Enterprise risk management

Ljubljana, 17 June 2015

Jaap Veenenbos MSc.
Managing director Aon Global Risk Consulting CEE

Agenda & Objectives

- About Aon and Aon Global Risk Consulting
- Introduction to Risk Bearing Capacity, Risk Tolerance and Risk Appetite
- Application in insurance optimization
- Making ERM operational
- Aon Risk Maturity Index and emerging risks
About Aon and Aon Global Risk Consulting

Aon Worldwide | Six Core Solution Areas
Aon Worldwide

Aon plc (NYSE: AON) is the leading global provider of risk management services, insurance and reinsurance brokerage, and human resource consulting and outsourcing.

- #1 Rated risk services broker, reinsurance intermediary, and human resource consulting and outsourcing provider
- 66,000 Number of Aon colleagues around the world
- 500 Number of global offices
- 120 Number of countries in which Aon operates

Aon Worldwide

<table>
<thead>
<tr>
<th>Aon plc</th>
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</thead>
<tbody>
<tr>
<td>Risk Solutions</td>
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<tr>
<td>Aon Risk Solutions</td>
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<tr>
<td>Retail Brokerage</td>
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<tr>
<td>Risk Assessment and Advisory</td>
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<td>Health &amp; Benefits</td>
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<tr>
<td>Captive Management</td>
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<td>Affinity Programs</td>
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<td>Select Personal Lines</td>
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<td>GRIP Solutions</td>
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<td>Actuarial and Analytics</td>
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<td>Claims Advocacy and Administration</td>
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<td>Technology Solutions</td>
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<td>Aon Benfield</td>
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<tr>
<td>- Treaty Reinsurance Brokerage</td>
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<td>- Facultative Reinsurance Brokerage</td>
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<td>- Capital Markets and Financial Advisory</td>
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<td>- Analytics and Technical Services</td>
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<td>- Claims Management</td>
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<td>- Strategy, Claims and Operations Consulting</td>
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<td>HR Solutions</td>
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<td>Aon Hewitt</td>
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<tr>
<td>Talent</td>
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<tr>
<td>- Rewards &amp; Compensation</td>
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<td>- Engagement &amp; Effectiveness</td>
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<td>- Talent Acquisition &amp; Assessment</td>
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<td>- Defined Benefit &amp; Defined Contribution Administration</td>
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<td>- Financial Services</td>
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<td>- Health &amp; Benefits Consulting</td>
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<tr>
<td>- Health &amp; Welfare Administration</td>
</tr>
<tr>
<td>- Health Care Exchanges</td>
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</tbody>
</table>
Aon Worldwide | Unprecedented Platform of Clients’ Base

of top **Fortune 500** firms

of top **P&C insurance** firms

of top **Technology** firms

of top **Healthcare** firms

of top **Consumer** firms

of top **Financial** firms

of top **Utilities** firms

of top **Telecom** firms

...are Aon Clients

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**Aon CEE & CIS – Risk Solutions**

<table>
<thead>
<tr>
<th>Country</th>
<th>Offices</th>
<th>People</th>
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</thead>
<tbody>
<tr>
<td><strong>Poland</strong></td>
<td>5</td>
<td>267</td>
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<tr>
<td><strong>Ukraine</strong></td>
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<td><strong>Russia</strong></td>
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<td><strong>Kazakhstan</strong></td>
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<td><strong>Estonia</strong></td>
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<td>14</td>
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<td><strong>Latvia</strong></td>
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<td>11</td>
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<td><strong>Lithuania</strong></td>
<td>4</td>
<td>80</td>
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<td><strong>Czech Republic</strong></td>
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<td>53</td>
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<td><strong>Slovakia</strong></td>
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<td><strong>Hungary</strong></td>
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<td><strong>Croatia</strong></td>
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<td><strong>Romania</strong></td>
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<td><strong>Bulgaria</strong></td>
<td>2</td>
<td>32</td>
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<td><strong>BMA Partnerji</strong></td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td><strong>ACB</strong></td>
<td>1</td>
<td>10</td>
</tr>
<tr>
<td><strong>Vipox</strong></td>
<td>2</td>
<td>6</td>
</tr>
</tbody>
</table>

