MANAGEMENT REPORT AND FINANCIAL STATEMENTS

2010

KfW BANKENGRUPPE

KEY FIGURES OF KFW

	2008	2009	2010
	EUR in millions	EUR in millions	EUR in millions
Financial statements			
Business volume	478,038	482,470	524,629
Balance sheet total	400,199	407,237	445,514
Bonds issued	297,682	324,323	360,145
Subordinated liabilities	3,247	3,247	3,247
Own funds	10,531	12,236	14,888
Net interest income	1,555	2,141	2,389
Interest rate reductions	606	571	558
Net commission income	150	199	205
Administrative expense	506	552	555
Net income/loss for the year	– 2,043	1,664	2,013
Cost/income ratio before interest rate reductions	21.9	19.0	17.6
Tier 1 ratio	9.3	11.6	14.7
Total capital ratio[1)]	12.2	14.6	17.7
Employees	3,307	3,321	3,543

[1)] *The regulatory total capital ratio and the tier 1 ratio are calculated for internal purposes.*

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The figures in tables were calculated accurately and added up. Figures may not add to totals because of independent rounding.

MANAGEMENT REPORT

ECONOMIC REPORT

General economic environment

The global economic recovery continued in 2010, leading to strong economic growth, particularly in the first half of the year. This recovery was mainly due to continuing highly-expansive monetary policy and fiscal stimuli in many countries. Positive growth effects also resulted from ongoing inventory build-up. In the second half of the year, the global economy adopted a more moderate pace but remained on an expansionary course.

All in all, global gross domestic product increased by around 5% in 2010 in real terms, following a decline in 2009. The growth drivers proved to be, above all, the Asian emerging markets. Aggregate output in these markets reached or exceeded the pre-crisis level in many cases. Development was particularly dynamic in China and India, where, in real terms, gross domestic product grew by over 10% and just under 10%, respectively. In most industrialised countries, meanwhile, the structural repercussions of the global financial crisis remained noticeable. The growth lost through the crisis could be only partially offset in 2010. Within the euro area, too, the growth disparities between regions widened further. Germany functioned as Europe's economic motor, in contrast to countries such as Greece and Ireland where the recession deepened.

Development on the financial markets in 2010 was hampered by growing concerns about rising government budget deficits resulting from the crisis. Credit default expectations rose considerably for some euro area member states and, during spring, reached a level for Greece at which support measures became necessary. However, the aid measures in response, which were agreed at the beginning of May, and the newly-established euro rescue package were unable to calm the financial markets for long. Ireland, another euro area member state, had to be supported in November. In view of the difficult financial market environment, the European Central Bank held tightly to its policy of generous liquidity provision for the banking sector and maintained key interest rates at a very low level. US monetary policy also maintained a highly expansive stance. In autumn the Federal Reserve Bank announced a considerable increase in the volume of its security purchases. The central banks' highly expansive monetary policy measures have been reflected in extremely low money market rates and relatively steep yield curves on average.

The problems in the European sovereign debt sector caused high volatility on the currency markets. While at the beginning of 2010 the euro was still reaching levels of over 1.45 against the dollar, it temporarily fell below 1.20 at the start of June as the Greek crisis worsened. On average, the EUR/USD exchange rate stood at 1.33 in 2010, making it around 5% lower than in the previous year. The German real economy recovered considerably more quickly and strongly from the economic crisis than had been expected at the beginning of the year. In 2010, gross domestic product grew by 3.6% in real terms. This represented the highest annual average increase since German reunification. The recovery is particularly impressive in international comparison. Germany entered the crisis with an economy in relatively good structural health and – because it is highly export-oriented – had to contend only with a steep, but relatively short-lived drop in global demand. For the same reason, the country has benefited from global economic momentum in the upturn. Alongside export demand, domestic demand, i.e. consumption and investment, grew notably in 2010. Household consumption benefited from the declining unemployment rate which, uniquely among large industrialised countries, fell to below the pre-crisis level as early as summer 2010. The short-time working programme (Kurzarbeit), with which the state eased the cost burden on companies and helped them to maintain staff despite the sometimes severe loss of sales during the crisis, played a significant part in this positive labour market development. The improved sales prospects in the domestic market, together with increasing exports, had a positive impact on companies' willingness to invest. With perceptible increases in capacity utilisation, gross fixed capital formation contributed considerably to economic growth. Due to the strong upswing, public finances performed significantly less badly than had been feared at the start of 2010, although at 3.5%, the German government deficit, as with the deficits of almost all European Union countries, exceeded the Maastricht criterion in 2010 due to the after-effects of the stimulus measures.

Development of KfW

The overall environment for KfW was uniquely favourable in 2010. KfW benefited from considerably improved growth and a low level of risk, as well as from continuing attractive refinancing conditions with low interest rates. Business activity therefore generated record earnings of EUR 2.0 billion, compared to EUR 1.7 billion in the previous year. With this result, the remaining losses carried forward from the rescue of IKB Deutsche Industriebank AG have been fully recovered. In addition, the capital base was strengthened to secure its promotional capacities for the long term and in preparation for stricter capital requirements in accordance with the new Basel III requirements. This includes the addition of EUR 0.6 billion to the fund for general banking risks. A normalisation of earnings is expected for 2011. Business performance in 2010 was largely characterised by the following developments:

1) Record demand for KfW products – the significant increase in promotional business volume, particularly in domestic business including the KfW Special Programme that expired as planned on 31 December 2010, played a large role in overcoming the economic crisis.
2) A stable operating result at a consistently high level due to KfW's continuing highly favourable funding situation.
3) Substantial reversal of risk provisions for lending business due to the global economic recovery which happened sooner than expected at the beginning of the year and the improved risk situation in key business segments as a result.

1) Record demand for KfW products

KfW expanded domestic promotion for the economy, the environment, housing and education by EUR 15.7 billion in 2010 to a record volume of EUR 66.6 billion, thus playing a significant role in alleviating the impact of the economic and financial crisis on German companies and in laying the foundations for economic recovery. The total financing volume also increased considerably, remaining at a very high level (EUR 74.7 billion)[2]. This is also reflected in the increase in KfW's total assets in financial year 2010 of EUR 38.3 billion or 9 % to EUR 445.5 billion. KfW was also mandated by the Federal Government, in accordance with the KfW Law, to participate, without assuming any risk, in the European Union measures to refinance Greece and granted a loan of EUR 22.3 billion in this context. The total commitment volume for financial year 2010 was therefore EUR 97.0 billion.

The financing volume of KfW Mittelstandsbank increased by 20 % year-on-year, to EUR 28.5 billion. This growth was primarily driven by KfW entrepreneur loan commitments of EUR 8.0 billion and strong demand for the KfW "Renewable Energies" programme in the amount of EUR 9.6 billion. Further commitments under the "KfW Special Programme" including global loans, totalling EUR 6.2 billion, made a substantial contribution to SME financing again in 2010.

The financing volume of KfW Privatkundenbank increased from EUR 16.1 billion to EUR 20.0 billion in the year under review. This increase was attributable to the high level of demand for the "Energy-efficient Construction and Rehabilitation" programmes (EUR 8.7 billion) and the "KfW Home Ownership Programme" (EUR 6.5 billion).

There was a significant increase in the financing volume of KfW Kommunalbank to EUR 15.8 billion (previous year: EUR 9.4 billion). Both commitments in direct municipal financing and the volume in global loan business showed solid development and improved on the prior-year levels.

The commitment volume of KfW Entwicklungsbank also rose considerably to EUR 4.5 billion (previous year: EUR 3.5 billion). KfW Entwicklungsbank added EUR 2.8 billion of own funds to German government budget funds for projects in developing and transition countries and considerably expanded its position as international climate and environmental bank.

The commitment volume in the Asset securitisation business area also increased year-on-year, from EUR 1.5 billion to EUR 2.1 billion.

2) Stable operating result at a consistently high level

The operating result before valuation increased further on the previous year's high figure of EUR 1,823 million , by EUR 226 million to a record level of EUR 2,049 million.

A substantial contribution came from net interest income, which was above the prior-year level despite interest rate reductions remaining high at EUR 558 million. Short-term refinancing opportunities, which remained very favourable throughout 2010, made a particular impact here. The cost/income ratio[3] before interest rate reductions improved further to 18 %.

3) Earnings benefit from global economic recovery

The considerable increase in the annual result was primarily due to the improved risk situation compared with the previous year. The improved economy in Germany meant that general risk provisions – particularly those created in the past few years for the sectors affected by the crisis – could be reversed. The necessary reversal of risk provisions created in the previous few years more than offset the new requirement for risk provisions arising for immediate credit risks in 2010.

KfW also continued its conservative risk provisioning policy in financial year 2010 and boosted its fund for general banking risks to EUR 600 million.

[2] Excluding one-time effects from loans granted to the Republic of Greece in 2010.

[3] General expenses in relation to adjusted income, which is calculated from the net interest and commission income plus interest rate reductions.

Impact of the Accounting Law Reform Act

The German Accounting Law Reform Act (*Bilanzrechtsmodernisierungsgesetz* – BilMoG) brought about the most comprehensive modernisation of commercial law since the Accounting Directives Act (*Bilanzrichtliniengesetz*) in 1985.

The impact on financial reporting for KfW is largely due to the changes in determination of the settlement amount of provisions, particularly of provisions for pensions and similar commitments. The parameters to be used are listed in full in the Notes; the resulting effects of first-time application are recognised under extraordinary expenses.

Statutory regulations regarding recognition and measurement of hedging relationships have also been established for the first time through the BilMoG. A detailed explanation thereof is also provided in the Notes.

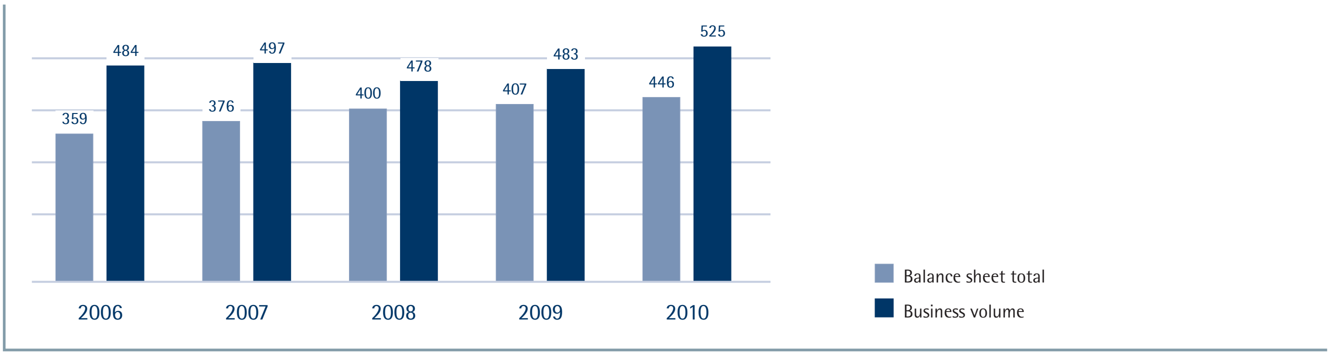
The extensive disclosure requirements intended to increase transparency are addressed in the Notes to these single-entity financial statements and the Management Report and also by reference to the financial report.

KfW adheres voluntarily to the Federal Public Corporate Governance Code. The declaration of compliance is included in the Management Report.

Development of net assets, financial performance and results of operations

KfW's volume of business was EUR 524.6 billion in 2010 (previous year: EUR 482.5 billion). The increase is largely due to the high level of demand for special lending programmes and global loans. Irrevocable loan commitments increased by EUR 17.0 billion in 2010, particularly due to the portion of the loan granted to the Republic of Greece that has not yet been paid out; this is compensated by a decline in contingent liabilities in the securitisation business.

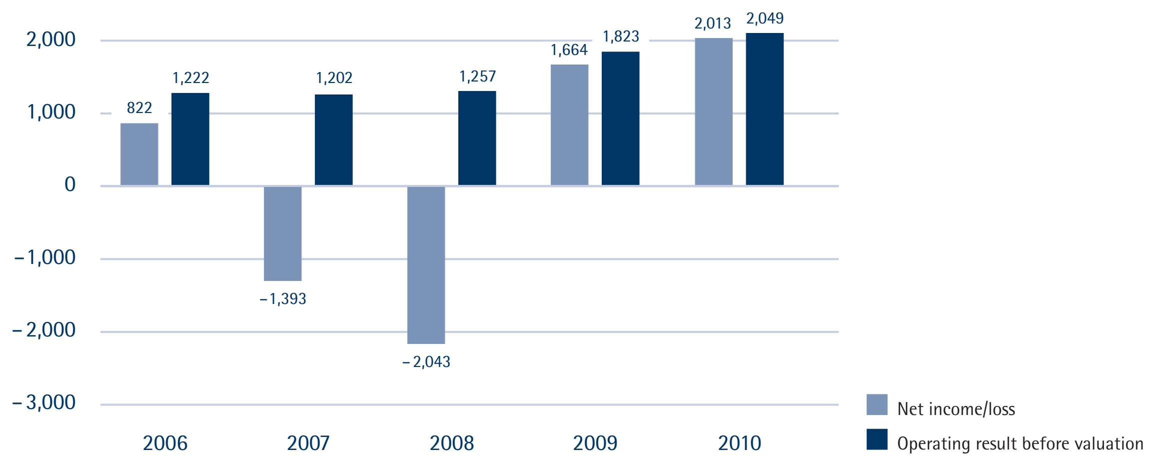
Balance sheet total and business volume
EUR in billions



At EUR 2,049 million, the operating result before valuation and net income/loss improved again and remained at a high level, mainly due to stable high net interest income.

The operating result was also strengthened by a very positive risk provisioning and valuation result – particularly due to the reversal of credit risk provisions. The combination of these two effects in financial year 2010, i.e. favourable refinancing conditions on the one hand and the improved level of risk on the other, was historically unique. Given these conditions, KfW reported record profits of EUR 2,013 million (previous year: EUR 1,664 million) after adding EUR 554 million to its fund for general banking risks, taking it to EUR 600 million.

Operating result before valuation and net income/loss
EUR in millions



Volume of lending

The volume of lending (loans and advances, including loans on a trust basis and guarantees, and irrevocable loan commitments) increased to EUR 419.6 billion (previous year: EUR 386.2 billion).

