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Dresdner Bank:

Integrating Risk into Corporate Strategy

*This case was written by **AV Vedpuriswar**, ICFAI Knowledge Center. It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation.*

The case was compiled from published sources.

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Dresdner Bank: Incorporating Risk into Corporate Strategy

Introduction

Dresdner Bank, Germany's third largest bank, after Deutsche Bank and HVB Group, had about 1,100 branches in more than 60 countries. In addition to its core retail lending and deposit activities, the bank also offered corporate finance and investment banking services. The company's asset management operations had been combined with those of insurance giant Allianz to form Allianz Dresdner Asset Management (ADAM). Allianz owned more than 95% of Dresdner Bank. Following Alliance's acquisition in 2001, Dresdner restructured into two business units: Corporates and Markets, which combined the company's investment banking and business lending operations; and Private and Business Clients, which entailed retail banking, loans, and portfolio management.

Background Note

Dresdner Bank was founded as the Dresdner Bankhaus in 1872 by Carl Freiherr von Kaskel. Formed partly to finance railway construction, Dresdner became Germany's second largest bank behind Deutsche Bank by 1884. That year the bank moved its headquarters from Dresden to Berlin.

In 1895, Dresdner opened its first foreign office in London. Eight years later, it formed an alliance with US banker J.P. Morgan and opened branches in South America and Asia. Dresdner's high interest rates attracted several depositors and spurred lending activity.

After Germany's defeat in WWI, the bank's foreign operations ceased. Reconstruction and war reparations put a severe strain on the company. The Weimar Republic's economic reforms briefly stabilized Dresdner, but in the midst of the Great Depression, the government took over 90% of the bank in 1931.

In 1939, Dresdner merged with Austria's second largest bank, Laenderbank. Dresdner helped fund the Nazi war machine during WWII. For this, it was disbanded by the Allies into 11 smaller banks with limited market areas in 1945.

In 1952, Dresdner's remnants were merged into three larger banks: Rhein-Main Bank, Rhein-Ruhr Bank, and Hamburger Kreditbank, which then merged in 1957 to reform Dresdner. Dresdner became the first West German bank to expand abroad after WWII, into Luxembourg. In 1966, the bank established a cooperative agreement with Banque Nationale de Paris (now BNP Paribas). A year later, the bank established German-American Securities (now Dresdner Securities (USA) Inc.), an investment bank in the US.

Dresdner began focusing on asset management in 1988, buying UK firm Thornton & Co. In 1996, the bank acquired RCM Capital Management, a Californian asset manager. In 1998, the bank formed ADAM Service, an asset management joint venture with Allianz.

After the German reunification in 1990, Dresdner opened Dresdner Bank Kredietbank in its hometown. Within a year, Dresdner had become Germany's second largest bank. In 1995, Dresdner bought UK merchant bank Kleinwort Benson, which it merged with its investment banking operations to form Dresdner Kleinwort Benson in 1996.

Through 1999 and into 2000, Dresdner considered merging with Deutsche Bank. But talks repeatedly fell through due to discontent with the performance of Dresdner Kleinwort Benson. The failed merger prompted CEO Bernhard Walter's resignation. Dresdner bought US-based Wasserstein Perella Group and merged it with Dresdner Kleinwort Benson to form Dresdner Kleinwort Wasserstein. Dresdner also ended several Eastern European joint ventures with BNP Paribas. In 2001, shareholder/insurer Allianz bought Dresdner Bank.

Organization Structure, Systems and Processes

Monitoring of risks was implemented as a joint effort between the divisions' Risk Management functions and the independent Group Risk Control function on the basis of the risk policy guidelines set out by the Board of Managing Directors.

Exhibit: I
Dresdner Bank Group's Risk Policy

Source: Dresdner Bank Annual Report, 2002.

Risk Control reported directly to the Chief Risk Officer (CRO), who was a member of the Board of Managing Directors. Its core tasks were to record risks, and monitor them. Risk Control attempted to ensure that all risks complied with the limits approved by the Board of Managing Directors and with qualitative risk standards. It was also responsible for internal and external risk reporting and supported the Board of Managing Directors in the risk-based allocation of capital to different business divisions as part of strategic planning. Risk Control established Group-wide standards, suitable limit structures and appropriate methods for risk measurement. These tasks were performed in cooperation with the Risk Management for the divisions concerned. The divisions were directly responsible for risk and profits as part of their business activities.

At the end of 2002, the German Financial Supervisory Authority published its Minimum Requirements for Banking Activities (Mindestanforderungen für das Kreditgeschäft – MaK), which set out the framework for active risk management by banks.