* Headcount numbers as of April 30, 2014
Introduction BMA Partnerji / Aon Partner for Slovenia

- Present in Slovenia since 1997
- 6 employees (5 licensed insurance brokers)
- More than 200 clients / companies from various industries
- More than EUR 7 mio premium in portfolio
- Consultancy and insurance brokerage for a wide range of insurance, including: property & financial loss insurance, all kind of liability insurance, credit, motor vehicle, accident & other employee benefits insurance… and capacities for tailor made solutions
- Cooperation with local and international insurance companies
- Access to London (reinsurance) market and capacities
- Deliver Aon Global Risk Consulting risk management services
Introduction to Risk Bearing Capacity, Risk Tolerance and Risk Appetite

Reasons Companies Are Moving To Define Their Risk

| Accountability: | Management, policyholders/owners, employees, rating agencies, regulators, and other stakeholders need to know how much risk you are willing to take, not just how much you currently take |
| Governance: | Set of principles that guide risk-taking behavior |

- Guides decision making toward the optimal balance between risk and return
- Provides a clear reference point to monitor risk taking, and to trigger appropriate action as the boundaries are approached (or breached)
- Minimizes the likelihood of “surprises” when adverse risk events occur
Confusion

But....

- Lot’s of confusing and conflicting terminology
- Implementation presents many challenges
- Meaningful integration with existing business processes is daunting
- Best practice is not clear and firmly established

However, there are some emerging core principles that can be used to organize a sensible, clear and pragmatic approach — that is the goal of our work together.

Risk Appetite/Tolerance/Capacity

<table>
<thead>
<tr>
<th>Regulators</th>
<th>National Association of Corporate Directors US</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>COSO (US)</td>
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</table>

<table>
<thead>
<tr>
<th>Professional Organizations</th>
<th>Institute of Risk Management</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Society of Actuaries</td>
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<table>
<thead>
<tr>
<th>Consultants</th>
<th>Towers Watson</th>
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<tbody>
<tr>
<td></td>
<td>IBM</td>
</tr>
<tr>
<td></td>
<td>Aon</td>
</tr>
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</table>
### Risk Appetite/Tolerance/Capacity

<table>
<thead>
<tr>
<th>Regulators</th>
<th>National Association of Corporate Directors (US)</th>
<th>The level of risk that their organization is willing to accept in order to meet its strategic objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>COSO (US)</td>
<td></td>
<td>The amount of risk, on a broad level, an organization is willing to accept in pursuit of stakeholder value</td>
</tr>
<tr>
<td>Professional organizations</td>
<td>Institute of Risk Management</td>
<td>The amount of risk that an organization is willing to seek or accept in the pursuit of its long-term goals</td>
</tr>
<tr>
<td></td>
<td>Society of Actuaries</td>
<td>The level of aggregate risk that an organization can undertake and successfully manage over an extended period of time.</td>
</tr>
<tr>
<td>Consultants</td>
<td>Towers Watson</td>
<td>The appropriate exposure to risk [a company] will accept in order to enhance the organizations value over a given time frame</td>
</tr>
<tr>
<td></td>
<td>IBM</td>
<td>Risk appetite is… equivalent to risk tolerance… balances risk hunger against risk aversion and is multifaceted, taking into account several fundamental considerations.</td>
</tr>
<tr>
<td></td>
<td>Aon</td>
<td>Insight through data analytics and optimizing total cost of risk</td>
</tr>
</tbody>
</table>

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**What is risk?!**
Spectrum of Risk

Risk Capacity

Risk Tolerance

Risk Appetite

The full range of risks which could impact, either positively or negatively, on the ability of the organization to achieve its long term objectives.

The boundaries of risk taking outside of which the organization is not prepared to venture in the pursuit of its long term objectives.