Volume of lending

	31 Dec. 2010	31 Dec. 2009	Change	Change
	EUR in millions	EUR in millions	EUR in millions	in %
Promotion of the German economy				
Kommunalbank	72,919	65,510	7,409	11
Mittelstandsbank	112,361	104,497	7,864	8
Privatkundenbank	117,469	108,425	9,043	8
Other investment finance	5,744	6,645	– 901	– 14
International business				
Export and project finance	43,745	45,358	– 1,613	– 4
Loans for developing countries	26,197	23,395	2,801	12
Other[1)]	22,336	0	22,336	–
Guarantees	18,799	32,389	– 13,590	– 42
Total volume of lending	**419,570**	**386,220**	**33,350**	**9**
Loans on a trust basis	16,191	16,314	– 123	– 1

[1)] *Incl. special business related to the loan granted to the Republic of Greece in 2010*

The increase in the volume of domestic lending to EUR 308.5 billion is mainly a result of the rise in investment finance to support SMEs. The percentage of these promotional loans for the German economy in relation to the total lending volume remained almost unchanged at 74 %.

International business increased to EUR 92.3 billion and accounts for 22 % of the total lending volume, including the loans to the Republic of Greece (EUR 22.3 billion).

Guarantees, which are mainly related to KfW's securitisation activities, declined by EUR 13.6 billion to EUR 18.8 billion, thus accounting for just 4 % of the lending volume.

Loans on a trust basis totalled EUR 16.2 billion, remaining at the prior-year level.

Funding

Last year, KfW funded its business predominantly by issuing bonds in the capital market. KfW raised funds in the amount of EUR 76.4 billion in 2010 (previous year: EUR 74.7 billion).

Bonds issued increased by EUR 35.8 billion year-on-year. Securitised liabilities of EUR 360.1 billion were reported as at 31 December 2010.

Bonds issued accounted for 89 % of borrowed funds, unchanged from the previous year. They therefore remain KfW's most important source of funding.

The share of funds from banks and customers (excluding federal budget funds) increased slightly from 7 % to 8 %. This includes cash collateral received to reduce counterparty risk from the derivatives business in the amount of EUR 11.1 billion. Federal budget funds accounted for 3 % of borrowed funds, unchanged from the previous year.

There were also subordinated liabilities in the amount of EUR 3.2 billion.

Borrowed funds

	31 Dec. 2010	31 Dec. 2009	Change	Change
	EUR in millions	EUR in millions	EUR in millions	in %
Federal Republic of Germany				
■ ERP Special Fund	259	168	91	54
■ Federal budget	11,303	11,344	– 42	0
	11,562	11,513	49	0
Other lenders	11,164	12,797	– 1,633	– 13
Liabilities to customers	22,726	24,310	– 1,584	– 7
Liabilities to banks	19,515	12,474	7,041	56
Bonds issued	128,340	116,850	11,490	10
Bearer securities (incl. Commercial Paper)	226,667	202,340	24,327	12
Accrued interest	5,138	5,133	5	0
Bonds and notes	360,145	324,323	35,822	11
Subordinated liabilities	3,247	3,247	0	0
Total	405,633	364,354	41,280	11

Own funds

Net income for the year amounted to EUR 2,013 million after the fund for general banking risks was increased to EUR 600 million. Net income for 2010 fully offsets the losses carried forward from 2009 in the amount of EUR 1,499 million. The remaining EUR 514 million were allocated to retained earnings.

KfW's own funds thus amounted to EUR 14.9 billion as at 31 December 2010, 22 % up on the previous year.

The regulatory total capital ratio was 17.7 % (previous year: 14.6 %).

Own funds

	31 Dec. 2010	31 Dec. 2009	Change
	EUR in millions	EUR in millions	EUR in millions
KfW's subscribed capital	3,750.0	3,750.0	0.0
Uncalled outstanding contributions	- 450.0	- 450.0	0.0
Capital reserves	5,947.0	5,947.0	0.0
Promotional reserves of the ERP Special Fund	*4,650.0*	*4,650.0*	*0.0*
Reserves from the ERP Special Fund	977.0	892.8	84.2
Retained earnings			
a) Statutory reserve under Section 10 (2) KfW Law	1,837.9	1,574.3	263.6
b) Special reserve under Section 10 (3) KfW Law	2,178.1	1,927.8	250.3
c) Statutory reserve under Section 17 (4) D-Mark Balance Sheet Law [1]	47.6	47.6	0.0
Loss carried forward	0.0	– 1,499.2	1,499.2
Net loss/net income for the year	0.0	0.0	0.0
Fund for general banking risks under Section 340 g HGB	600.0	45.9	554.1
Total	14,887.6	12,236.2	2,651.4

[1] *To be adjusted by the special loss account shown on the assets side in accordance with Section 17 (4) of the D-Mark Balance Sheet Law (EUR 27 million)*

Changes in other major balance sheet items

Total bonds and other fixed-income securities increased slightly by EUR 0.3 billion to EUR 37.9 billion. Holdings of securities of other issuers, which make up 76 % of the total holdings of all bonds and other fixed-income securities, increased slightly in 2010 by 1 % to EUR 28.7 billion.

These securities, held for the purpose of maintaining KfW's liquidity, are assigned to the Treasury securities portfolios, which are maintained mainly in euros and to a small extent in US dollars. Of the securities from other issuers, 78 % is eligible as collateral for funding operations with the ECB. In addition to the Treasury securities portfolios, KfW holds asset backed securities (ABS) with a book value of EUR 4.1 billion in connection with its securitisation and SME finance activities. Potential risks are sufficiently addressed by appropriate risk provisioning.

For price management purposes, KfW held own bonds with a nominal value of EUR 9.9 billion as at the end of the year (previous year: EUR 9.6 billion). This was equivalent to 3 % of bonds issued.

The shares and other non-fixed income securities held as at 31 December 2010 amounted to EUR 14.2 billion (previous year: EUR 15.3 billion). The primary reason for the decline was the substantial reduction in the securities managed externally in special funds in the course of implementing the securities strategy.

The value of shares in affiliated entities increased slightly year-on-year from EUR 2.4 billion to EUR 2.5 billion.

Other assets includes in particular the currency adjustment item from foreign currency derivatives in the amount of EUR 8.6 billion used in the context of management of the foreign currency exposure. It also includes the claim of EUR 0.6 billion against the Federal Agency for Special Tasks associated with Unification (Bundesanstalt für vereinigungsbedingte Sonderaufgaben – BvS), due to the transfer of the rights and obligations of the State Insurance Company of the GDR in liquidation (SinA) to KfW as at 1 January 2008. However, the obligations of SinA continue to be borne in economic terms by the BvS. The claim is offset by technical provisions in the same amount.

The majority of prepaid expenses and deferred charges is composed of deferred interest expenditure mainly for derivative financial instruments and leasing obligations in project finance attributable to the following period. The item also includes differences between the repayment amount and lower issue amount in the context of borrowed funds (discounts and placing commissions). The item deferred income shows in particular the discounts from lending operations deferred over the loan terms.

Provisions increased year-on-year by EUR 0.2 billion to EUR 2.2 billion. The total amount included provisions for pensions and similar commitments (EUR 0.7 billion) and other provisions (EUR 1.5 billion). Other provisions included in particular the technical provisions relating to SinA, the provision for covering future interest charges from the transfer of the ERP Special Fund as well as provisions created for losses on receivables.

Earnings position

KfW's operating result before risk provisioning and valuation was EUR 2,049 million, which was again higher than the previous year's figure of EUR 1,823 million.

Net interest income, KfW's most important source of income, increased year-on-year by EUR 249 million to a new record amount of EUR 2,389 million (previous year: EUR 2,141 million). This positive development was largely due to the continued excellent short-term refinancing conditions. Net interest income includes interest rate reductions of EUR 558 million (previous year: EUR 571 million).

Net commission income increased moderately by EUR 6 million to EUR 205 million, primarily as a result of the increase in processing fees in the lending business.

Administrative expense increased slightly by EUR 3 million to EUR 555 million. The rise in personnel expense due to an increase in the number of staff, salary adjustments and the offer of partial retirement and early retirement was almost fully compensated by a reduction in non-personnel expense. The main reason for the latter was the elimination of the one-off charges from financial year 2009.

The cost/income ratio before interest rate reductions improved further to 18 % (previous year: 19 %).

The risk provisioning and valuation result made a positive earnings contribution of EUR 678 million, which was far in excess of the previous year's EUR –106 million.

The valuation result increased further year-on-year from EUR 218 million to EUR 341 million. This positive development was driven by price gains realised from the redemption of units in special funds and disposals of securities. The positive earnings contributions from affiliated companies also boosted the good valuation result.
The positive risk provisioning result for 2010 (EUR 336 million) was considerably higher than the prior-year figure (EUR –325 million) and reflects the economic environment. Expenses relating to specific value adjustments for immediate risks were offset by the high amount of reversed portfolio value adjustments and proceeds from the realisation of collateral. Specific value adjustments and allowances for possible loan losses fell primarily due to write-offs in the amount of EUR 4.4 billion (previous year: EUR 5.2 billion). The largest proportion of this remained provision for risks from the various IKB rescue measures in the amount of EUR 3.7 billion.

Non-performing loans in the amount of EUR 1,337 million were written off in financial year 2010 (previous year: EUR 1,310 million), the majority of which was attributable to receivables from the IKB rescue measures. Recoveries on loans written off totalled EUR 187 million in the year under review (previous year: EUR 38 million). This included separate compensation payments totalling EUR 118 million. Expected losses were addressed in the form of specific and general loss provisions.

For the first time since 2006, the fund for general banking risks was increased by EUR 554 million, a charge on the income statement, taking it to EUR 600 million.

The effects of first-time application of the new requirements of German commercial law brought about by the BilMoG are reported separately and had a one-time negative earnings effect of EUR 75 million. The main reason for this was expenses from the increase in provisions for pensions and similar commitments.

Financial year 2010 closed with a record profit of EUR 2,013 million.

Events after the end of the financial year

No matters of particular importance for the assessment of the net assets, financial position and results of operations of KfW have occurred since the end of financial year 2010.

SUSTAINABILITY REPORT

The sustainable improvement of economic, social and ecological conditions is the key value of KfW's mission statement. The KfW Law includes measures to protect the environment, measures with purely social objectives and to promote education, and also development policy cooperation, as independent promotional activities.
As the bank of the German Federal Government and federal states, KfW uses the Federal Government's sustainability strategy as the basis for its decisions. The comprehensive financing and promotional offering of KfW Bankengruppe in Germany and worldwide follows a set of objectives that largely correspond with those of the national sustainability strategy. This is clear from our promotional track record: Environmental and climate protection alone regularly constitutes around one third of the overall financing volume.
KfW restructured its sustainability management system in 2010, thus addressing the ever increasing importance of sustainability for KfW's business performance. The Chief Executive Officer now bears direct responsibility for strategy and communication in sustainability issues. A group-level environmental and climate protection steering committee chaired by the KfW Executive Board member in charge of environmental issues was created to manage group-wide coordination and development of KfW business activities in the area of environmental and climate protection. The committee assumes a central role not only in ensuring and developing the offering of sustainable financing in environmental and climate protection but also in coordinating and developing the sustainability policy of our business areas.

Dialogue with our stakeholders

The regular dialogue with our stakeholders on current developments and issues serves as a foundation for our actions. One clear example of this culture of dialogue was last year's conference "Climate protection and energy future: Setting the course for a climate-friendly economy in Germany" that KfW organised. One day after the cabinet decision on the Federal Government's Energy Concept, politicians, economists, scientists and representatives of associations met under the patronage of Federal Environment Minister Dr Norbert Röttgen at our branch office in Berlin for discussions on the challenges of climate change and potential strategies for dealing with them.

Moreover, via its website KfW provides target-group specific information on all the bank's activities that now fall under the term "sustainable action".

The men and women on our staff

The employees are the cornerstone of the current and future success of the entire KfW Bankengruppe. Important components of personnel policy include fair wages, part-time work, equal opportunities and a large number of professional and health benefits. The relevant key figures remained high in 2010. Severely disabled employees constitute 6 % of staff. The proportion of part-time employees rose slightly over the previous year from 18 % to 19 %, while the share of women in managerial positions remained constant at 26%.
In 2010, as part of certification for career and family related solutions under the "berufundfamilie" scheme, KfW performed the re-audit for the third time in a row. It was supplemented by an employee survey on current measures as well as on other potential needs in combining career and family and/or personal life. With a high participation rate and an overall positive result, the auditors confirmed that KfW maintains a family-friendly stance and culture that is above average compared to other companies.

Sustainable products

Environmental and climate protection as a promotional focus
In addition to financing for start-ups and SMEs, environmental and climate protection now constitutes KfW's most important promotional focus. The KfW Group provided a total commitment volume of EUR 25.3 billion to Finance environmental and climate protection measures in Germany and abroad in 2010 (+28 % year-on-year). Thus, 31 % of the total commitment volume of KfW's core business was dedicated to financing environmental and climate protection projects.
KfW's promotional programmes make a key contribution towards achievement of the Federal Government's climate protection targets. According to

preliminary estimates, the investments promoted in Germany in the area of energy-saving building rehabilitation and the expansion of renewable energies in 2010 alone will result in a permanent CO_2 reduction of around 6.6 million tonnes per year.

Evaluating environmental and social risks in core business

An environmental and social impact analysis is a major component of the assessment of every project we help finance in developing and transition countries as well as for export and project financing, above all in countries outside the EU or the OECD. The assessment systematically monitors the projects to be financed for any potential negative impacts. The environmental and social impact assessment defines protection and offsetting measures, which are overseen by a monitoring programme. KfW has over 40 of its own experts from various scientific disciplines who are not only employed to examine projects but may also be involved as needed to support projects through all stages of development.

Binding sustainability guidelines setting out the requirements for the environmental and social impact assessments specific to each business area and the procedures for implementing them have been developed for all business areas. All guidelines have been revised since 2007. A revised sustainability guideline goes into effect from 1 January 2011 for Financial Cooperation with developing countries, in which the environmental and social impact assessment is combined with a climate change assessment. This assessment ensures in a two-step process that any climate risks to the project's success are detected early and minimised, and that any potential to reduce emissions is understood and utilised where it is possible and makes sense.

Sustainable business operations

Principles for Responsible Investment (PRI)

In 2006, as one of the first German companies to join the United Nations "Principles for Responsible Investment" initiative, KfW undertook to invest its own funds in fixed and variable-rate securities, also in terms of socially responsible actions. A good 85 % of the securities business in the stricter sense met these criteria as at the end of 2010. This refers to KfW's liquidity reserve, which amounted to just under EUR 20.0 billion as at 31 December 2010.

In-house environmental protection

We also aim to address the high expectations of our owners as well as our employees with our in-house environmental protection. For instance, our newly constructed and rehabilitated administrative buildings are to serve as an example of energy-efficient construction and rehabilitation. The „West-Arkade" building, a 14-storey state-of-the-art office building for up to 700 employees at our Frankfurt location, which was inaugurated in the summer, has one of the world's lowest energy requirements for an office tower, with primary energy consumption of 98 kWh per square metre. KfW's remaining greenhouse gas emissions, particularly from business travel and heating, have been offset using emission reduction credits, resulting in a carbon footprint of zero for the bank since 2006. The primary focus of KfW's in-house environmental protection however has always been on preventing environmental damage. This is evident in the amount of energyrelated emissions, which shows that the need for offsetting has continually fallen over the years, from around 29,000 t CO_2 in 2006 to just under half that amount in 2009 (15,800 t CO_2).