Key requirements, such as the organizational separation of the sales and credit risk management (lending functions), were met by the Corporates & Markets and Private and Business Clients divisions in 2002. While sales people contacted customers, in all cases, individual loan commitments and creditworthiness were analyzed objectively and independently as part of credit risk management. Dresdner had separated the Risk Management and Risk Control functions.

Credit risk monitoring, which formed part of Group-wide Risk Control, was responsible for risk measurement methodologies and regularly performed portfolio analyses.

The Group Capital Committee (CapCo), chaired jointly by the CRO and CFO, set up in 2000, served as a discussion and decision-making forum for all key methodological, strategic and operational questions concerning the funding, investment and allocation of capital at the corporate level.

The Risk Management & Control Committee (RM&C), established in 2002 formulated and implemented group-wide guidelines and standards with regard to the risk policy and management of credit and counterparty risks. The committee also acted as the decision-making body in the implementation of major risk-relevant projects. The RM&C worked for improved coordination in the area of credit and counterparty risks. The overall portfolio was subject to a monthly review, coordinated by Risk Control, in which the risk management units of the individual divisions participated.

The Commitment Committee (COMCO) was set up for the Corporates & Markets division. It acted as the decision-making board for transactions and business-related activities. When evaluating individual transactions, COMCO considered all relevant types of risk, such as market risks, reputation risks, operational risks and legal risks. The basis for COMCO's supervisory function was the information provided by Credit Risk Management, along with additional information from the business units and the respective units supporting them.

The Audit Department within the Corporate Centre was an independent internal body that monitored operating procedures and workflows, Risk Management and Risk Control as well as the internal control system. The tasks and functions of the Audit Department were documented in detail in the relevant internal instructions resolved by the Board of Managing Directors and in the general framework.

Following the takeover by Allianz, Dresdner's Corporate Centre Risk Control started working closely with the Group Risk Control department at the Allianz Group Centre. Risk Control acted as the centre of competence for risk standards and the measurement of banking risks within the Allianz Group and supported the Allianz Group Centre in this area. This included measuring individual risks, as well as risk capital allocation performed as part of the value adding process (EVA) for the Banking segment.

Basel II

Regulatory requirements strongly influenced Dresdner's risk policy. The revised version of the Basel Capital Accord (Basel II) entailed a major overhaul of the existing regulations governing capital adequacy in the case of credit risks. Operational risks would be included for the first time. Basel II, which was scheduled to come into force in 2006, would set out fundamental guidelines for risk-oriented price determination at banks. Dresdner was actively involved in the discussion on the Basel II drafts. Dresdner also supported the regulatory authorities in carrying out surveys and collecting data on subjects relevant to Basel II.

Credit and Counterparty Risks

Dresdner defined credit and counterparty risk as the potential loss resulting from the default of a business partner, or write-downs resulting from an unforeseen deterioration in creditworthiness. This definition comprised credit risks in the lending area, including country risks; issuer risks in the case of securities offerings; and counterparty risks from trading activities.

The central element of the authorisation, monitoring and control process in the bank's lending and derivatives business was the individual credit rating of customers and their loan commitments. The result of this credit assessment was the classification of customers into rating classes. Dresdner used 16 rating classes from eight to 16. Classes I to VI corresponded to the external investment-grade ratings, while classes VII to XIV corresponded to the non-investment-grade ratings. The two lowest categories (XV and XVI) were for commitments classified as impaired or defaulted. Dresdner determined the default probabilities for individual rating procedures and classes on the basis of annual calibration processes.

Dresdner ensured the quality of its rating procedures through regular monitoring. Years of rating experience combined with the latest statistical methods allowed the bank to further improve its rating procedures. These modifications were in line with the Basel II requirements relating to the IRB Advanced Approach that Dresdner intended to adopt.