The amount of risk that an organization is willing to seek or accept in the pursuit of its long term objectives.
Risk Appetite – Key in financial decision making

Degree of acceptance to uncertainty

Amount financially capable of being supported

Behavioural norms and expectancies

Level to achieve optimal outcomes

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Risk Appetite

Risk Appetite – we will:

- Actively assume risk to create a portfolio that provides a return of x basis points over the risk-free rate.
- Maintain a conservative investment posture that emphasizes protection of principal and a moderate return on invested assets.
- Avoid or strongly mitigate risks for which we do not receive compensation (including reputational, operational and regulatory).
- Maintain a level of solvency that will provide a credit rating of x.
- ...

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Risk Tolerance – we will not:

- Tolerate a financial loss that consumes the sum of our trailing two-year average of annual earnings and 5% of our equity once in any seven year period.
- Tolerate a reputational loss that results in a swing in the firm’s stock price of more than 10% or sustained media coverage.
- Tolerate a liquidity event that requires us to liquidate more than 10% of our invested assets in any ten year period.
- ...

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set the road map  draw the line
Appetite and Tolerance – overview of research and methodology

Risk Appetite: methodological ideas
- Analyse interplay Risk Management Programme and Strategic Objectives/ KPIs. Categorise Risks and evaluate how likely they are to affect objectives/KPIs.

Risk Tolerance: methodological ideas
- Quantitatively analyse Risk Universe T20 Risks to find key risk stress points and potential financial impact.
- Meet SMT/ Voting software, qualitative perspectives feed into statement of Risk Appetite
- Translation into Risk Appetite Statement - sets aim of Risk Management programme which success measured against.
- Tolerance thresholds. Future planning. Analysis of breaches and how they can be managed through escalation.

Framework for Risk Finance Decisions

Sample Approach to Defining Risk Appetite/Risk Tolerance

<table>
<thead>
<tr>
<th>Qualitative</th>
<th>Quantitative</th>
<th>Inputs</th>
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<tbody>
<tr>
<td>✓</td>
<td></td>
<td>Corporate Identity</td>
</tr>
<tr>
<td>✓</td>
<td></td>
<td>Management and Board Perspectives</td>
</tr>
<tr>
<td>✓</td>
<td></td>
<td>Company Historical Reference Points</td>
</tr>
<tr>
<td>✓</td>
<td></td>
<td>Risk Modeling and Sensitivity Testing</td>
</tr>
<tr>
<td>✓</td>
<td>✓</td>
<td>Operating Unit Annual and Long-Range Objectives</td>
</tr>
<tr>
<td>✓</td>
<td>✓</td>
<td>Key Risk Indicators</td>
</tr>
</tbody>
</table>

Phase I
- Corporate Risk Appetite & Tolerance

Phase II
- Risk Tolerances for Key Risk Categories

Phase III
- Actionable Risk Appetite and Limits
Example: Risk Appetite, Risk Tolerance, Components actions

- The risk strategy is articulated explicitly and is directly calibrated to the company’s targeted financial performance indicators (e.g., capital, earnings, economic value)

- Management engages the Board of Directors in discussion around risk appetite and corporate risk tolerances
  - Board approves the risk appetite and corporate risk tolerances at least once a year
  - Ties into RFDP, Captive Consulting, ERM, etc.

- The risk profiles of the individual business units and the overall enterprise consider stress events to ensure the company can withstand unexpected scenarios
  - Quantitative risk modeling
  - Qualitative desktop scenarios

Example: Risk Appetite, Risk Tolerance, Components actions

- Risk limits associated with individual business activities are established in a manner consistent with the overall risk appetite through a quantitative, bottom-up aggregation process

- Monitoring and reporting of compliance with the corporate risk tolerance occurs...
  - At different levels throughout the organization (BoD, C-suite, business heads, etc.)
  - On a regular basis (e.g., quarterly)

- Top-down risk appetite is supported by bottom-up risk identification and management
  - Ties to ERM, BCM
Application in insurance optimization - Risk Finance Decision Platform (example)

What is RFDP?
RFDP is an integrated, analytical process that links three main components:

1. Risk Appetite Analysis
   Establishes appetite levels for enterprise risks and tolerance levels for insurable risks which are linked to corporate performance objectives and volatility thresholds.