KfW bonds as an investment in sustainability

Independent rating agencies specialised in the sustainable investment sector analyse and rate the corporate social responsibility of equity and bond issuers for institutional investors. Such CSR ratings assess a large number of other aspects in addition to environmental management and the products and services companies offer. Other aspects include, for example, flexible working models for employees, organisational measures to combat corruption and security investment strategies implemented. For many years, KfW has been rated by the two CSR rating agencies "Oekom Research" and "Sustainalytics", and has been assigned a top ranking by each in their international sector comparisons. Thus all KfW bonds offer attractive investment opportunities to those investors who consider a company's sustainability performance in their investment decisions. Sustainalytics (Frankfurt) assigned KfW its top rating in the "Development Agencies" segment in 2010. KfW was ranked third out of 75 non-exchange listed banks. Oekom Research (Munich) ranked KfW fourth in the "Development Banks" segment in 2010. This means it is rated a "prime investment".

RISK REPORT

This risk report corresponds in structure, scope and content to the group risk report published in the group management report. As risk management and risk controlling are focused on the KfW Group, a risk report at single institution level is not prepared.

Current developments

In financial year 2010, the global economy gained considerable momentum over 2009, although it slowed towards the end of the year. As expected, government rescue measures to limit the effects of the financial market crisis were reflected in the high budget deficits of the industrialised nations. This, combined with structural deficiencies in some EU countries led to a loss of confidence among capital market investors. As a result, refinancing via the capital market became too costly for some countries. International support measures of immense proportions were necessary to avoid a payment default by Greece. Ireland was the first country to have to resort to the newly established European stabilisation fund. Support measures for other euro-zone countries cannot be ruled out for 2011 unless the steps taken by the relevant countries to reduce their budget deficits and debt can restore investor confidence for the long term.

The European financial sector was heavily impacted by the negative effects of the sovereign debt crisis in Europe on the earnings and funding situation in 2010. The governmental support measures to safeguard the liquidity of euro-zone countries have had – and continue to have – a risk-mitigating effect, as do the refinancing instruments provided by the ECB. The very expansive monetary policy has been reflected in extremely low money market rates and the relatively steep yield curves on average. In addition, in some countries (e.g. Portugal, Spain, Ireland and Greece), the quality of loan portfolios deteriorated further. All in all, the risks in the banking sectors of some European countries remain substantially heightened in 2011. Furthermore, the higher capital and liquidity requirements under Basel III will pose a great challenge to the majority of banks over the next few years.

The overall positive economic development worldwide was also a positive factor for the different corporate segments in Germany. Sectors which were particularly hard hit by the crisis, such as the aviation and automotive industries, showed significant recovery and in some cases were back close to pre-crisis levels. The clear trend towards recovery has enough potential for continued positive development in 2011. However, the latent danger due to the strong export focus should not be completely ignored.

The problems in the European sovereign debt sector caused high volatility on the currency markets in 2010. The euro temporarily suffered extreme depreciation when the Greek crisis worsened, falling below 1.20 against the US dollar at the beginning of June, for example. The annual average EUR/USD exchange rate for 2010 was 5% below the previous year.

KfW Bankengruppe has also been affected by the aforementioned developments due to its international promotional mandate. However, the effects on the group portfolio were manageable overall, and KfW was able to reduce risk provisions in the Group during the course of the year. All recognisable risks are measured using conservative standards and are taken into account in the new business management through systematic establishment of risk guidelines. The regular calculations of risk-bearing capacity show that the KfW Group can bear the risks assumed in the context of its mandate.

As in the previous years, KfW systematically further developed its processes and instruments in risk management and control in financial year 2010, also taking heed of experience gained in the financial market crisis. The key issues were revising the risk-bearing capacity concept and developing a systematic and intensive sector monitoring process. KfW IPEX-Bank and DEG were also further integrated into group risk management. The ongoing development of processes and instruments in risk management and control in 2011 will be strongly affected by the developments in the banking supervision environment. The current focus in this regard is on the third amendment to the MaRisk requirements for risk-bearing capacity, strategy and stress tests, the implementation of the amendments to the German Banking Act *(Kreditwesengesetz – KWG)*, particularly relating to securitisation, and the foreseeable changes under Basel III meaning increased liquidity and capital requirements.

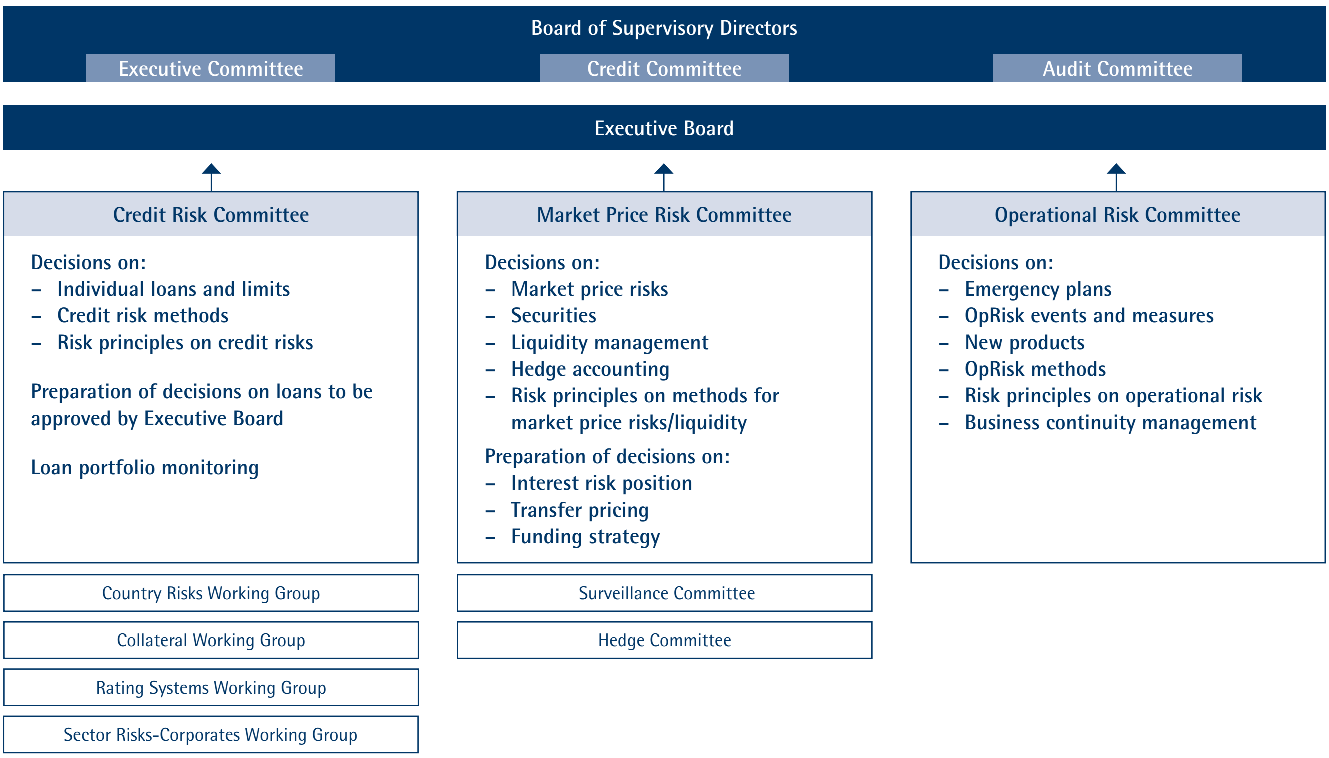
Basic principles and objectives of risk management

The Group has a statutory promotional mandate, which provides the foundations for its special position and its institutional structure. Sustained promotion is the Group's overarching purpose. Measuring and controlling the risks assumed is a key factor in order to optimally employ the available resources to carry out this promotional mandate. As part of its risk management, the Group aims to enter into risks only to the extent that they appear acceptable with regard to the current and anticipated earnings and the probable course of the risks. Group risk/return management takes into account the special characteristics of a promotional bank. Banking supervisory law requirements, such as the minimum requirements for risk management (German Minimum Requirements for Risk Management – MaRisk), constitute important secondary requirements for KfW's risk management structures and procedures.

In order to establish risk management and control competence within the organisation of the bank, KfW offers training courses which include a modular programme on risk topics. This training programme enables employees and management staff throughout the KfW Group to acquire orientation knowledge or to deepen their specialised knowledge.

Organisation of risk management and monitoring

Risk management bodies and functional aspects of risk management
As part of its overall responsibility, KfW's Executive Board determines the bank's risk principles and guidelines. KfW's supervisory bodies – the Board of Supervisory Directors and the Federal Ministries of Finance and of Economics and Technology, which alternate in providing the chairman and deputy chairman of the Board of Supervisory Directors – are informed at least once per quarter of the Group's risk situation. The Executive Committee of the Board of Supervisory Directors is responsible for particularly urgent decisions. The Chairman of the Board of Supervisory Directors decides whether an issue is urgent. Risk management within the KfW Group is exercised by closely intertwined decision-making bodies. The Executive Board is at the helm of the system; it makes the key decisions on risk policy. There is also a quarterly Executive Board meeting which includes the directors and focuses on risk management and accounting issues. These include in particular the reports prepared at the end of each quarter, but also major changes to the Group's risk manual. There are three risk committees below the level of the Executive Board (Credit Risk Committee, Market Price Risk Committee and Operational Risk Committee) which prepare decisions for the Executive Board and also make their own decisions within defined ranges of competency. Further working groups support these committees. The Chief Risk Officer of KfW generally has the right of veto in the committees. If no unanimous decision has been reached, an issue may be escalated to Executive Board level.



Credit Risk Committee

The Credit Risk Committee is chaired by the chief risk officer, and meets once a week. Its other members are the director of Risk Management and Controlling and two members of the Executive Board with front-office responsibilities. The Credit Risk Committee is supported by the Country Risks, Collateral, Rating Systems and Sector Risks-Corporates Working Groups. The weekly meetings involve in particular decisions on loans and limits. Further meetings, held on a quarterly basis, are also attended by representatives of the business areas, some central staff departments and subsidiaries of the KfW Group. Internal Auditing has guest status. The development of supervisory requirements and the effects of their implementation for KfW, as well as for KfW IPEX-Bank and DEG are discussed in these quarterly meetings and major changes to existing risk principles and credit risk methods, and drafts of new principles and methods are adopted. The committee also monitors the Group's loan portfolio.

Market Price Risk Committee

The Market Price Risk Committee is chaired by the chief risk officer, and meets once a month. Other members include the Executive Board member responsible for capital market activities, and the directors of Treasury and Capital Markets, Asset Securitisation, Risk Management and Controlling and Accounting. The Market Price Risk Committee makes decisions regarding entering into market price risks, valuation of securities, changes in market price risk methods, liquidity management issues and risk principles on market price and liquidity risk management. It also makes preparations for Executive Board resolutions on interest risk positions, transfer pricing and the funding strategy. The Market Price Risk Committee is supported by the Surveillance Committee, which deals with valuation of securities and equity investments, and the Hedge Committee, which deals primarily with the earnings effects of IFRS hedge accounting and the further development thereof.

Operational Risk Committee

The Operational Risk Committee comprises directors and meets once a quarter. It is chaired by the director of Risk Management and Controlling. The central staff departments and subsidiaries of KfW are also represented on this committee. It is responsible for dealing with issues relating to operational risk. These issues include in particular measuring and evaluating operational risks including legal risks and the relevant provisions in the risk manual, in addition to business continuity management. Resolutions and recommendations by the Operational Risk Committee are presented to the Executive Board.

There are six working groups or committees below the level of these bodies, which report to the Credit Risk Committee or Market Price Risk Committee and prepare decisions. These are:

Country Risks Working Group

The Country Risks Working Group is the central unit for assessing country risks. It is composed of economists from the regional departments of KfW Entwicklungsbank and representatives of KfW IPEX-Bank, DEG and KfW's Transaction Management. It is chaired by Risk Management. The working group currently meets once a month due to the crisis situation (in particular the Euro crisis, Middle East crisis). If necessary, country ratings can be adjusted between the regular meetings. The role of the Country Risks Working Group is to identify, analyse and assess political and economic risks (and rewards) in the global economy and particularly in the countries in which the KfW Group does or plans to do business. Proposals for risk ratings assigned to developing, transition and emerging countries are made by the economists, while proposals for ratings assigned to industrial countries are submitted by Risk Management. Countries are ultimately assigned to risk categories on the basis of discussions conducted within the Country Risks Working Group. If no consensus is reached, Risk Management casts the deciding vote. Risk Management reports on the conclusions of meetings to the Credit Risk Committee.

Collateral Working Group

The Collateral Working Group is a central body serving KfW and its subsidiaries which ensures sufficient understanding of and uniform procedures throughout the Group for all essential aspects of collateral acceptance and valuation, and collateral management processes for lending and trading activities and structured products. It also makes recommendations for development and enhancement measures for approval/decision by the management and, when the matter falls within its defined range of competency, takes these decisions independently. The Collateral Working Group is composed of representatives from various business areas and departments. Its central functions include development, enhancement and review of collateral valuation procedures, review and expansion of accepted and acceptable collateral and the related acceptance criteria, definition and review of minimum requirements of collateral management processes and collateral acceptance and establishment of conditions for meeting guidelines under regulatory law regarding risk mitigation techniques.

Rating Systems Working Group

The Rating Systems Working Group is a central body serving KfW and its subsidiaries, which ensures sufficient understanding of all essential aspects of credit risk measurement instruments. These include in particular rating systems, loan portfolio models, risk indicators and limit management systems. The working group's tasks include evaluating and approving reports on validation and further development as well as deriving recommendations for measures to develop and enhance credit risk measurement instruments.

Sector Risks-Corporates Working Group

The new Sector Risks-Corporates Working Group, which was formed in 2010, is a central body of experts serving KfW and its subsidiaries which analyses sector-based credit risks in the corporate segment and bundles analyses which have been conducted decentrally. It provides relevant information based on the analyses to the areas of the Group concerned and if appropriate, makes proposals to minimise risk.

Surveillance Committee

The Surveillance Committee is an integral component of the surveillance and impairment process for securities and structured credit products, and reports to the Market Price Risk Committee. One of the Surveillance Committee's central functions is to recommend valuation figures for the securities and structured products which are not to be recognised at fair value through profit or loss, i.e. for positions in the IFRS categories *"loans and receivables"*, *"held-to-maturity investments*" and *"available for sale"*, and fixed assets under the German Commercial Code *(Handelsgesetzbuch – HGB)*. These recommendations are presented to the Market Price Risk Committee for decision-making.