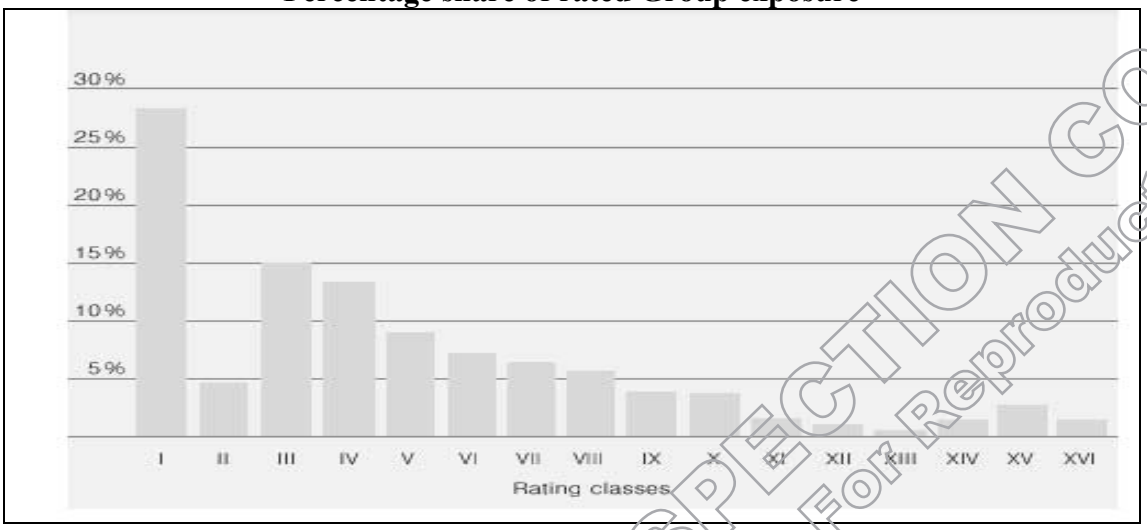
The quality of Dresdner's rating forecasts and the rating process itself were monitored independently, by Risk Control, on a regular basis. Automated, statistical methods were used in the high-volume business of the Private and Business Clients division. For business clients, credit quality assessment was supplemented by qualitative factors. The less homogeneous portfolio in the Corporates & Markets division demanded a series of specific rating procedures.

Dresdner believed that a combination of automatic calculation of the quantitative rating component, the structured assessment of qualitative factors and a clearly defined process for individual adjustments was desirable. Expected losses from credit or transfer risks and an adequate return on the capital required to cover unexpected risks were taken into account when fixing the terms and conditions for loans. The central control parameter in loan decisions was the expected loss, which was calculated on the basis of historical credit risk parameters such as default rates and revenue quotas. It was also a key parameter in the planning process and in performance measurement. This ensured that internal planning and control processes were based on the same credit risk parameters that were also applied to external – i..e. accounting and regulatory – requirements.

Portfolio Overview

Rating classes I to VI (i.e. investment-grade loans) accounted for around 70% of the total exposure.

Figure: (i)
Percentage share of rated Group exposure



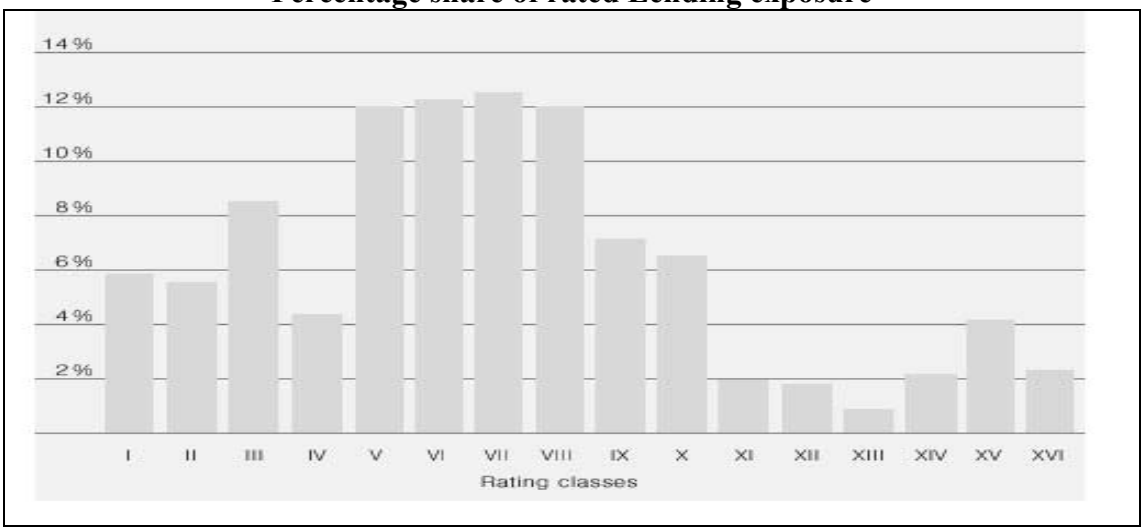
Source: Dresdner Bank Annual Report, 2002.

The volume of the total portfolio was largely determined by Dresdner's trading activities. The most important transactions in that area (with the public sector and banks/financial service providers) had substantially lower default probabilities. For example, rating class I accounted for around 85 % of the volume with public authorities/ non-profit organizations, while rating classes III to V accounted for 60 % of the volume with banks/financial service providers. These two sectors represented 56% of Dresdner's total portfolio.