2. Dynamic Risk Modeling
   Generates a thorough understanding of current insurance exposures, individually and/or in portfolio.

3. Design & Program Stress Testing (including funding)
   Provides a cost/benefit comparison of various risk management strategies including captive and alternative risk strategies.

Risk Finance Decision Platform
Benefits of RFDP

- Provides cost-benefit analysis and support tool for risk management and insurance decisions

- Provides unparalleled advice to determine the impact of program structures
  - Retained losses
  - Insurance recoveries
  - Losses in excess of insurance coverage
  - Impact of non-transfer mitigation strategies

- Many studies have realized annual Total Cost of Risk savings of about 5% without significantly increasing risk exposure

Key RFDP Value Points

- Overall Platform
  - Outcomes provide decision support for key stakeholders
  - Results are easily comprehended and support risk management decision making

- Risk Appetite (Financial Analysis)
  - Total Risk Appetite determination is tailored for your company and is based on your company's performance objectives and thresholds
  - Risk Appetite for insurable risks is evaluated and appropriately represents only a fraction of your company's total tolerance for risk
  - Risk Appetite results are dependent on your company's specific performance drivers and enterprise volatility

- Dynamic Risk Modeling (Actuarial Modeling)
  - Individual risk and risk portfolio investigations can be conducted to thoroughly understand your company's current exposures
  - Framework is flexible enough to “plug-in” additional evaluations

- Program Design and Brokerage (Insurance Market Factors)
  - Platform results can be combined with insurance market expertise to develop optimal insurance program strategies
  - Captive utilization and alternative risk financing strategies can be incorporated into the model
Risk Appetite Analysis in RFDP - Objectives, Process

- Objectives
  - Establish acceptable boundaries within which to structure risk retentions
  - Provide a balanced scorecard approach to risk appetite
  - Provide guidance on the value / necessity of risk transfer
  - Maximise efficiency of corporate balance sheet

- Process
  - Quantification of current KPI’s and unutilised risk retentions
  - Benchmark against industry indices or competitors
  - Apply constraints and limitations
  - Utilise market intelligence to overlay anticipated outcomes
  - Engage in an interactive discovery process

Risk Appetite Analysis in RFDP - Benefits

- Benefits
  - Establishes parameters within which to structure risk finance arrangements
  - Creates transparent decision making framework
  - Provides external benchmarks
  - Puts insurable risks into group context
  - Adaptive to specific group circumstances
  - Supports group risk financing strategy
Risk Appetite Investigation Process

Tolerance
- Build financial statements
- Key Performance Indicators based on:
  - Historical Accounts
  - Budgets / Forecasts
- Benchmark:
  - Peers / Indices
- Assess impact of loss scenarios
- Unutilised aggregated retentions

Group Risks
- Review Risk Register
- Assess alternative use of risk bearing capacity:
  - Business risks
  - Insurable risks
- Consider banking or other covenant restrictions or limitations
- Development of risk sectors

Appetite
- Shareholder expectations
- Corporate culture & management attitude
- Structure
- Retention location
- Formal / informal

Group Strategy
- Identify analyst expectations
- Understand sensitivity to rating agencies
- Group strategy & targets
- Acquisitions and disposals
- New geographies and industry sectors

Key Financial Drivers
Identify key financial drivers and performance targets; e.g. solvency, profitability, liquidity and evaluate the threshold of materiality of a loss in light of the solvency, profitability and liquidity indicators.