In 2010, the valuation processes for the equity investment portfolio were integrated into the Surveillance Committee, which reports on them to the Credit Risk Committee.
Members of the Surveillance Committee include representatives of the middle and back-office departments (Risk Management and Controlling, Accounting as well as Transaction and Collateral Management) and of the responsible front-office departments.

Hedge Committee
The economic management of market price risks at KfW is the responsibility of the Market Price Risk Committee. Management measures of this kind can lead to fluctuations in valuation/results in purely accounting terms, when instruments that are to be recognised at fair value under IFRSs are used. At KfW, this applies in particular to the use of derivatives. The role of the Hedge Committee is to analyse the treatment of these instruments recognised at fair value under IFRS in line with the economic objective of the use of derivatives at KfW, and to further develop their use in compliance with IFRS provisions.

The subsidiaries of the KfW Group and the organisational units exercise their own control functions within the group-wide risk management system. In these instances, too, group-wide projects and working groups ensure a coordinated approach, for example in the rollout of rating instruments to subsidiaries or the management and valuation of collateral.

Responsibility for developing and assuring the quality of the risk management and control lies outside the credit departments, with Risk Management and Controlling. There is a comprehensive risk manual for this purpose and is continually updated. The rules and regulations laid out in the risk manual are binding for the entire Group and are accessible to all employees. Risk principles (i. e. normative rules for loan and risk management procedures) and portfolio guidelines (e. g. business restrictions, collateral requirements, etc.) make up the core of the risk manual. A new set of guidelines on the internal capital adequacy process was prepared in 2010. In addition, the risk strategy requirements were comprehensively revised, and substantial changes were made to the risk principles for operational risk and to various portfolio guidelines. The risk principles and portfolio guidelines serve as the framework for the operating activities of all business areas. The risk manual ensures that uniform procedures are applied throughout the Group to identify, measure, control and monitor risks. In addition, group-wide regulations are supplemented in individual business areas by specific rules. Risk Management and Controlling reviews these for conformity with group-wide regulations.

Risk Management

The primary task of the Risk Management Department is to ensure that the Group is able to bear the risks falling within its defined risk tolerance. For this purpose, it formulates and regularly reviews the Group's risk strategy, including the risk management of the major subsidiaries. The risk strategy builds on the basic business policy and establishes general risk principles and concrete risk policy measures in line with business strategy. A variety of instruments to control credit, market price and operational risks are used to implement the risk strategy. These instruments include risk management instruments for individual counterparties and portfolios: capital allocation, second vote for loan approvals, limit management systems, portfolio guidelines, risk guidelines for countries and sectors, and early warning systems. Concentration limits apply at various sub-portfolio levels (including borrower units, countries and sectors) to prevent major individual losses and to restrict risk concentration in the loan portfolio. If necessary, a selective risk transfer can also be made to the capital market (e. g. through credit derivatives), depending on the market situation.

At KfW, Group Risk Management has the second vote in terms of credit risk assessment on a single exposure level. KfW IPEX-Bank and DEG have their own second vote independent of the front office. The relevant business decision-making processes are structured with a view to risk. The need for a second vote is determined by the type, scope (material risk content and effect on the overall risk position) and complexity of a transaction.

Risk Management Loan Support

The Risk Management Loan Support department is responsible for non-performing loans and for providing intensive support for banks and corporates in the KfW portfolio. It becomes involved and assumes full responsibility and further functions as soon as initial signs of crisis are in evidence. The objective is to achieve recovery of a loan through restructuring, reorganisation and workout arrangements. If the business partner is deemed incapable or unworthy of restructuring, the priority becomes optimum realisation of the asset and the related collateral. Internal interface regulations are in place with the relevant business areas to ensure clear control of competences and allocation; Risk Management Loan Support also cooperates closely with the credit departments and legal department.

In the event of crisis in the banking sector, the department has to be able to act immediately both in-house and externally. The financial institution crisis plan has been further developed for this purpose. It primarily provides for the establishment of a working group headed by Risk Management, immediate loss analysis and implementation of the next steps necessary.

Risk Controlling

Risk Controlling is in charge of measuring and reporting all risks and risk groups of the KfW Group and analysing the Group's risk-bearing capacity. In this regard uniform methods and models are implemented throughout the Group on an operating level. Stress tests and scenario calculations are also used with the goal of quantifying the capital requirements needed to ensure the Group's risk-bearing capacity, including in situations characterised by considerably worsening economic conditions.

The department is involved in the quality management process for the risk indicators used in risk management and control, and also provides professional support for the information systems used in reporting. In operational risk and business continuity management, the department is responsible for the group frameworks and guidelines and supports the business areas in implementing these standards.

Risk reporting is in line with regulatory requirements (MaRisk). The Executive Board is informed on a monthly basis about the Group's risk situation. A risk report is issued quarterly to the Group's supervisory bodies. The respective bodies will be informed on an ad-hoc basis as the case may be.

Risk Methods, Instruments and Process Management

The Risk Methods, Instruments and Process Management Department is responsible for providing suitable methods and instruments for group-wide risk analysis and management. The development of a long-term, sustainable, consistent method and instrument strategy for risk management and risk control is rounded off with regular validations and developments and enhancements of models and methods. The focus is on models to measure, control and price credit and market price risks. In addition, the department is also responsible for the coordination and project management of the professional implementation of the requirements placed on instruments and IT systems used in risk management and control. In addition, it coordinates the formulation and development of group-wide risk principles as well as the procedure manual for risk management and control.

Internal Auditing

The Internal Auditing Department supports the Executive Board, is not bound by directives and works independently of group procedures. It generally audits all of KfW's processes and activities to identify the risks involved and reports directly to the Executive Board.

The audit cycles for individual audit areas are determined by Internal Auditing based on an annual risk assessment of the audit areas. In so doing the department takes into account the economic capital requirements of the operations to be audited.

In addition to promotional business (including the KfW Special Programme), auditing activities focused on risk management procedures and methods and the accounting department in 2010. The risk management audits focused on the further development of risk management processes and methods.

While maintaining its independence, Internal Auditing monitored important projects, particularly the implementation and development of IT systems. In 2010 Internal Auditing monitored, as in previous years, the further development of risk measurement procedures by participating (with guest status) in meetings of decision-making bodies.

KfW's Internal Auditing is also the group auditing department for the KfW Group. It incorporates the internal auditing departments of the subsidiaries in group-wide audit reporting.

Internal control system

KfW's internal control system (ICS) objectives are to ensure

- the effectiveness and profitability of business activities
- the correctness and reliability of external and internal accounting
- compliance with legal provisions applicable to KfW
- and the protection of its assets.

This is based on the organisational structure and the principles, procedures and measures introduced with a view to the organisational implementation of management decisions.

The internal control system (ICS) comprises the regulations introduced on the management of corporate activities and measures that ensure functionality of and compliance with these regulations. Accordingly, the ICS includes monitoring measures that are integrated into processes, such as internal controls, and measures that accompany processes such as those relating to compliance. KfW's internal control system is supplemented by monitoring measures independent of processes via Internal Auditing, which also include an assessment of the adequacy and effectiveness of the ICS.

The ICS at KfW is based on the relevant standards, in particular those set forth in the KWG and MaRisk, and the market standard COSO model[1)]. KfW's subsidiaries base their own internal control systems on the ICS at KfW and implement them in a similar way.

The Executive Board of KfW bears the overall responsibility for the internal control system. The design and implementation at the different corporate levels is the responsibility of the relevant managers according to the organisational structure. Regular reports are submitted to the supervisory bodies; at KfW to the Audit Committee of the Board of Supervisory Directors.

Accounting-related internal control system

KfW has implemented an accounting-related ICS to minimise the risk of error in single-entity and consolidated financial statements and ensure the correctness and reliability of internal and external accounting.

The accounting-related ICS has five dimensions at KfW:

1. Control environment
The control environment defines the framework for the adoption and application of regulations. The accounting-related ICS covers all systems and processes from recording business transactions to further processing and booking, and defines the relevant key controls for the responsible organisational units.

2. Risk assessment
Risk assessment includes the identification, analysis and evaluation of risks. In the accounting-related ICS, all processes between the accounting department and the relevant departments are subjected to a risk evaluation, with profitability aspects taken into account, with a view to their influence on the completeness, accuracy, recognition and measurement in the financial statements. The preparation and structuring of each control item in the front-office, settlement and accounting department processes are focused on strictly defined subject areas, which comprise a complete chain of accounting-related steps from the recording of transactions to external reporting. Workshops are held on a regular basis for accounting staff and staff from KfW's business areas to rectify discrepancies and agree on procedural adjustments based on practical experience.

3. Control activities
Control activities are aimed at achieving corporate objectives effectively and reducing or detecting risks. All defined control functions are clearly assigned and are exercised by the managers of the respective departments. Each control is documented for auditing purposes and monitored centrally. The accounting department is responsible for the coordination and central monitoring of these processes.

The IT systems used at KfW are protected against unauthorised access and are integrated in the ICS. Data in the feeding systems (sub-ledgers) and the general ledger are matched on a monthly basis to ensure the completeness

1) COSO = Committee of Sponsoring Organizations of the Treadway Commission, www.coso.org and accuracy of the data for further processing in the financial statements. External data sources (e.g. Bloomberg, Reuters) are used to valuate financial instruments, and are continuously monitored. Model-based valuations are in line with the market standard.

4. Information and communication

Information and communication ensures that all parties involved receive the necessary information in order to meet their control-related responsibilities. The applicable principles, organisational structure and workflow and the central processes relevant for accounting and risk management are recorded in process descriptions, working instructions and generally accessible manuals. The relevant accounting requirements are documented in full detail in a group accounting policy (IFRS) and an accounting manual (HGB). These are updated on a regular basis according to amendments by the standard setters or legislation and provided to the relevant group units. In addition, the members of group staff involved with accounting receive regular and comprehensive training.

The entire control process is automated within the ICS, from carrying out the control through issuing confirmation to ongoing tracking. During the preparation of the annual financial statements, reports are submitted to the decision makers in a prompt and decision-oriented manner.
The Executive Board and Audit Committee are regularly updates on the effectiveness of the accounting-related internal control system and compliance with legal requirements.

5. Monitoring

The monitoring of the ICS ensures its functionality and effectiveness. The accounting-related ICS is subject to an ongoing monitoring and escalation process. Updates and expansions are also accounted for on an ongoing basis. The established processes provide enough scope to accommodate both accounting changes and new (technical) procedures, thereby ensuring the annual financial statements' consistent high quality level.

Risk management approach of the KfW Group

Risk identification → Risk mapping → Risk strategy → Risk management → Risk monitoring & reporting

Risk identification
- Credit risk incl. country risk
- Interest rate risk
- Currency risk
- Credit spread risk
- Other market price risks
- Operational risk (incl. legal and reputational risks)
- Liquidity risk

Risk mapping
- Economic capital for market and credit risks
- Standard approach for operational risks acc. to Solvency Regulation
- Key liquidity indicators acc. to Liquidity Regulation and KfW Law
- Regulatory capital for credit and market risks

Risk strategy
- General risk principles
- Definition of objectives for the next financial year
- Risk strategy at group level
- Sub-strategies for different types of risk

Risk management
- Risk-bearing capacity concept
- Stress testing

Individual counterparties
- Second vote
- Rating
- Individual counterparty limits
- Restructuring

Portfolio
- Risk guidelines
- Portfolio guidelines
- Sector and country limits
- Limits for market price risks
- OpRisk management

Risk monitoring & reporting
- Risk reports
- Operational monitoring in limit management system
- Early warning system
- OpRisk measures monitoring

The chart above shows the KfW Group's risk management process. Risk management within the KfW Group serves one central purpose: ensuring the Group's risk-bearing capacity.

Risk-bearing capacity

Risk management was improved during the reporting year by creating stronger links between regulatory and economic risk-bearing capacity. This integration is to be further developed in 2011.
A key component of the new concept is stronger integration of economic and regulatory objectives in the management of risk-bearing capacity. Compliance with economic and regulatory requirements are treated as equal higher-level objectives. Accordingly, all risk monitoring and management measures must ensure that an economic solvency target and a tier 1 and total capital ratio target are met. The economic and regulatory risk coverage potential have been harmonised for this purpose. KfW uses the modified available capital in accordance with Sections 10 and 10 a KWG as economic resources available for risk coverage (available financial resources).

A further core issue is a stronger proactive focus of the risk-bearing capacity concept resulting from an additional forward-looking component. This evaluates the absorption potential of KfW's reserves – and thus also its ability to act – in the event of certain (stress) scenarios. A traffic light system has been established in this context with thresholds set by the Executive Board for the strategic and operational management of economic and regulatory risk-bearing capacity.

Regulatory risk-bearing capacity

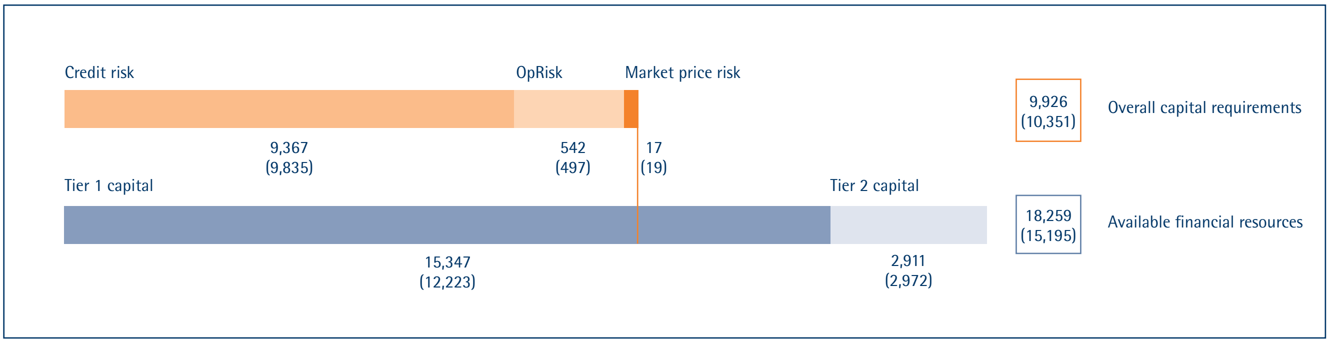
Indicators under supervisory law	2010	2009
	EUR in millions	EUR in millions
Risk position	124,077	129,386
Tier 1 capital	15,347	12,223
Regulatory capital (available financial resources)	18,259	15,195
Tier 1 ratio	12.4 %	9.4 %
Total capital ratio	14.7 %	11.7 %

The "Risk position" indicator is the product of the total amounts of capital charges for counterparty risks, market risks and operational risks multiplied by 12.5.