75 % of the group's lending exposure with private individuals consisted of construction finance which was secured by mortgage loans. The bulk of transactions in the Corporates & Markets division involved service providers and industrial companies.

The business of the domestic regions, Dresdner Bank subsidiaries and the Head office accounted for three-quarters of the lending business. In fiscal year 2002, lending business at associated companies located outside Western Europe declined and totalled 11% of the total lending volume.

Figure: (ii)
Percentage share of rated Lending exposure



Source: Dresdner Bank Annual Report, 2002.

Loan Loss Allowances and Provisions for Credit Risks

Loan loss allowances comprised specific loan loss allowances, general loan loss allowances and country risk allowances.

Specific loan loss allowances were set up for risks arising from loans identified and quantified during the fiscal year.

General loan loss allowances were set up for loan related risks which might already have arisen but which had not yet been identified by the balance sheet date. The amount of loan loss allowances was determined by empirical calculation of historical default probabilities and loss ratios for the lending portfolio (provided that other risk provisions had not already been made). This calculation was based on the statistical methods of credit risk measurement and took into account the overall economic conditions.

Country risk allowances covered the possibility that a country would be unable or unwilling to provide sufficient funds in the underlying currency to service its cross-border debt as agreed, or

that it might freeze the settlement of corresponding liabilities by the Bank's borrowers domiciled in the respective country ("transfer risk").

Exhibit: II
Loan Loss allowances

€ mn	*Counterparty risks*		*Counterparty risks*		*Potential risks (General loan loss allowances)*		*Total*	
	2002	**2001**	**2002**	**2001**	**2002**	**2001**	**2002**	**2001**
31 December	6,060	6,760	367	488	813	804	7,249	8,052

Source: Dresdner Bank Annual Report, 2002.

Counterparty risk of € 4,720 million applied to domestic risks and € 1,349 million to foreign risks. Loans and advances to customers accounted for € 5,735 million and loans and advances to banks for € 334 million. The net increase in loan loss provisions in the past fiscal year amounted to € 2,218 million.

Exhibit: III
Derivative (Trading and Banking book)

Market segments	Notional amounts by time to maturity				Positive replacement
€ mn	< 1 year	1–5 years	> 5 years	Total	costs *)
Interest rate derivatives	1,184,939	704,728	577,353	2,467,020	45,708
Currency derivatives	433,096	60,657	22,192	515,945	11,860
Equity/Index derivatives	72,108	52,790	3,860	128,758	5,107
Credit derivatives	5,704	56,655	3,564	65,923	1,320
Other transactions	5,233	2,569	324	8,126	417
Total	**1,701,080**	**877,399**	**607,293**	**3,185,772**	**64,412**

*) Not including netting effects.

Source: Dresdner Bank Annual Report, 2002.

The counterparty risks associated with derivative trading activities mainly arose in case of over-the-counter (OTC) transactions. The quantum of counterparty risk at any given time was the additional expense or reduced revenue that would result from the replacement of the transaction by an equivalent position in the event of a default. At the end of the year, aggregate positive replacement costs for all OTC traded derivatives amounted to € 64,412 million (gross, before netting). Given the possibility of default in case of trading in OTC derivatives, counterparty selection was vital. Counterparties ranked in the internal rating categories I to VI (investment grade), accounted for 95 % of the positive replacement costs in Dresdner's rated derivatives portfolio.

Exhibit: IV
Counterparties and Replacement Costs

Counterparties by industry sector	Positive replacement costs	
€ mn	**31 Dec 2002**	31 Dec 2001
Banks	47,738	29,344
Other financial services providers	11,673	6,144
Insurance companies	484	800
Industrial companies	327	1,107
Telecommunication, media, technology	745	726
Transport	276	203
Extractive industries	667	259
Real estate	112	14
State budgets	676	377
Other	1,714	1,075
Total – before netting	**64,412**	**40,049**
Total – after netting and collateral	**17,212**	**16,248**

Source: Dresdner Bank Annual Report, 2002.

Dresdner entered into cross-product master netting agreements with business partners to reduce the counterparty risk. Netting allowed all claims and liabilities not yet due to be offset against each other in the case of counterparty default. These master agreements served not only to reduce the cost of regulatory capital tied up but also to reduce the utilization of internal counterparty limits. After taking netting effects into account, positive replacement costs declined by € 45.4 billion (as opposed to a reduction of € 22.8 billion in the previous year). In addition, there was an increasing trend towards collateralization of current potential risks (positive replacement costs after netting). At the end of the year, the value of the collateral received in relation to these derivatives transactions amounted to roughly € 1.8 billion. The replacement costs for Dresdner thus amounted to around € 17.2 billion (previous year: € 16.2 billion).