<table>
<thead>
<tr>
<th>Formula</th>
<th>Description</th>
<th>Company’s Analysis</th>
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<tbody>
<tr>
<td>EBIT Interest Coverage</td>
<td>Company’s ability to pay the interests on debt</td>
<td></td>
</tr>
<tr>
<td>EBITDA Interest Coverage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Funds from Operations / Total Debt</td>
<td>Company’s ability to reimburse the debt</td>
<td></td>
</tr>
<tr>
<td>(where ( \text{Funds from Operations} \equiv \text{Net Income + Depreciations} ))</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Free Cash Flow from Operations / Total Debt</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(where ( \text{FCF from Operations} \equiv \text{Funds from Operations} - \text{Capital Expenditures} - \text{Change in Working Capital} ))</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pretax Return / Average Capitalization</td>
<td>Company’s profitability</td>
<td></td>
</tr>
<tr>
<td>(where ( \text{Pretax Return} \equiv \text{EBIT} ))</td>
<td></td>
<td></td>
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<tr>
<td>Operating Income / Sales</td>
<td></td>
<td></td>
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<tr>
<td>(where ( \text{Operating Income} \equiv \text{EBITDA} ))</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long Term Debt / Capitalization</td>
<td>Company’s capital structure</td>
<td></td>
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<tr>
<td>Total Debt / Capitalization</td>
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</tbody>
</table>
Risk Appetite Analysis in RFDP- Information Requirements

- Documentation
  - Report & Accounts for last financial period
  - Forecast for current / future period
  - Analysts reports
  - Risk registers
  - Insurance programme overview

- Workshop with personnel representing
  - Finance / treasury
  - Business strategy
  - Risk

RFDP – Next steps

- Understand current program
- Identify viable options
- Estimate premiums
- Run simulations and measure effectiveness of the current and alternative programs
- Approach marketplace
- Drop in actual quotes
RFDP Model Example: Risk Appetite, Risk Tolerance, Program Design

1. TCOR analysis (including actuarial probability analysis) developed for current program. (Red Line)

2. TCOR analysis developed for alternative program (Blue Line) that included higher levels of retained risk.

3. Client risk tolerance for a shock loss or an aggregation of unexpected losses identified as $25M above current levels of expected annual losses.

4. Part of savings used to purchase Stop Loss Program (Green Line).

5. Benefit of Stop Loss

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RFDP Real Example: Risk Appetite, Risk Tolerance, Program Design

<table>
<thead>
<tr>
<th>Program</th>
<th>Expected TCOR (Premium + Loss)</th>
<th>Risk Appetite Breach Point</th>
<th>TVaR at 95%</th>
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<tbody>
<tr>
<td>Unlimited</td>
<td>$22.8 million</td>
<td>86%</td>
<td>$39.1 million</td>
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<tr>
<td>Current</td>
<td>$26.1 million</td>
<td>78%</td>
<td>$32.2 million</td>
</tr>
<tr>
<td>Alternative</td>
<td>$23.4 million</td>
<td>87%</td>
<td>$33.9 million</td>
</tr>
</tbody>
</table>

Y-Axis: Total Cost of Risk ($ in millions)  
X-Axis: Confidence Level  
Events Frequency (Events/Years)  
1/5 1/10 1/20 1/100
Summary of RFDP Value

- RFDP integrates with brokerage and risk financing processes by generating meaningful information to achieve the following risk transfer objectives:
  - Maximize reward for risk trade off, including the expected reward
  - Raise probability of success within risk tolerance
  - Control tail variance and exposure

- Incorporating RFDP into the decision making process results in:
  - A “health check” of current risk transfer strategies
  - Guidance on placing more efficient and better suited risk transfer programs (including maximizing captive use)
  - Disclosure of “why” risk management decisions are made
Making ERM operational

Enterprise Risk Management

Value Creation
*Performance*

Returns
- Shareholders
- Investors
- Partners

Growth
- Business Units
- Managers

Governance
- Controls
- Compliance

Financial Strength
*Conformance*

Capital
- Debtholders
- Agencies
- Regulators
Enterprise Risk Management

External risk drivers:
- Stakeholders
- Competitors
- Regulators
- Business Partners
- Suppliers

Internal risk drivers:
- Projects
- Business Units
- Business processes
- Executive Board