KfW is not subject to the requirements of Sections 10 and/or 10 a of the German Banking Act *(Kreditwesengesetz – KWG)*. For internal purposes, however, the regulatory capital ratios are voluntarily calculated based on the key legal requirements. In-house rating methods are used for large sections of the loan portfolio to calculate the risk exposure (advanced IRB approach).

KfW Bankengruppe's regulatory capital ratios improved greatly on the previous year. As at 31 December 2010, the total capital ratio taking into account the consolidated comprehensive income was 14.7 % (previous year: 11.7 %), and the tier 1 ratio was 12.4 % (previous year: 9.4 %). The positive development is largely due to the increase in regulatory capital due to the consolidated comprehensive income. In addition, the selective reduction of risk positions and methodical further development of risk assessment contributed to the decline in capital requirements for credit risks.

Regulatory risk-bearing capacity as of 31 December 2010 (EUR in millions)



In brackets: figures as of 31 December 2009
The capital requirement for credit risk was calculated to be 8 %.

Economic risk-bearing capacity

To determine economic risk-bearing capacity, potential financial losses are measured with the aid of two central risk-measuring indicators: expected loss and economic capital required to cover unexpected losses.

Expected loss refers to losses that are expected to arise on a statistical average over a number of years. Expected losses, along with other parameters, are important when credit is priced. Expected losses are defined as the product of:

- the probability of a borrower's default (probability of default, PD),
- the expected amount of receivables at the time of the potential default (exposure at default, EAD) and
- the (anticipated) loss rate upon default (loss given default, LGD).

The probability of default is estimated for each borrower with the aid of rating methods. The result of the rating measures is an estimate of the probability that a counterparty will be unable to fulfil its obligations within the next twelve months. In particular, collateral has to be evaluated to estimate the magnitude of the likely loss.

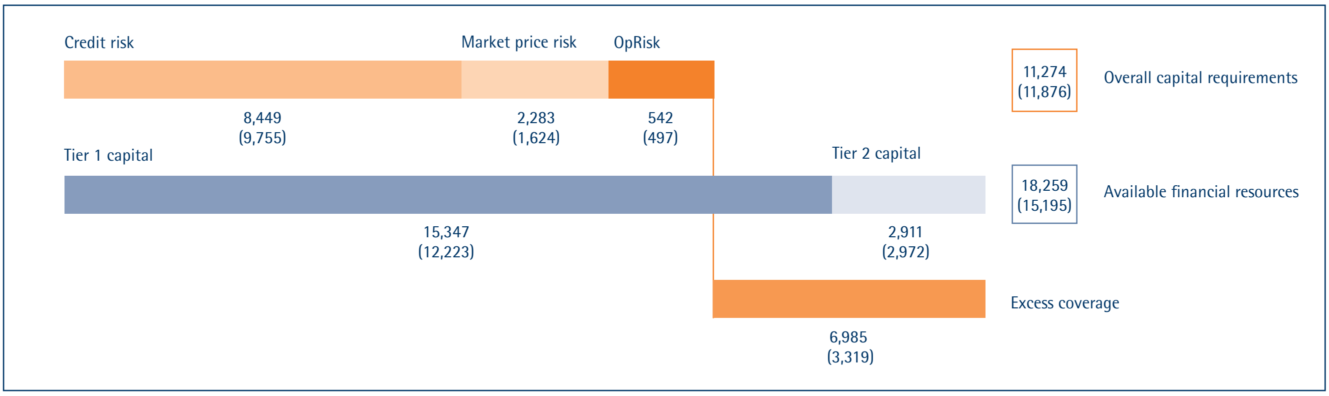
The risk potential to be backed by capital is quantified by Risk Controlling with the aid of statistical models. For credit risks, the loss potential is computed using a loan portfolio model and using the risk measure "credit value-at-risk". The difference between credit value-at-risk and expected loss is referred to as the economic capital requirement.

The Group takes a similar approach with regard to market price risks. Value-at-risk is also calculated using statistical models. For market price risks, the value-at-risk is also the economic capital requirement.

The forecast period for both risk categories is one year. The capital requirement for credit and market price risks is aggregated, taking diversification effects into account. The capital requirement for operational risks is calculated using the regulatory standard approach according to the German Solvency Regulation *(Solvabilitätsverordnung – SolvV)*.

To assess the risk-bearing capacity, the capital requirement (economic capital requirement) is matched against the risk-covering potential. Using this method, the economic risk-bearing capacity as at 31 December 2010 satisfied a solvency level of 99.99 %. This means that overall capital requirements are covered by the risk-covering potential. The excess coverage of the risk-covering potential over the total capital requirement as at 31 December 2010 (EUR 6,985 million) was an improvement on the previous year's figure (EUR 3,319 million) calculated on the basis of the new definition of risk-covering potential and a solvency level of 99.99 %.[2] The significant increase is partly due to the rise the risk-covering potential and the selective reduction in risk positions. In addition, the adjustments to the methods, such as the new calculation of loss given default (LGD) in the on-lending business and the revised risk assessment for equity investment fund business, led to a decline in the economic capital requirement.

Economic risk-bearing capacity as of 31 December 2010 (EUR in millions)



In brackets: figures as of 31 December 2009[3]

[2] A solvency level of 99.96 % was used in the previous year.

[3] Capital requirement determined at a 99.99 % solvency level for purposes of comparison; risk coverage potential adjusted in accordance with the new definition (modified available capital in accordance with sections 10 and 10 a KWG)

Hidden burdens and reserves are treated separately: the balance of hidden reserves and burdens existing as at the balance sheet date on the basis of IFRS is offset against the available economic capital buffer (excess coverage) in a memo item. Excess coverage after hidden reserves and burdens (on the basis of IFRS) amounted to EUR 6,090 million as at 31 December 2010.

KfW addresses liquidity and other risks by monitoring appropriate key figures and by regularly controlling the processes of the banking operations.

KfW's risk measurement is based on state-of-the-art models used in banking practice. However, each model represents a simplification of a complex reality and builds on the assumption that risk parameters observed in the past can be considered representative of the future. Not all possible influential factors and their complex interactions can be identified and modelled for the risk development of a portfolio. This is one reason why KfW carries out stress tests both in the credit risk models and in the market risk models. The Group works continually to refine its risk models and processes. In 2011 KfW plans, among other things, to factor the increased correlations arising from the financial and economic crisis into risk measurement and to adapt the internal methodology for estimating exposure at default (EAD) to the regulatory approach. These changes will lead to an increase in the economic capital requirement for credit risks. In addition, the current environment of rising capital market interest rates is likely to increase in the economic capital requirement. In 2011 a fundamental review of the model for measuring interest rate risks is planned. This is likely to also lead to a change in capital requirement.

Stress and scenario calculations

When assessing risk-bearing capacity, KfW takes into account potential additional capital requirements for stress scenarios calculated in accordance with conservative standards. To ensure a stronger proactive focus in its risk-bearing capacity concept, KfW monitors, on a quarterly basis, a forecast scenario (baseline scenario), a downturn scenario (slight economic slow-down) and a stress scenario (deep recession), and their effects on economic and regulatory risk-bearing capacity. This forward-looking component shows KfW's resilience and ability to act in the event of these scenarios and therefore delivers direct management stimuli.

The forecast scenario provides a preview of risk-bearing capacity at year-end. The impact of the expected economic development on credit risks and interest rates is also included. The current forecast for year-end 2011 shows a slight decrease in the excess coverage of the risk-covering potential over the economic capital requirement compared to 31 December 2010.

In the downturn and stress scenario, effects on earnings and changes in the capital requirement are simulated for a 12 month period presuming negative economic development. In the stress scenario, the effects of a severe recession are depicted. In both scenarios the bank assumes increasing credit risks (of differing severities). These scenarios anticipate modest falls in EUR and USD interest rates. Due to the difficult market environment to be expected in this case the stress scenario also assumes an increased capital requirement for interest risks. Potential losses from operational risks also reduce the risk-covering potential.

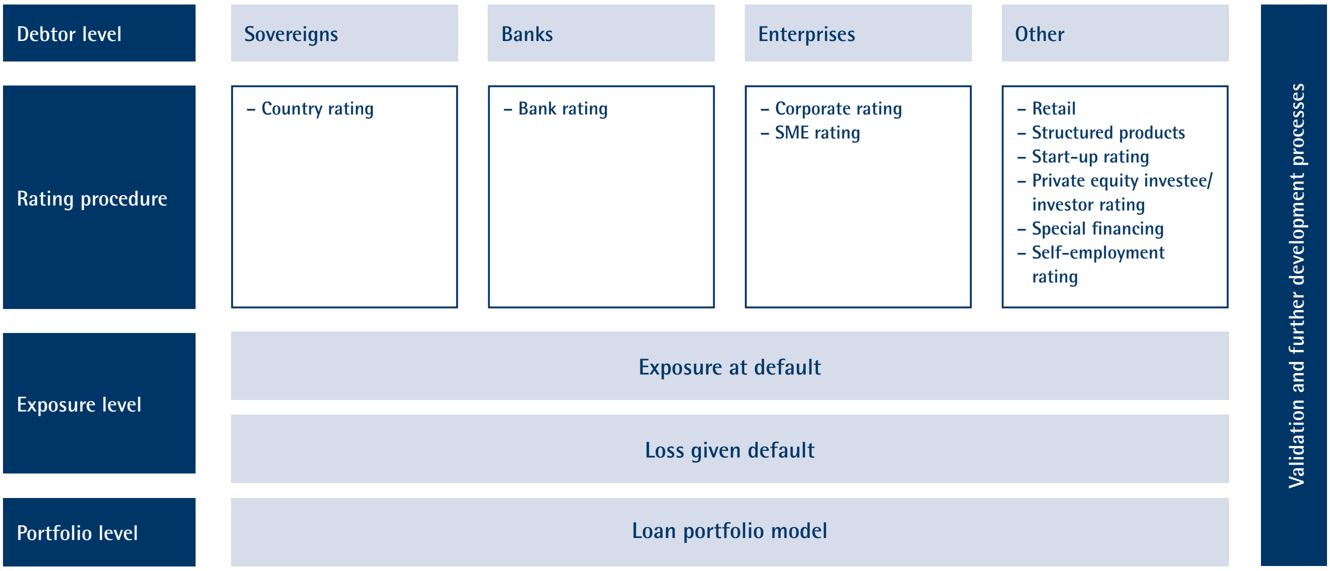
On the basis of the analyses carried out, KfW assumes a reduction in excess coverage of EUR 7.0 billion to EUR 2.9 billion in the stress scenario. Risk-bearing capacity is therefore assured at a solvency level of 99.99 % even under unfavourable economic conditions.

In addition to the tests based on economic scenarios, scenario stress tests are carried out. To this end, current potential macroeconomic dangers are regularly identified, on the basis of which the resilience of KfW's risk-bearing capacity is examined.

Types of risks

COUNTERPARTY DEFAULT RISK

The KfW Group assumes counterparty risks[4)] in the context of its promotional mandate. The main risks in the domestic promotional lending business are in the areas of start-up finance for small- and medium-sized enterprises and equity investments. In addition, KfW assumes risks in the context of export and project finance as well as in the context of promotion for developing and transition countries.



Counterparty default risk is **measured** by estimating the probability of default (PD), the exposure at default (EAD) and the (anticipated) loss given default (LGD).

In identifying the probability of default, the Group uses internal rating procedures for banks, corporates, small- and medium-sized enterprises, private equity investors, private equity investees, the self-employed, start-up businesses, and countries. These procedures are based on scorecards and follow a uniform and consistent model architecture. For specialised financing, a simulation-based rating method is often used. For structured products, cash flow-based rating methods are applied. For securitisation transactions, tranche ratings are determined stochastically on the basis of the default pattern of the asset pool and the waterfall structure of the transactions. The rating procedures aim at forecasting one-year default probability. As a rule, middle and back-office departments are responsible for preparing ratings for risk-bearing business. Ratings are updated at least once annually, with the exception of business partners with whom only retail business is conducted.

Mapping the default probability to a master scale which is uniform for the entire KfW Group ensures comparability of ratings issued using different rating procedures and for various business areas. The master scale consists of 20 different classes which can be divided into four groups: investment grade, non-investment grade, watch list and default. The range of default probabilities and the average default probability are defined for each master scale class.

Specific organisation regulations, which mainly specify the responsibilities, competencies and control mechanisms associated with a particular rating, apply to each rating procedure. External ratings are mapped to the KfW master scale to ensure the comparability of internal ratings within the KfW Group with ratings of external rating agencies. Periodic validation and further development of the rating procedures ensure that KfW is able to rapidly respond to changes in overall conditions. The aim is to continuously optimise the discriminative power for all rating procedures. Rating instruments and procedures largely meet the minimum requirements of the prevailing regulatory standards (MaRisk/Basel II).

[4)] *Counterparty default risk is defined as the risk of financial loss that can occur if the borrower or counterparty fails to meet contractual payment obligations. Counterparty default risk also includes country risk, comprising transfer, conversion and political risks.*

Exposure at default (EAD) and valuation of collateral are heavily weighted when determining the severity of loss. Collateral has a risk-mitigating effect in calculating loss given default (LGD). In valuating acceptable collateral the expected net revenue from collateral realisation in case of loss is estimated over the entire loan term. This estimate takes into account haircuts based, in the case of personal surety, on the probability of default and the magnitude of loss incurred by the collateral provider. For tangible collateral the haircuts are chiefly attributable to fluctuations in market prices and devaluation resulting from depreciation. The determined value is an important element in estimating loss given default within the KfW Group. Depending on the availability of data, the various valuation procedures for individual types of collateral are based on internal and external historical data and expert estimates. The valuation parameters are reviewed on a regular basis. This guarantees the reliable valuation of individual collateral. A risk principle for loan collateral regulates uniform management, valuation and recognition of collateral across the Group.

The KfW Group has various portfolio guidelines to limit risks from **new business**. These guidelines form the basis for the second vote on lending transactions and serve as an orientation guide for loan approvals. They are also designed to ensure adequate quality and risk structure of KfW's portfolio[5]. These guidelines distinguish between types of counterparties and product variants and define conditions under which business transactions may generally be conducted.

Existing higher-risk exposures are divided into a watch list and a list for non-performing **loans**. The watch list serves to identify potential problem loans early and, if necessary, to make preparations for handling these loans. KfW closely monitors the economic and financial environment of the respective borrower in the case of a potential problem loan. It regularly reviews and documents the economic situation and the collateral provided and formulates proposals for remedial action. In the case of non-performing loans, the units in charge of restructuring are responsible for this process. This enables the involvement of specialists from an early stage to ensure professional management of problem loans.