Credit risk exposures included in credit and counterparty risk management were managed using a global, multi-stage limit system. Both the replacement costs and any potential future price fluctuations were taken into account in calculating counterparty risk limits. A value-at-risk procedure was used when quantifying collateralized transactions. A simulation procedure was used for unsecured transactions to assess portfolio and correlation effects when calculating exposure. Trial calculations had revealed that the potential exposure could be reduced significantly in currency and interest rate transactions.

When quantifying counterparty risks from derivatives for regulatory purposes, both replacement costs and a global estimate of future market fluctuations (potential exposure) were taken into account. The assessment of this potential risk depended on the underlying product involved and the individual time to maturity. The result of this calculation was referred to as the "add-on ". This was combined with the relevant replacement cost to arrive at the credit equivalent value of a derivative transaction. The aggregate credit equivalent values were quantified in line with Principle I of the German Banking Act (i.e. before credit-based weighting and after regulatory netting) at € 34.6 billion (previous year: € 33.9 billion). The risk-weighted assets from derivatives relevant for regulatory capital amounted to € 8.1 billion (previous year: € 8.5 billion).

Country Risk

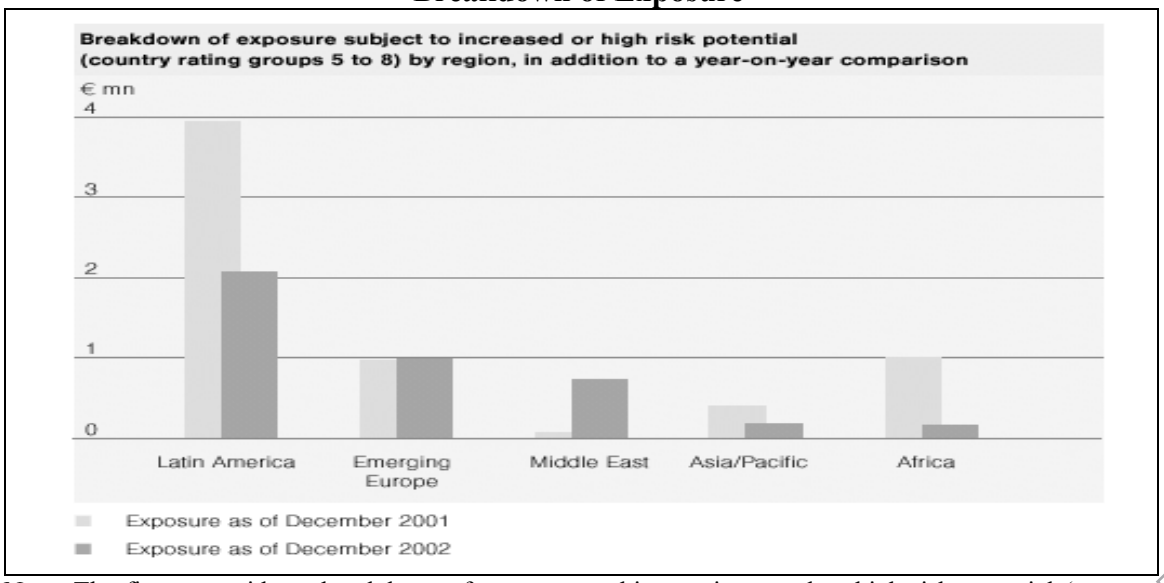
To measure country risk, Dresdner used a weighting system that consisted of various quantitative (mainly macro-economic) as well as qualitative economic, social and political factors. The system focused in particular on solvency in the foreign currency. The country rating system comprised eight risk groups – classes 1-4 for countries without identifiable country risks and classes 5-8 for countries with an increased or high risk potential.

A comprehensive country limit system assigned limits at the level of regional and country rating classes as well as for every country individually. In addition, ceilings were set for individual countries in order to avoid clustering risks.

Dresdner's overall country risk exposure could be broken down into countries without an identifiable country risk (97.0 %, previous year: 96.9 %)and countries with an increased or high risk potential (3.0 %, previous year: 3.1%).

Approximately 85% of the exposure in country rating groups 5 to 8 was attributable to the lending business, and about 15 % to trading activities. Dresdner continued efforts to reduce the proportion of countries with an increased or high risk potential.

Figure: (iii)
Breakdown of Exposure



Note: The figure provides a breakdown of exposures subject to increased or high risk potential (country rating groups 5 to 8) by region, in addition to a year-on-year comparison.
Source: Dresdner Bank Annual Report, 2002.

