating the best vendor candidates will routinely involve background research, site visits, management interviews and a range of gap analysis and investigative techniques by appropriately qualified auditors. As described earlier, this process should focus on the full spectrum of risks, including those unique to the country and sector as well as considering risks that may not cause a direct interruption to supply.

Reliance on a potential vendor’s self-assessment of their own risk exposures and ability to manage them is generally to be avoided and should not be taken as definitive, even from large well established vendors. Countries and companies can differ widely in their cultural interpretation of what is a significant risk and well managed. Similarly, the levels of insurance protection typically taken, such as coverage against errors and omissions or business interruption, can also vary greatly and may be unacceptable relative to the customer’s exposure. A realistic approach to contractual ‘offloading’ of liability and risk must also be struck – simply passing liability over to an unsuitable service provider is the same as not managing the risk at all.

Where multiple vendors are involved the costs to undertake comprehensive due diligence can be significant, but this needs to be placed in the context of the outsourced functions criticality to the business and how the business could be influenced by the collaborative and shared risk/reward characteristics of the relationship.

However, this is one area that should not be cut back. Developing a rigorous pre-diligence selection process so potential vendors are kept to a minimum will keep costs down, as will developing standardised evaluation and diagnostic procedures to enhance speed of data collection and ensure consistency in the analysis.

Finally, once the data has been gathered this will need to be evaluated for the significance of any gaps or areas of concern highlighted and a decision made as to whether the findings are sufficient to disqualify the prospect outright or allow them the opportunity to address and rectify the concerns.

An outsourcing agreement should not only address operational, financial and relationship matters and the parties’ respective obligations and rights and remedies, but it should also prescribe a framework for dealing with unforeseen circumstances and managing change through the term of the agreement. Experienced legal counsel will appreciate these requirements, and be able to provide guidance and suggestions for how to ensure the agreement captures these elements at the appropriate level of detail.
Operational Phase

How risk is managed during the service provision stage can offer significant upside for cost optimisation. If one of the parties has much greater size or expertise in managing risk then efficiencies can be gained if they take the lead in risk management by leveraging lower unit mitigation costs or access to more competitive risk transfer (insurance). Conversely, if the vendor has low sophistication or little experience with managing risk, which can be a common occurrence in developing offshore destination countries, then providing support and training to improve their systems and capabilities will improve their ability to maintain continuity of supply and thus the customers own supply chain resiliency. In addition to avoiding potentially damaging service interruptions, this improvement in the risk profile may also enable insurance premium discounts or access to greater capacity with, for example, contingent clauses in business interruption insurance policies that can provide indemnity against supplier triggered losses.

Further, for outsourced services that have physical product movement, strong vendor risk management may negate the need to hold excess inventory stocks to buffer potential supply chain disruptions, leading to significantly lower inventory costs in terms of tied up capital, logistics and warehousing, and insurance from the supply chain. Cost optimisation and arbitrage opportunities will be dependent on the outsource structure and profile of the counterparties but offers a solid opportunity for creating competitive advantage.

However, regardless of the outsourcing model adopted problems will invariably arise and it is important that the outsourcing agreement prescribes the means for resolving them without having to seek recourse through the courts, which would severely sour, if not terminate, the parties’ relationship. To the extent that contractual remedies are required, the most common include pre-agreed damages (liquidated damages) for delays in providing services, and credits against fees (service credits) for failure to meet service levels. English law, for example, prohibits contracts from prescribing penalties for a party’s failure to meet its obligations, so it is important that the amount of liquidated damages or service credits be linked to a genuine pre-estimate of the customer’s loss resulting from the service provider’s default.

Other non-monetary remedies to be considered include requiring the service provider to develop and implement work-around plans which require the allocation of additional resources (at the service provider’s cost) to accelerate performance where it has been deficient, and the right to “step-in” and monitor or direct the provision of services in certain circumstances.