RISK PROVISIONING

The KfW Group takes appropriate measures to address all identifiable default risks in its lending business by making risk provisions for loans. These risks also include political risks resulting from financing transactions outside Germany. For loans with an immediate risk of default (i. e. non-performing loans) KfW recognises individual impairment charges or provisions for undisbursed portions. These events are identified on the basis of criteria that meet both Basel II and IFRS requirements. Criteria include the identification of considerable financial difficulties on the part of the debtor, payment arrears, concessions made to the debtor owing to its financial situation (for example, in the context of restructuring measures), conspicuous measures undertaken by the debtor to increase its liquidity, and a substantial deterioration in the value of collateral received. These criteria are further specified in KfW's risk manual. Individual impairment charges are determined by means of an impairment procedure. The calculation of individual impairment charges is also based on an individual assessment of the borrower's ability to make payments in the future. The calculation takes into account the scope and value of the collateral as well as the political risk. A simplified impairment procedure is performed for small and standardised loans on the basis of homogeneous sub-portfolios.

Risk provisions for latent risks (i. e. portfolio impairment) are derived from the valuation of loan receivables in the context of annual rating procedures and collateral valuations. Portfolio impairment charges are recorded for both economic and political risks. The basis for this is the expected loss model described above, which is adjusted for IFRS purposes. Risk provisions for irrevocable loan commitments and financial guarantees are set up using the same method of calculation.

Further portfolio impairment charges taken for the sectors and countries particularly affected by the economic crisis were significantly reduced as a result of the economic recovery.

MAXIMUM RISK OF DEFAULT

According to IFRS 7.36, the maximum exposure to credit risk for the KfW Group arising from financial instruments is the total loss of the respective risk positions. Contingent liabilities and irrevocable loan commitments are also taken into account. Carrying amounts have been reduced by the risk provisions made.

Payment arrears on the balance sheet date were reported only in Loans and advances to banks and customers, and Securities and investments. Individual impairment charges were also reported under Contingent liabilities and Irrevocable loan commitments.

[5] These guidelines take into account the special nature of KfW's promotional business.

Maximum risk of default (EUR in millions)

	Loans and advances to banks		Loans and advances to customers		Value adjustments from macro fair value hedge accounting		Derivatives used for hedge accounting; other derivatives		Securities and investments; investments accounted for using the equity method		Contingent liabilities; irrevocable loan commitments	
	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
Carrying amount as equivalent for maximum risk of default	263,222	241,139	102,878	92,892	7,478	6,751	29,891	19,645	35,236	36,709	72,257	57,889
Risk provisions	200	420	5,221	6,484	0	0	0	0	20	4	484	355
Carrying amount neither past due nor impaired	262,969	240,832	100,984	90,551	7,478	6,751	29,891	19,645	34,993	36,469	72,256	57,848
With conditions renegotiated (in the reporting year)[1)]	*0*	*0*	*886*	*2,165*	*0*	*0*	*0*	*0*	*11*	*2*	*0*	*0*
Collateral	*170,154*	*151,885*	*23,627*	*19,948*	*0*	*0*	*9,353*	*1,535*	*94*	*9*	*2,828*	*2,458*

[1)] *Includes financial instruments that would be past due or impaired without renegotiation of conditions.*

Financial instruments past due and not individually impaired (EUR in millions)

	Loans and advances to banks		Loans and advances to customers		Securities and investments; investments accounted for using the equity method	
	2010	2009	2010	2009	2010	2009
Carrying amount less than 90 days past due	86	115	268	439	1	1
Carrying amount 90 days and more past due	16	21	215	318	0	0
Collateral	56	132	257	351	0	0

Individually impaired financial instruments (EUR in millions)

	Loans and advances to banks		Loans and advances to customers		Securities and investments; investments accounted for using the equity method		Contingent liabilities; irrevocable loan commitments	
	2010	2009	2010	2009	2010	2009	2010	2009
Carrying amount	151	172	1,411	1,584	242	239	1	41
Individual impairments, provisions	88	282	4,483	5,421	0	0	429	278
Collateral	26	14	428	265	7	5	0	0

At year-end 2010 EUR 1.8 billion (net after deduction of risk provisions; previous year: EUR 2.0 billion) were classified as individually impaired out of EUR 511.0 billion (previous year: EUR 455.0 billion) in financial instruments outstanding. Potential losses are conservatively estimated, and individual impairment charges have been recognised in the amount of EUR 5.0 billion (previous year: EUR 6.0 billion). This includes provision for risks from the various IKB rescue measures in the amount of EUR 3.7 billion (previous year: EUR 4.2 billion).

In addition to provisions for immediate risks of default, the KfW Group makes provisions for latent risks of default (economic and political risks). As at 31 December 2010, risk provisions for transactions not individually impaired totalled EUR 0.9 billion (previous year: EUR 1.3 billion). The collateralisation of loans in the Group portfolio primarily relates to on-lending business and promotional business guaranteed by the Federal Republic of Germany or individual federal states[6]. By far the largest portion of collateral is attributable to assigned end-borrower receivables from on-lending business. Tangible collateral, e.g. ships and aeroplanes, plays only a minor role with regard to the total amount of collateral.

The high exposure as regards derivatives with positive fair values has to be put into the context of the netting agreements with counterparties. These also include derivatives with negative fair values and considerably reduce the counterparty risk.

There was an increase in irrevocable loan commitments of EUR 14.9 billion in the reporting year. This is primarily a result of the support loan for Greece, which has not yet been called in full.

As part of the restructuring of a syndicated loan, the Group took possession in the reporting year of assets that had previously been held as tangible collateral, with a pro rata value of USD 108.7 million, by means of a rescue acquisition. These assets are to be sold within 5 years in an orderly sale. The equity position with a pro rata value of USD 703,000 under the new structure adopted was written down to a memo value of USD 1, while a risk provision of USD 20 million exists for pro rata debt financing as at 31 December 2010. As at the reporting date the Group carries the assets at a pro rata value of around USD 72 million.

PORTFOLIO STRUCTURE

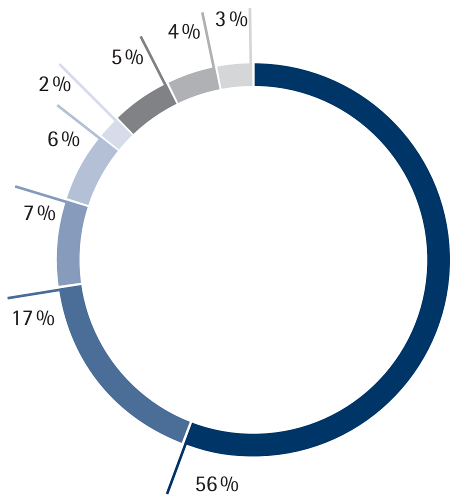
The contribution of individual positions to the risk associated with the KfW Group's loan portfolio is assessed based on an internal portfolio model. Concentrations of individual borrowers or groups of borrowers give rise to the risk of major losses that could jeopardise KfW's existence. On the basis of the economic capital concept, Risk Controlling measures the risk concentrations by individual borrower, sector and country. The risk concentrations are primarily reflected in the economic capital requirement. This ensures that not only high risk volumes but also unfavourable probabilities of default and undesirable risk correlations are taken into account. The results form a central basis for the management of the loan portfolio.

Regions

As at 31 December 2010, 73% of the Group's loan portfolio[7] in terms of economic capital requirements was attributable to the euro area (previous year: 72%). There were slight shifts within the euro area: while capital requirements for loans fell in Germany, they increased mainly in crisis-hit countries of the euro area due to higher probability of default.

Economic capital requirements by region, 2010

	2010	2009
Germany	56%	57%
Euro area countries (excl. Germany)	17%	15%
EU countries (excl. euro area countries and Germany)	7%	7%
Europe outside EU	6%	7%
Africa	2%	2%
Asia (incl. Australia and New Zealand)	5%	5%
Latin America	4%	3%
North America	3%	4%



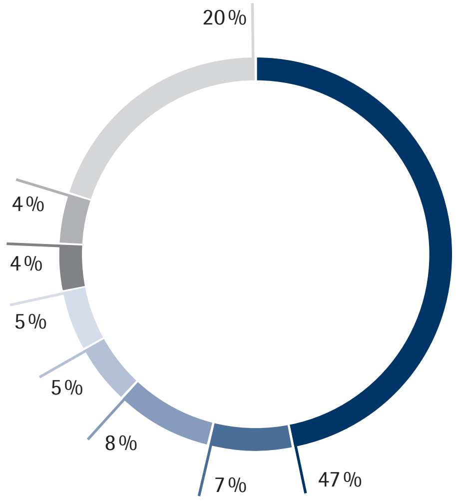
[6] *The collateral is presented as recognised for purposes of internal management of economic risks. Participation effects are taken into account in order to avoid reporting double collateralisation.*
[7] *The loan portfolio includes loans as well as securities and investments in performing business.*

Sectors

The significant share of overall capital required for credit risks attributable to the financial sector is due to the KfW Group's promotional mandate. By far the greatest portion of the Group's domestic promotional lending business consists of loans that are on-lent through banks. The distribution of capital requirements among all sectors has proved stable on the previous year.

Economic capital requirements by sector, 2010

	2010	2009
Financial sector	47 %	49 %
Public sector	7 %	7 %
Consumer/retail	8 %	6 %
Private equity firms	5 %	6 %
Shipping	5 %	5 %
Basic industries	4 %	4 %
Aviation	4 %	4 %
Other	20 %	19 %

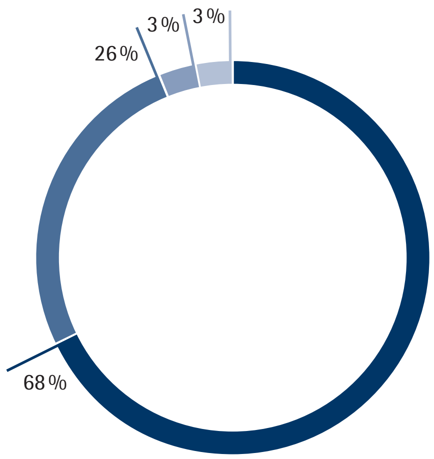


Credit quality

As credit quality is a major factor influencing the economic capital requirement, it is appropriate in analysing the credit quality structure to examine the distribution of net exposures by credit quality category. The credit quality is unchanged on the previous year with regard to the four categories presented. This is due to two interrelated effects in 2010. While the situation for financial institutions stabilised in the reporting year, the economic crisis triggered numerous rating downgrades in corporate financing. The Group's loan portfolio therefore continues to show a good credit quality structure.

Credit quality by net exposure, 2010

	2010	2009
Investment grade (M1–M8)	68 %	68 %
Non-investment grade (M9–M15)	26 %	26 %
Watch list (M16–M18)	3 %	3 %
Default (M19–M20)	3 %	3 %



Structured products in the group portfolio

In this section, the Group's portfolio of structured products, divided into asset-backed securities (ABS) and platform securitisations (PROMISE, PROVIDE), is presented separately.

Asset-backed securities

In addition to its own holdings of ABSs, the Group's ABS portfolio includes ABS investments in special funds. These investments were again reduced over the last year.

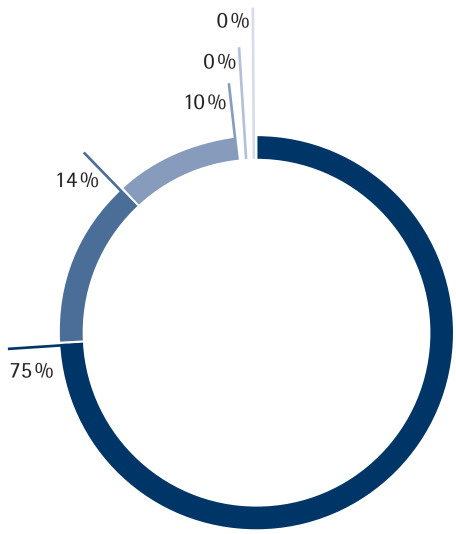
The ABSs had a par value of around EUR 5.0 billion as at the balance sheet date, 31 December 2010. Accounting for the mark-to-market valuation of the securities reported at fair value and impairments, the portfolio had a total value (including pro-rata interest) of EUR 4.6 billion. The following tables show the composition of the ABS portfolio by asset class, rating and geographic distribution of the underlying assets in the securitisation portfolios.

Exposure based on par values, 31 December 2010

	CLO	RMBS	CMBS	CDO	ABS & other	Total 2010	Total 2009
	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions
Investment grade	1,709	1,172	387	1	854	4,123	4,515
Non-investment grade	309	7	2	2	1	322	560
Watch list	15	62	4	–	–	80	439
Default	219	10	49	192	–	471	382
	2,252	1,251	442	195	855	4,995	5,896

Geographic breakdown of the underlying asset pool (based on nominal), 2010

	2010	2009
Europe	75 %	68 %
World	14 %	15 %
North America	10 %	16 %
Africa	0 %	0 %
Asia	0 %	1 %



The portfolio volume was lower than the previous year's figure due to sales and repayments (nominal value EUR –0.9 billion). A comparison of the rating structure of the portfolio shows a considerable reduction in watch-list holdings, which is also largely attributable to sales and repayments. At the same time, the proportion of securities with default status has increased due to declines in credit quality, particularly for CLO securities. The regional focus of the ABS portfolio remains on Europe.

Overall, European securitisations showed a solid performance, including German securitisations. Even three years after the outbreak of the crisis, cumulative default rates for European securitisations are very low.

The Group has indirect exposure to additional risks, associated with structured securities, via the risk protection measures for IKB. For example, KfW assumed all of IKB's rights and obligations under IKB's liquidity lines to refinance the special purpose entities of the Rhineland Funding Capital Corporation conduit. Taking into account redemptions and loss realisation, receivables in the amount of EUR 3.8 billion from the purchasing companies remained outstanding as at 31 December 2010. Impairment charges of EUR 3.4 billion have been taken on these receivables.

Platform securitisations

Banks can transfer credit risks synthetically from SME loan portfolios to the capital market using the securitisation platform PROMISE. KfW complements its promotional offering with its securitisation programme PROVIDE, which aims to securitise private housing loans. The securitisation of housing loans and of corporate loans each accounted for around half of the underlying asset volume as at the reporting date 31 December 2010. As of the same date, the volume securitised via the platforms totalled EUR 15.4 billion. Of this total, EUR 14.7 billion was securitised through credit default swaps or credit-linked notes. The Group has retained risks from senior tranches with respect to the remaining EUR 0.6 billion. The decline in the securitisation volume of EUR 12.2 billion against the previous year was primarily a result of the use of the originator banks' call options. In addition, no new business was entered into in 2010.

Risk in the platform business is primarily defined by the quality of the securitised portfolios. There are currently no immediate loss expectations for KfW.

Market price risk

Market price risks result primarily from potential losses that may arise from changes in:

- the interest structure (interest rate risks),
- exchange rates (currency risks),
- issuer-related premiums on the interest rate of securities (credit spread risks) and
- other market prices (e.g. share prices, commodity prices).