The reduction in exposure in the course of the past 12 months reflected the changed economic situation in Latin America, among other things. The only increase in exposure related to the Middle East region and was due to the decline in ratings of individual countries.

At the end of 2002, the aggregate country risk allowance amounted to € 367 million (2001: € 488 million). This decrease was mainly the result of the reduction in exposure as well as the increase in specific loan loss allowances particularly in Latin America.

Market Risks

Dresdner used the value-at-risk (VAR) method to measure the market risk in the bank's global trading business. VAR was defined as the statistically determined potential loss that might occur in a trading portfolio. It was calculated on the basis of a pre-defined period and had a given confidence level. VAR could be applied to all kinds of financial instruments, including equity, foreign exchange, or interest rate instruments.

Dresdner's internally developed VAR model took both general and specific risks into account. The VAR model was supplemented by stress tests.

In addition to regulatory reporting requirements, VAR was calculated for the purpose of internal limit setting and risk determination using a confidence level of 95 % and a one-day holding period. In contrast to the calculation for regulatory purposes, this calculation process assigned greater weight to more recent market fluctuations.

VAR was just one of the ways in which Dresdner Bank depicted its risk profile. The bank also used operational risk indicators and limits, which were tailored to the needs and specific risk situations of the individual trading units. Trading activities were managed using the VAR and operational market risk limits. Limit utilization was ascertained and monitored on a daily basis by Risk Control. Where limits were breached, the management was notified and immediate action taken to remedy the situation. The limits were revised and adapted at regular intervals to reflect changing market situations and planned risk profiles.

As a rule, a distinction was made between activities in the trading book and activities undertaken in order to manage market risk in the banking book. The latter also contained assets for investment purposes.

Back Testing

The results obtained were regularly checked against the so-called "hypothetical performance " by backtesting. The VAR calculated on the basis of current positions was compared to the actual change in value on the following day. The hypothetical performance reference value required for this purpose was calculated under the assumption that the portfolio remained unchanged. For backtesting, risks were determined using a confidence level of 99 % in line with the regulatory requirements. However, the holding period was only one day. Statistically speaking, this meant that for 100 given daily losses, the negative hypothetical performance could exceed the relevant risk value determined in advance only on a single day. Only one such outlier was observed in 2002. This outlier was caused by a sharp market movement that was the result of an unexpected interest rate decision taken by the US Federal Reserve in mid-August.

Market Risks in Trading Book

The risks from Dresdner's trading activities decreased in comparison with the previous year, mainly as a result of a reduction in interest rate instrument positions.

Exhibit: V

Value-at-risk statistics (99 % confidence level, 10-day holding period)

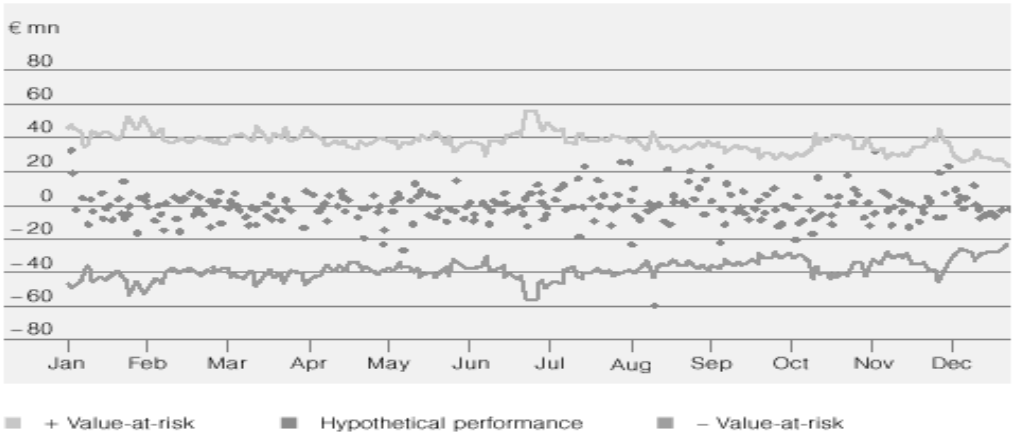
	Year-end	2002 annual statistics			Year-end
€ mn	**2002**	Mean value	Maximum	Minimum	2001
Aggregate risk	81	120	167	35	147
Interest rate risk	65	101	147	65	124
Equity risk	45	53	83	26	64
Currency/ commodity risk	13	17	104	2	18
Diversification effect[1]	– 42	– 51	–	–	– 59

[1] No diversification effect can be taken into account since the maximum and minimum values were measured at different dates.

Source: Dresdner Bank Annual Report, 2002.