Performance Improvement

Risk control

Shareholder value

ERM Outcome:
- Client value

ERM process

ERM management

Evaluate Risk Process

Risk Identification & Prioritization

Risk Quantification

Risk Management Implementation

Risk Response Solution

Growth

Profitability

Continuity

Governance, Culture and Disclosure

Aon Risk Solutions | Central Eastern Europe | Global Risk Consulting
Enterprise Risk Management

Systematically Build and Improve Risk Management Capabilities

<table>
<thead>
<tr>
<th>Capabilities characteristic of individuals vs. the organization</th>
<th>Process established and repeating: reliance on people is reduced</th>
<th>Policies, processes and practices defined and formalized across the organization</th>
<th>Risks measured, managed and aggregated on an enterprise-wide basis</th>
<th>Organization focused on RM as a source of competitive advantage and continuous improvement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial</td>
<td>Established</td>
<td>Uniform</td>
<td>Managed</td>
<td>Optimizing</td>
</tr>
</tbody>
</table>

Risk

Opportunity

Risk Control and Engineering Practice Group, service offerings

**Risk Control advisory**

- Property and Machinery risk audits
  - Recommendations
  - Risk Rating
  - PD/BI MFL / EML Assessments
  - Life Safety & Security
  - Underwriting reporting
- PD / BI Surveys & valuations
  - Underwriting
  - Valuations
  - Due Diligence
- Operational risk advisory
  - Property, machinery break down
  - Liability (product, environmental, directors)
  - Health, Safety, Security (operational, behavioral)
  - Quality (business process review)
  - Construction (project) risk management
- Natural Catastrophe Modeling
  - Flood, Windstorm, earth quake
- Risk management
  - Awareness training,
  - Interim management and implementation
- Risk Management Information System
  - Aon Property System
  - Scorecard (risk rating)
  - TCoR (RiskCenseo)

**Risk engineering services**

- Regulatory & Compliance Support
  - Building & Fire Code Consulting
  - Regulator Negotiations
  - Egress & Accessibility Code Analysis
- Design Services
  - Fire Suppression
  - Fire Detection
  - Security Alarm Systems
  - Life Safety and Accessibility Designs
- Computerized Fire Modeling
- Smoke Control Systems
  - Consulting
  - Testing
- Construction Management
  - New Builds
  - Retrofits
- Management Information System
- Purchase advisory
- Environmental compliance
Any questions before we continue

Aon Risk Maturity Index and Global Risk Management Survey
Risk Maturity Index and Global Risk Management Survey

Aon Risk Maturity Index
What’s your organization’s risk maturity rating?
Why?

— Sustainable Performance Improvements →

How We Designed the Index

Governance & Infrastructure

Process

Integration

Culture & Communication

10 Characteristics

40 Components

125 Questions
Focused Campaigns to Build Global Database

500+ Organizations
25+ Industries
5 Continents

Global Findings: Ratings Distribution

<table>
<thead>
<tr>
<th>Rating Level</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Initial</td>
<td>3.4%</td>
</tr>
<tr>
<td>Initial to Basic</td>
<td>10.5%</td>
</tr>
<tr>
<td>Basic</td>
<td>15.2%</td>
</tr>
<tr>
<td>Basic to Defined</td>
<td>19.5%</td>
</tr>
<tr>
<td>Defined</td>
<td>19.1%</td>
</tr>
<tr>
<td>Defined to Operational</td>
<td>17.3%</td>
</tr>
<tr>
<td>Operational to Advanced</td>
<td>10.1%</td>
</tr>
<tr>
<td>Advanced</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

Developed with

Aon Risk Solutions
Central Eastern Europe | Global Risk Consulting
Global Findings: Revenue Band Averages

Average Risk Maturity Ratings by Annual Revenue

![Chart showing average risk maturity ratings by annual revenue bands.]

Global Findings: Averages by Respondent Title

Average Risk Maturity Rating by Respondent Title

![Chart showing average risk maturity ratings by respondent title.]

Developed with
Wharton

Empower Results™