KfW and its subsidiaries are non-trading book institutions as per the German Commercial Code; consequently, their market price risks are limited to the banking book.

Interest rate risks

The main market risk component in the KfW Group is interest rate risk. The Group assumes limited interest rate risks in order to take advantage of opportunities for returns. Additionally, interest rate risks arise from the special design of the domestic lending business with its prepayment options. KfW takes this into account in its risk management by including the estimated future volume of exercised prepayment options in its funding strategy.

To record interest rate risks in its banking book, the KfW Group uses standard software that integrates all data relevant for risk assessment. This standard software is used to determine current balances of interest rate maturities (euro, US dollar and British pound). On this basis, the KfW Group regularly performs value-at-risk calculations to assess its interest risk position. The applied simulation-based method – which was subject to major revision as at 31 December 2009 – is based on a two-factor Cox-Ingersoll-Ross model, which is used to estimate the distribution of risk positions in the Group given possible changes in market interest rates. In accordance with MaRisk requirements, the separation of the aggregate banking book business into one bank-ing book for equity and one for debt instruments, as previously practised by KfW in determining the present value of interest risk, is no longer permitted as of 2010. Therefore these two books were combined into an aggregate banking book for risk assessment and management purposes.

Key optional components of business (e.g. terminable loans) are accounted for in the Group's cash flow. The economic capital requirements are identified – as are credit risks – for a period of one year. Periodic stress tests supplement this calculation to estimate possible losses under extreme market conditions. Apart from a parallel shift in the yield curve prescribed by supervisory law, these tests include scenarios such as a twist in the yield curve and an extension of the holding period.

Currency risks

Foreign currency loans are largely refinanced in the same currency or secured by appropriate foreign currency hedging instruments. This also applies to individual impairments for which the corresponding replacement assets are provided. Foreign currency equity investments of DEG and to a small extent promotional instruments of KfW Entwicklungsbank, in contrast, are at present not funded in the same currency. Open currency positions resulting from accrued margins or impairment losses are generally closed as soon as possible.

Risks from open currency positions remaining at the balance sheet date are measured by a variance/covariance approach in the form of a value-at-risk with a holding period of three months. The required parameters (exchange rate volatility and the expected value of changes in exchange rates) are estimated on the basis of historical data.

As at 31 December 2010, DEG has now been included in currency risk measurement for the first time, analogous to the inclusion thus far of KfW IPEX-Bank. Measurement and control approaches for currency risk at the different KfW Bankengruppe companies are currently being revised as part of a project aimed at standardising the Group's currency management. Going live is scheduled for 2011.

Credit spread risks

Credit spread risks were integrated into the calculation of the risk-bearing capacity for the first time during the reporting year. For the Group, risks arising from credit spread changes are estimated for positions in the categories *"available-for-sale financial assets"* and *"financial assets at fair value through profit or loss"*. The economic capital requirement is determined for a one-year period based on historical simulation to satisfy the 99.99 % solvency level.

Other market price risks

Other market price risks include share price risks from equity investments. They also include commodity price risks from CO_2 certificates which the Group keeps in its own books. Risks from CO_2 certificates arise as a result of the Group's decision to act as an intermediary between the buyers and sellers of CO_2 certificates. As a result, KfW also keeps certificates in its own books.

Other market price risks are measured using variance/covariance approaches. The required parameters (price volatility and the expected value of changes in prices) are calculated using historical data. The historical data used for estimating the model parameters for CO_2 certificates is daily prices since the beginning of 2005 and for share price risks monthly prices since 2001.

The Market Price Risk Committee manages market price risks based on the valuation and analysis of interest and currency positions, other market price risks and stress tests for interest rate risks. The objective of this is long-term management of a reasonable market risk position for the bank. The strategy pursued is defined annually as part of the Group's business area planning. This strategy is monitored using a limit system for all market price risks.

In accordance with MaRisk, framework conditions imposed by the Executive Board which are in line with market standards apply for the transaction, processing and settlement of trades.

In total, market price risks within the Group required a total of EUR 2,283 million in economic capital as at 31 December 2010. This position is composed of the following individual risks:

Total economic capital for market price risks

	31 December 2010	31 December 2009[1)]
	EUR in millions	EUR in millions
Interest rate risks	1,623	1,444
Currency risks	114	46
Credit spread risks	425	–
Other market price risks	121	134
Market price risk	**2,283**	**1,624**

[1)] *Figures for the previous year were adjusted to satisfy the 99.99 % solvency level.*

The capital requirement for interest rate risks rose slightly as at 31 December 2010 due to a rise in volatilities in the interest rate environment while interest risk positions remained structurally unchanged.
The rise in currency risk as at 31 December 2010 is largely based on the inclusion of DEG in the currency risk measurement.

Credit spread risks were integrated into the risk assessment for the first time in the current financial year.

With respect to the remaining market price risks, required economic capital was virtually unchanged as against the previous year, at EUR 121 million.

Liquidity risk

Liquidity risk is the risk of a lack of liquidity. KfW differentiates between institutional liquidity risk (the risk of not being able to meet payment obligations) and market liquidity risk (the risk that the required funds are only available at costs higher than the risk-commensurate interest rate).

The primary objective of liquidity management is to ensure that the KfW Group is at all times capable of meeting its payment obligations. KfW's subsidiaries are principally responsible for ensuring and managing their own liquidity and complying with the existing regulatory requirements. KfW, however, is available as a contractual partner for all commercial transactions of its subsidiaries, particularly for their funding. For this reason the liquidity requirements of the subsidiaries are included both in KfW's funding schedule and in the liquidity maintenance strategy.

Liquidity risk is measured on the basis of the liquidity risk indicator under regulatory law, the utilisation threshold in accordance with the KfW Law and economic scenario analyses.

A significant component for liquidity risk assessment is the contractual payment obligations (principal and interest) of the KfW Group arising from financial instruments, which are shown in the table below by maturity range:

Payment obligations arising from financial instruments by maturity range, 31 December 2010[1)]

	Up to 1 month	1 to 3 months	3 months to 1 year	1 to 5 years	5 years and more	Total
	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions
Liabilities to banks and customers	13,355	2,848	1,831	13,366	18,979	50,380
Certificated liabilities	9,855	15,183	34,179	199,748	143,622	402,587
Net liabilities under derivative financial instruments	– 674	– 327	– 3,201	– 6,453	–14,208	–24,862
Liabilities under derivative financial instruments	*23,508*	*44,442*	*62,208*	*375,690*	*309,201*	815,049
Subordinated liabilities	0	0	146	404	3,359	3,909
Liabilities under on-balance sheet financial instruments	22,536	17,705	32,956	207,065	151,752	432,014
Contingent liabilities	6,982	0	0	0	0	6,982
Irrevocable loan commitments	65,276	0	0	0	0	65,276
Liabilities under off-balance sheet financial instruments	72,257	0	0	0	0	72,257
Liabilities under financial instruments	**94,793**	**17,705**	**32,956**	**207,065**	**151,752**	**504,271**

Payment obligations arising from financial instruments by maturity range, 31 December 2009[1)]

	Up to 1 month	1 to 3 months	3 months to 1 year	1 to 5 years	5 years and more	Total
	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions
Liabilities to banks and customers	7,893	2,924	2,006	15,672	21,026	49,521
Certificated liabilities	8,559	7,605	40,138	178,190	132,984	367,476
Net liabilities under derivative financial instruments	– 225	– 519	942	– 9	– 12,051	– 11,863
Liabilities under derivative financial instruments	*25,409*	*26,881*	*69,370*	*347,303*	*282,940*	751,903
Subordinated liabilities	0	0	146	494	3,415	4,055
Liabilities under on-balance sheet financial instruments	16,227	10,009	43,231	194,347	145,374	409,190
Contingent liabilities	7,529	0	0	0	0	7,529
Irrevocable loan commitments	50,360	0	0	0	0	50,360
Liabilities under off-balance sheet financial instruments	57,889	0	0	0	0	57,889
Liabilities under financial instruments	**74,116**	**10,009**	**43,231**	**194,347**	**145,374**	**467,079**

1) The net liabilities under derivative financial instruments comprise payment obligations which are offset against the corresponding payment claims from derivative contracts; the gross liabilities are reported as liabilities under derivative financial instruments. Irrevocable loan commitments and contingent liabilities are generally allocated to the first maturity range.

Liquidity risk management is based on scenario calculations. This approach first analyses the expected inflow and total outflow of funds for the next twelve months based on business already concluded. This basis cash flow is then supplemented by uncertain payments (e.g. borrowings from the capital market, expected loan defaults or planned new business). The result provides an overview of the liquidity required by KfW in the next twelve months. The required liquidity is calculated for the three scenarios of normal case, stress case and worst case, the main difference being variation among the uncertain payments.

The available liquidity potential is calculated parallel to this. It largely consists of KfW's ECB collateral account, repo assets, liquidity portfolios and the volume of commercial paper that is regularly placeable on the market. The available liquidity potential is subjected to stress in the same way as the other cash flow components in the stress case and worst case scenario tests.

The ratio of cumulative required liquidity to the cumulative available liquidity potential is calculated for each scenario. This figure may not exceed the value of 1 in any scenario for any period. The prescribed horizon in the normal case scenario is twelve months, in the stress case six months, and in the worst case, three months.

The key figures are calculated and reported to the Market Price Risk Committee on a monthly basis. The following table shows the key risk indicators for the scenarios as at 31 December 2010:

KfW liquidity risk indicators as at 31 December 2010

	Indicator
Normal case	0.36
Stress case	0.65
Worst case	0.66

Since the indicators for all three scenarios including the extremely conservative "worst case" are significantly below 1, KfW can be said to have a comfortable liquidity position at present.

Current refinancing environment

International financial markets continued to feel the impacts of the financial crisis in financial year 2010. This was topped by the debt situation of some countries – particularly in the euro area, which was increasingly regarded as critical. Against this backdrop, the general market environment was characterised overall by a high degree of nervousness and volatility. KfW's strengths – top-notch credit rating combined with a transparent emission strategy – were highly regarded on the international capital markets in this environment. In order to fund its promotional business, KfW issued 371 bonds in a total of 17 different currencies in the year under review, thus raising long-term funding with a value of EUR 76.4 billion. In terms of short-term refinancing on the money market, KfW profited from the persistent low risk tolerance of many investors. This kept demand for KfW commercial paper at a comparatively high level. During the reporting year, the bank issued a total of 1,624 individual securities under two commercial paper programmes. Average outstanding volume for the year totalled EUR 18.9 billion and USD 7.4 billion. For financial year 2011 KfW expects a stable long-term funding requirement of around EUR 75.0 billion at the previous years' level.

Operational and other risks and business continuity management

The KfW Group defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risks but does not include strategic risks.

The organisational structure provides for a two-tier system comprising decentralised OpRisk Management and central OpRisk Controlling units liaising with the Operational Risk Committee.

Operational risks are managed decentrally within the business areas and subsidiaries, by the respective directors and/or managing directors and the coordinator of the operational risks and business continuity management function.

The responsibility of the business areas and subsidiaries in the decentralised OpRisk Management unit involves controlling operational risks within the respective areas of responsibility. This includes identifying and assessing operational risks, analysing and reporting risk events, as well as determining, evaluating and implementing risk-mitigation measures. In using OpRisk instruments, directors and managing directors are supported by the respective coordinator of the operational risks and business continuity management function as well as a central operational risk management team.

The operational risk management team performs central control of operational risks and business continuity management in the area of risk management and control. This unit develops the methods for identifying and assessing risks and monitors their uniform application. The operational risk management team is mapped to the business areas so that each business area has one central contact.
The central OpRisk Controlling unit provides OpRisk instruments within its authority to select methods, and further develops them. The methods and instruments for identification, assessment and management of operational risks are the events database, assessment, controlling of measures, determination of regulatory capital, and reporting regulations. Business continuity management includes the provision of the business impact analysis, methods and IT tools to use for exercises and tests as well as for planning business continuity.
Central responsibility also includes the critical plausibility check of risk identification and assessment performed at a decentral level The operational risk management team trains the decentralised function coordinators and informs them of new developments.

In accordance with the definition laid out in the German Solvency Regulation, operational risks in the KfW Group are integrated into its economic capital management as part of a comprehensive management approach covering all risk types. Quantification as well as determining capital requirements is performed in accordance with the regulatory standard approach. This resulted in OpRisk backing for 2010 in the amount of EUR 542 million (EUR 497 million for 2009).

OpRisk assessments are performed regularly at business area and process level for purposes of risk management and control. The risk assessment process was completely revised in 2010 and given a quantitative focus. A pilot project was successfully concluded. The rollout was started in the decentralised business areas in the second half of 2010 and will be completed by mid-2011.

The monthly risk report to the KfW Executive Board, which also contains OpRisk event data, constitutes the core of management reporting. Moreover, material events are reported to the Executive on an ad hoc basis.

The Group addresses legal risks by involving its in-house legal department early in the process and by cooperating closely with external legal advisers in Germany and abroad.

As reputational risks are also based on operational risks, they are taken into account in KfW Bankengruppe in the risk management process for operational risks, in the assessment, in gathering event data and in outsourcing risk analysis.

As part of business continuity management, KfW has implemented a proactive (emergency provision) and a reactive emergency organisation (emergency management). These comprise the emergency team and the crisis team. Business continuity management is a management process to continue key business processes, for which time is critical, in cases of emergency and crisis.

Business continuity plans have been developed and are to be updated for all relevant processes and support resources. Emergency plans exist for the following scenarios: damage to buildings, IT failure, unavailability of staff or service providers.

Fully equipped emergency workspaces have been created at an alternative location sufficiently far away from KfW premises for processes in which time plays a particularly critical role.

The business continuity plans are tested in accordance with the annual planning by the departments. Additionally, in 2010 crisis teams held drills at an alternative location of KfW.

A readily available external alarm system was implemented for use in emergency and crisis situations.

FORECAST REPORT

Global economic development will remain mixed in 2011. The Asian emerging markets are likely to record high growth rates again. Meanwhile, the economic environment in industrialised economies will remain difficult, and not only with regard to government finances. Structural adjustments in many countries are still in their infancy. In view of the problematic state of government budgets, many countries will follow a path of fiscal consolidation that will dampen growth. Monetary policy, in contrast, will continue to be highly expansive for a long time yet in most industrialised nations, in order to cushion the impact of the crisis and ease the refinancing of the banking sector.

In some emerging markets, however, particularly India and China, pressure is increasing to keep a stronger rein on monetary policy and to scale back fiscal stimuli in order to counteract increasing inflation. Overall, the upward trend in the economy is likely to continue in 2011, although momentum may slow somewhat in comparison with the previous year.