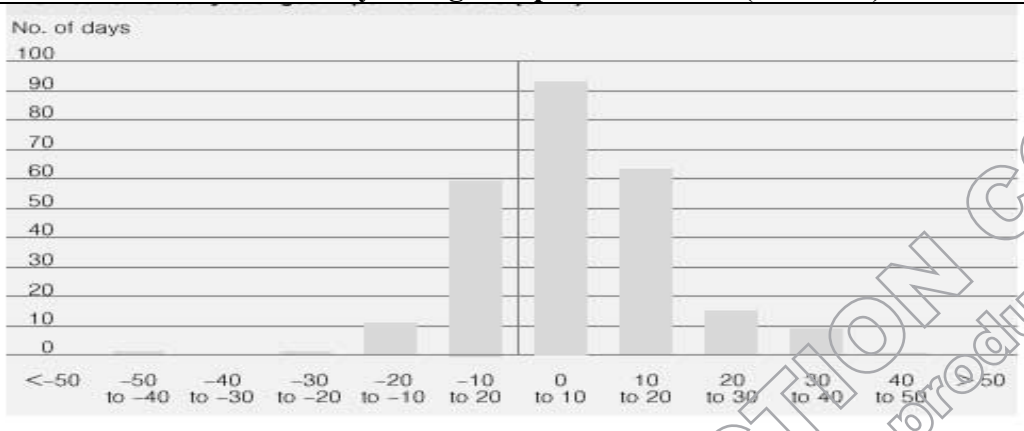
Figure: (iv)

Backtesting: Value-at-risk (99 % confidence level, 1 day holding period) versus hypothetical performance



Source: Dresdner Bank Annual Report, 2002.

Figure: (v)
Distribution of daily changes in portfolio value (€ million)



Source: Dresdner Bank Annual Report, 2002.

Market Risks in the Banking Book

The market risk in the banking book mainly comprised the risk of interest rate changes. Interest rate risks were analyzed on the basis of sensitivities and value-at-risk indicators. To quantify interest rate risks in the banking book, cash flows were calculated for interest bearing assets and liabilities as well as for derivative positions. Sensitivities and value-at-risk indicators were calculated on the basis of these cash flows. Positions without a specific interest rate maturity were included in risk management on the basis of historical experience and the expected development of the relevant product markets.

The Treasurer was responsible for performance and risk in relation to the management of interest rate risks in the banking book. The risks resulting from the range of positions in Dresdner Bank's banking book were limited using operational VAR limits in the same way as for the day-to-day monitoring of trading activities. Risk Control determined, monitored and reported the risk limit utilisation on a daily basis. VAR was calculated on the basis of a confidence level of 99 % and a ten-day holding period.

Taking into account portfolio effects, the interest rate value-at-risk from the Group's banking book amounted to € 31.9 million at the end of 2002 (previous year: € 95.3 million). The year-on-year decrease was mainly due to the deconsolidation of Deutsche Hyp.

In addition to interest rate risk, Dresdner was subject to currency risks. All loans and deposits in foreign currency were refinanced or reinvested in the same currency and with matching maturities. The residual risk of exchange rate changes in commercial business primarily resulted from the intra-year development of results at overseas affiliated enterprises.

Liquidity Risks

Liquidity risk was the possibility that Dresdner might not be able to meet its current and future payment obligations in full or on time. In the case of a liquidity crisis, refinancing might only be possible at higher market rates (funding risk), or assets might have to be liquidated at a discount to the market rates (market liquidity risk).

The daily preparation of a scenario-based run-off profile and an associated limit system, provided Dresdner with an integrated instrument for the management of liquidity risk. This liquidity management system was implemented at Dresdner and several of its larger subsidiaries in 2002.

Group Treasury was responsible for liquidity risk management within the group. Regional Treasury units monitored local markets and reported regularly to the Group Treasury. Risk Control was responsible for monitoring risk limits, validating the methodology used and reporting.

Group Treasury and Risk Control had laid down principles for liquidity management as part of a Group Liquidity Policy. This policy met both regulatory requirements and internal standards. It included the setting of liquidity risk limits as well as the establishment of an escalation process when limits were breached. Liquidity risk measurement was based on a liquidity management system that modeled the maturities of cash flows and drew up a run-off profile, taking into account the available prime-rated securities.

Group Treasury used this as the basis for daily analyses as part of its liquidity management process. In addition, volumes of liquid assets, securities deposited as collateral with central banks and unsecured funding through banks and the market for certificates of deposit were monitored daily.

Short-term cumulative liquidity mismatch limits (up to two years) as well as long-term refinancing ratio limits (over two years) were monitored and analysed by Risk Control on a daily basis. These analyses included a number of different liquidity inflow and outflow scenarios as well as stress tests. The Group's liquidity profile remained within the established limits at all times during the period under review.