At the most basic level, customers should ensure that the vendor has satisfactory business continuity management (BCM) planning standards and capabilities in place (tried and tested) to ensure supply resiliency in the event of risks arising that can lead to service interruption. Failure to sufficiently audit a vendor’s ability to maintain supply continuity could reflect poorly on the customer’s management in the event of an interruption, and if significant financial loss is incurred as a result, potentially precipitate shareholder action.

Given the long-term nature of most outsourcing arrangements, an outsourcing agreement must also provide a framework for managing change. A good change management process should enable either party to raise proposed changes and prescribe a process for these to be reviewed, further developed and agreed. From the customer’s perspective, it is also worthwhile to agree the rates, or a formula for calculating rates, for additional work arising out of the change, to avoid the risk of impasse on this issue.

Specific changes that the parties should consider addressing include:

- technology changes, for instance, the service provider could be required to refresh technology used in the provision of the services in accordance with market trends, or to reduce fees where technology improvements allow the services to be provided more efficiently;
- market changes, the customer may require the right to benchmark the services and fees to assess whether they are still in line with those in the marketplace;
- regulatory changes, especially in regulated industries such as financial services, a good outsourcing agreement should address how the risk of regulatory changes that impact the provision of the services will be apportioned between the parties.
Finally, a strong governance regime is fundamental to ensuring that operational challenges and issues can be resolved and managed in an agreed and equitable manner. Outsourcing is increasingly a partnorial based transformation strategy where communication, collaboration and sharing of risk/reward parameters is the order of the day. Such a relationship will however need a strong governance structure that is equally respected and supported by all parties, perhaps including a joint executive steering committee and dedicated staff with accountability for relationship management and integration.

**Termination and exit management**

This is a critical part of an outsourcing transaction and must not be overlooked. Both parties, particularly the customer, should therefore give thought to the circumstances in which the outsourcing relationship can be brought to an end. Typically, unless one of the parties is in breach, the contract will continue for an agreed duration. However, well before the end of the contract, the parties will need to develop a detailed exit strategy setting out the process of unwinding the original transaction. This is a complex task and will require the cooperation of all of the parties to ensure the risk of service disruption does not materialise.

In the case of multisourcing, one of the potential advantages is the ability to terminate a supplier or switch services from one supplier to another without any significant service disruption. Whether this can be done will, however, depend on the termination provisions in the contract as some vendors may have negotiated a break charge in the event of a termination “for convenience”.

Before dismantling or restructuring the risk management framework the parties should examine the lessons learned from the relationship, and how this knowledge can be utilised. Firms can build formidable expertise in managing outsourcing risk that can be deployed in future deals as well as shared and applied to other areas such as procurement and supply chain risk management. It is therefore beneficial to capture and preserve this as part of the knowledge capital of the organisation.
Conclusions
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The benefits that next generation outsourcing models provide are now increasingly recognised by both service providers and customers. Enhanced flexibility in responding to market demand fluctuations, closer collaboration and integration of vendor/customer strategy and operations, and shared risk/reward incentivisation are proving a powerful combination in achieving sustainable competitive advantage.

But outsourcing remains an extremely complex challenge, presenting a diverse suite of risks that must be managed within a structured yet dynamic framework. Risks are wide ranging and manifest at all stages of the lifecycle of a deal and must be considered holistically and quantified to enable the success of the contract to be optimised.

Risk management should factor from the very beginning of any outsourcing deal as this may prove to be a deciding factor in the structure that the deal will take or even whether it will proceed at all. A good understanding of an organisation’s own abilities to mitigate risks that may arise should be coupled with the fundamental assessment of the vendor as part of selection strategy. Even if the vendor is a world-leader in its field, due diligence and risk assessment should never be overlooked as the critical proaction for avoiding problems during the operational phase.

This paper has highlighted that outsourcing, despite offering considerable value under new model arrangements, is a complex process that exposes organisations to many and significant risks. It is therefore critical to the success of the deal that management of these risks is appropriately planned for, resourced and mitigated throughout the whole lifecycle of the outsourcing arrangement.
Further information

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