Dresdner's refinancing strategy aimed at achieving a broad diversification of its short-medium- and long-term refinancing basis with respect to investors, products, markets and maturities. The bank attempted to cultivate a domestic and international investor base to ensure that the bank's refinancing arrangements remained secure and stable.

Operational Risks

Operational risks arose during the course of business due to inadequacies or failures in processes, or controls, and might be due to technology, staff, organizational structures, or external factors.

A separate unit within Corporate Centre Risk Control was responsible for managing operational risks. This defined consistent minimum standards for the entire Group and coordinated preparatory measures relating to the regulatory determination of operational risks in line with the Basel Capital Accord.

Risk Control also assisted divisions and subsidiaries responsible for their own risk management to assess their operational risks and implement risk-minimizing measures. Dresdner had established guidelines and policies in order to facilitate a systematic and consistent operational risk process consisting of identification, quantification, and reporting as well as management and monitoring of operational risks.

Operational risks were identified and quantified, based on a model of the bank's business processes. A loss database facilitated focused, detailed analysis and elimination of the causes of actual losses incurred.

The individual business units used a structured self-assessment to assess the risks and quality of their workflows. All significant risk factors that could disrupt the Bank's business activities were assessed with respect to the potential frequency and amount of damage.

Risk indicators were warning signals that revealed changes in the operational risk profile of an organization's workflows to the responsible day-to-day management team. Warning messages were generated automatically when risk indicators entered the critical zone.

Other Risks

Dresdner defined business risks as unexpected fluctuations in financial performance that arose when expenses could not be reduced in line with a decline in earnings due to changes in the competitive situation, customer behaviour, or technological advances.

Dresdner defined *legal risk* as the risk of a loss due to the adoption of new statutory regulations, disadvantageous amendments to existing laws or regulations, or prejudicial changes in their interpretation. Legal risk also comprised the risk that contractually agreed provisions might not be enforceable, or that a court might replace an agreed contractual provision by another provision detrimental to the bank. Dresdner believed in using internationally recognised standard documentation. The contractual conditions for established products were continuously reviewed to include any amendments required by changes in legislation or case law. Where necessary, Dresdner obtained legal opinion.

A *strategic risk* was the risk of not achieving long-term corporate goals due to an inadequate strategic decision-making process or inadequate monitoring of the implementation of the strategies concerned on the basis of underlying business assumptions and projections. Dresdner took strategic risk into account by continuously monitoring its market position and competitive environment. The Board of Managing Directors regularly reviewed the validity of the strategies employed in the individual divisions and business units, the resulting strategic initiatives and investments, and the portfolio structure of the Group as a whole.

Dresdner defined reputation risks as direct or indirect losses that could arise due to the deterioration of its reputation, either in its own right or as part of the Allianz Group, among its shareholders, clients, staff, business partners, or the general public.

The Market Research and Media Analysis unit within Corporate Centre Corporate Communication identified risks affecting the bank's reputation and analyses and quantified them. These included direct communication problems (primary reputation risks) as well as any problems initially caused by the communication of other risks (secondary reputation risks). For this reason, the bank included reputation risk control in its integrated risk control model and worked closely together with Risk Control to ensure that suitable processes were installed and measures taken to limit such risks.

Risk Capital

Risk capital allocation as well as annual income and risk budgets played a major role in Dresdner's overall risk management policy. The central control parameter was Economic Value Added (EVA). In addition to the income and expense components in the financial statements, EVA took into account the risk capital requirement.

Within the EVA framework, the risk capital requirement was determined exclusively on the basis of the bank's internal risk measurement models. At the same time, the bank maintained compliance with the minimum capital requirements based on regulatory measurement procedures. The two-risk measurement approaches differed but were expected to converge to some extent after the implementation of Basel II.

In recent times, Dresdner had made significant methodological improvements in the bank's internal risk measurement procedures. Those included the harmonization of bank and insurance risk measurement, which were carried out in cooperation with Allianz's Risk Control department.

The risk capital requirement included credit and counterparty risks, market risks, operational risks, business risks and risks from shareholdings. These individual risks were aggregated to produce the overall risk for the bank after considering the impact of diversification.

The risk capital requirement was determined for each of the risk types. Credit and counterparty risks included country risks, as well as risks from shareholdings, and accounted for the largest proportion of the risk capital requirement.

List of References:

1. www.hoovers.com
2. www.riskreports.com
3. www.dresdner-bank.com
4. Dresdner Bank Annual Report 2002.

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