In the **euro area**, economic activity is likely to slacken slightly in 2011. However, there are differences between the countries in the euro area. Sentiment has deteriorated especially in the countries directly affected by the debt crisis, and falls in production must be expected. These countries are likely to remain under pressure with regard to their credit ratings. This particularly applies to the peripheral countries in the euro area whose economies are struggling. Economic activity in Greece, Ireland and Portugal may even shrink. Northern European countries, on the other hand, are showing more momentum.

The German economy could grow by significantly more than 2% and a real growth rate above the long-term trend also looks possible for 2012 from the current standpoint. Compared to the very high real growth of 2010, this is a slowdown in momentum of a growth rate that remains high; this slowdown is attributable in particular to the somewhat weaker global economic environment. The fundamental conditions for a stable upturn in Germany are more favourable than they have been for a long time, since in addition to the traditionally strong export economy – as "world supplier" its products have long met the needs of the emerging economies – the domestic economic situation has also improved. Higher wages and falling unemployment should further revive private consumption in 2011, giving positive momentum to domestic sales prospects and providing a key investment incentive, particularly in capacity expansion. But it is not only on the demand-side that investment is becoming more attractive. On the supply side too, there has been a turn-around in two important factors that have hindered domestic investment in the past ten years. In setting key interest rates for Europe, the ECB must take into account the persistent structural problems in the peripheral countries of the euro area. For Germany, this means that rates are likely to be low given the conditions in its domestic economy. In addition, exporting capital to the euro-zone periphery – and also to the US – is likely to have become considerably less attractive than before the crisis, meaning that in future, excess savings will increasingly be mobilised for investment in Germany again.

There are significant risk factors in this forecast due to the simultaneous exit from stimulating fiscal policy by numerous trading partner countries, the continuing current account imbalances in the European and global benchmark – despite the expected recovery of German domestic demand – and the financial crisis persisting in the euro-area periphery, which could also negatively affect economically strong countries like Germany due to the close financial and real-economic ties.

In terms of risk, a range of different developments are anticipated in the individual segments of the KfW credit portfolio in 2011, but these are expected to have a positive overall impact.

The risk profile in the **corporate sector** is expected to benefit in particular from the continuing, though less dynamic economic upturn. Sectors particularly affected by the crisis, such as mechanical engineering, automotive, aviation and shipping, look set to catch up, albeit at different rates. In small and medium-sized enterprises (SMEs) in particular, the signs of economic recovery are likely to be delayed due to trailing ratings and structural disadvantages in financing. Special attention should be paid, however, to growth in China and other Asian markets. These represent a large part of the export demand that benefits German companies to a greater extent than average. Fiscal or regulatory measures to curb excessive growth in these countries could harm the sales prospects of German companies. The after-effects of the financial and economic crisis are also evident at some companies in reduced equity buffers and liquidity reserves that have yet to be fully replenished. This makes them more vulnerable to an unexpectedly rapid fall in demand.

The development of the **European financial sector** will be influenced by two main issues – the debt crisis in several European countries and the new regulatory requirements of Basel III.
A considerable burden is expected for banks with strong regional ties to European problem countries in 2011 too. In addition to higher costs of refinancing and difficulties in raising funds, the cost of credit risk will continue to exert a negative influence on the profitability of these financial institutions, especially in countries with real estate market problems (Spain, Ireland).
Although the Basel III regulations, which have now been finalised but not yet transferred into national law, in some cases include long transitional periods, many banks will be working under extreme pressure as early as next year to implement the new requirements. Efficient use of capital resources will gain further importance. The higher capital requirements and new requirements regarding short-term liquidity will lead in the medium term to falling returns (RoE) at the banks. Basel III presents the banking world as a whole with major challenges. Increased competition will be evident among institutions and further market concentration in the banking sector cannot be ruled out.

In addition to the Basel III requirements, the discussion regarding the Landesbanks will continue in the **German banking sector**. The strict restructuring requirements imposed by the European Commission have led to an extensive process of adjustment at many Landesbanks. It remains to be seen to what extent merger activity will take shape in this sector in the coming year. The effects of the financial market and economic crises on the **US financial sector** also remain clearly visible in 2011. Particularly among small and medium-sized banks, the risk of insolvency remains heightened. The fragile state of the real estate market will continue to perceptibly influence credit quality, although the efforts made to restructure in recent years will have a positive effect on profitability, at least at the large universal banks.
The slow-down in global economic growth in 2011 is expected to cause a stagnation of credit defaults. Improvements in profitability will slow down and remain subject to considerable volatility in the individual quarters.

A slower recovery is expected in the **private equity market** compared to the corporate sector in 2011. With initially moderate risk appetite on the part of investors, potential transactions will record only low volumes.
The moderate recovery is set to continue in the European **securitisation market** in 2011. This assumes the sustained return to confidence in this asset class and the widening of the investor base. Issue volumes will remain considerably below the pre-crisis level; however growing trust on the part of investors will allow the public marketing of ABS transactions to gradually increase again.

The exceptional growth in KfW's promotional volume recently was a result of the crisis. The normalisation of the economic situation is also bringing normalisation to the promotional volume.

KfW is concentrating on supporting SMEs, ensuring the future viability of companies, protecting the climate and the environment, promoting housing and education, and improving municipal infrastructure. Other key areas are strengthening cooperation with developing, transition and industrialising countries and expanding the support for the export sector.

Domestically, KfW supports the German economy with the **promotional programmes of KfW Mittelstandsbank, KfW Privatkundenbank and KfW Kommunalbank.**

An important element of the promotional work that will be carried out by **KfW Mittelstandsbank** in 2011 is securing financing for the upturn. KfW Mittelstandsbank is making a contribution here by providing start-ups and SMEs with financing that meets their needs. KfW Mittelstandsbank is to strengthen and bundle its support for start-ups in 2011 through a realignment of its programmes. The promotion of innovation is also a particularly important funding priority for the future viability of enterprises. In terms of industrial environmental protection, increasing energy efficiency and the use of renewable energies remain important objectives. In addition to traditional promotional loans, KfW Mittelstandsbank also offers mezzanine funding and private equity.

At **KfW Privatkundenbank,** the promotion of energy rehabilitation and energy-efficient housing construction in the interests of climate protection remains an important focus. Support for measures to improve accessibility in residential accommodation is also to be expanded in preparation for the ageing of Germany's population. In addition, home ownership is promoted. Financing education will become increasingly important in the next few years, with a view to the Federal Government's goal of making Germany a country with a strong focus on education ("Bildungsrepublik Deutschland"). The KfW Student Loan already enables students to finance their first course of studies, regardless of financial standing, and lifelong learning is supported by the loan programme for further training to achieve master craftsman level in skilled manual trades.

Promotion of infrastructure by **KfW Kommunalbank** will be continued at a comparable level despite the expiry of special programmes connected to the infrastructure investment offensive. There will be a new focus on funding energy efficiency in municipalities. The special credit institutions of the federal states remain the main focus of the global loan business.
Given the multitude of influencing factors, only a rough estimate can be given for promotional business volume. New business volume totalling around EUR 48.0 billion is expected for domestic business in 2011.

Securitisation activities are and will remain an important component in providing the economy with sufficient lending, since the regulatory challenges of the future (including Basel III) and high medium to long-term refinancing requirements on the part of banks mean that the entire spectrum of refinancing opportunities must be exploited.

With its high-quality securitisation products and its activities – also as part of TSI (True Sale International), KfW is making a valuable contribution to reviving the securitisation market and is therefore supporting lending to SMEs and the housing sector. For 2011, KfW anticipates a new business volume of around EUR 3.5 billion for its securitisation platforms PROMISE and PROVIDE, and for its involvement in securitisation transactions of SME, lease and mortgage loans.

Other measures in addition to securitisation activities are planned to support the economy in 2011. For example, KfW will continue the successful programme for "refinancing export loans covered by federal guarantees" with changed conditions. The aim of the programme is to improve the financing situation of German exporters.

In the course of the global recovery of financial markets and the real economy, KfW IPEX-Bank saw a renewed increase in export projects and larger infrastructure projects in 2010 in the business area **Export and project financing** for which it is responsible. As a result of the financial crisis, and the increased capital requirements expected from Basel III, there continues to be strong competition in the banking sector for low-risk and well-collateralised financing structures. The bank does not anticipate an immediate increase in its business activities for 2011, but expects demand for medium and long-term financing, KfW IPEX-Bank's core product, to increase slightly year-on-year. It sees good opportunities in energy and environment financing, as well as infrastructure and transport projects. The regional focus is primarily on markets that play a special role for the German export industry. Besides European countries, this includes in particular the emerging markets in Asia and Latin America.

On the basis of the economic conditions described above, KfW IPEX-Bank anticipates a new business volume in the business area Export and project financing of around EUR 9.0 billion, about EUR 4.0 billion of which for the promotional business of KfW.

The **Promotion for developing and transition countries** business area comprises the business activities of KfW Entwicklungsbank, the KfW Carbon Fund and DEG.

As the international promotional bank of the Federal Government for development, environment and climate, **KfW Entwicklungsbank** will continue to concentrate its efforts in particular on the further mobilisation of funding for partner countries and to the benefit of international climate financing in 2011. Emphasis is placed here on developing innovative financing instruments (together with the Federal Government) and increasing the use of KfW's own funds in the more advanced developing and emerging market countries. Despite the budget consolidation, KfW Entwicklungsbank is increasing its commitment to developing and expanding the financial sector, promoting the water and energy sectors, and protecting the environment and climate. KfW Entwicklungsbank is supporting the Federal Government in forming global development partnerships for sustainability. In consultation with the Federal Government, KfW Entwicklungsbank is taking an active role in achieving EU objectives in development policy and climate protection, such as the design and implementation of common European financing platforms. In 2011 new commitments are expected of slightly over EUR 4.0 billion, similar to the previous year.

The environment in which the **KfW Carbon Fund** operates in 2011 will continue to be characterised by the lack of a binding international climate treaty for the period after the expiry of the Kyoto Protocol. Continuing uncertainties and increased market complexity have provided the KfW Carbon Fund with good marketing opportunities for the innovative "EIB-KfW CO_2 Programme II", developed in partnership with the EIB, which began to generate interest among numerous companies in the previous year. In 2011, given the economic environment, certificate purchases are planned pri-marily from projects with innovative programmatic approaches and projects in the poorest developing countries.

In the course of the **privatisation transactions with the Federal Republic**, KfW will continue to hold stakes in Deutsche Telekom AG, Bonn, and Deutsche Post AG, Bonn. Further privatisation transactions will take place in line with the prevailing market conditions and the strategic requirements of the Federal Government.

KfW expects high **refinancing volumes** for the next two years. At around EUR 75.0 billion, KfW expects funding requirements for financial year 2011 to be stable in comparison to previous years. A key parameter in determining the amount of the planned funding requirement is the promotional volume which remains consistently high, although a slight decrease is expected in 2011. The capital market environment should continue to normalise in the forecast period as it emerges from the financial and economic crisis. Nevertheless, the debt situation of some countries may still mean distortions or market disturbances – at least of a temporary nature. Due to the continuing high volatility on the international capital markets and a noticeable increase in supply from supranational and non-state issuers, competition is expected to remain challenging in 2011.

In order to refinance its funding requirements, KfW will rely on its tried-and-tested combination of high-volume benchmark bonds, other public bonds and private placements. EUR and USD will continue to be the main funding currencies. It is further to be expected that, alongside the British pound and Japanese yen, currencies such as the Australian dollar and Norwegian krone will play an important part in total funding.

First-class credit quality together with the diversified and reliable KfW refinancing strategy will remain the most important guarantees for KfW's access to primary markets in the future. Offers throughout the maturity range and flexibility in format and currency will be the key factors for successful, needs-based issuing activity.

In its current **earnings projections** for the Group, KfW expects to achieve total earnings of approximately EUR 1.0 billion in 2011. The key assumption for this forecast is a continuing economic recovery from the economic and financial crisis with a slight slowdown in the rate of growth. This is expected to be accompanied by moderate rises in interest rates and a slight flattening of the yield curve. All in all, KfW predicts economic conditions that will lead to decreases in net interest income, although this key component of the Group's operating result is expected to remain at a high level in 2011. In 2010, KfW benefited from the fact that a large proportion of the risk provisions created in 2009 were reversed. A normalisation is expected for 2011, and therefore a rise in risk provisions for lending business in comparison to 2010. Administrative expense in 2011 is expected to increase slightly over 2010.

In a scenario in which the economy falls back into recession, contrary to expectations, KfW expects stable, low interest rates. The increase in risk provisions for the lending business in the event of a recession would thus likely be compensated by higher net interest income. On the other hand, a scenario of unexpected dynamic recovery in the economy and increasing interest rates with a flattening yield curve would mean lower net interest income. However, in this case, a major reduction in loan defaults would also be likely, with a stabilising effect on the earnings situation.

Given the after-effects of the financial market and economic crisis, however, the forecast remains subject to a large degree of uncertainty. This primarily relates to the development of interest and exchange rates which have a considerable influence on the contribution of net interest income and valuation results to the overall result.

After the expiry of the stimulus package, KfW will use natural fluctuation to adjust the size of its **workforce** in 2011 to current requirements. This is likely to be repeated in the following year. No significant impact is expected on the personnel structure at KfW.

KfW will continue to offer the same number of trainee positions as in the past, in order to fulfil its responsibility with respect to the younger generation.

DECLARATION OF COMPLIANCE

The Executive Board and Board of Supervisory Directors of KfW have resolved to recognise the principles of the Federal Public Corporate Governance Code (Public Corporate Governance Kodex des Bundes – PCGK). The KfW Corporate Governance report contains the declaration of compliance with the recommendations of the PCGK.

FINANCIAL STATEMENTS AND NOTES

FINANCIAL STATEMENTS
BALANCE SHEET OF KFW AS AT 31 DECEMBER 2010

Assets

				31 Dec. 2010			31 Dec. 2009
	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in millions	EUR in millions	EUR in millions
1. Cash reserve							
a) Cash in hand			168			0	
b) Balances with central banks			603,854			337	
of which: with the Deutsche Bundesbank	603,854			**604,022**	337		337
2. Receivables from banks							
a) At call			149,512			171	
b) Other loans and receivables			292,239,787	**292,389,299**		271,618	271,789
3. Receivables from customers				**68,620,062**			58,914
of which: secured with mortgages							
of which: municipal loans	40,440,075				29,467		
4. Bonds and other fixed-income securities							
a) Money market paper							
aa) Of public issuers		0				0	
of which: eligible as collateral with Deutsche Bundesbank	0				0		
ab) Of other issuers		360,601	360,601			131	
of which: eligible as collateral with Deutsche Bundesbank	91,125				131		
b) Bonds and debentures							
ba) Of public issuers		3,578,010				2,348	
of which: eligible as collateral with Deutsche Bundesbank	3,445,101				2,211		
bb) Of other issuers		24,783,953	28,361,963			25,910	
of which: eligible as collateral with Deutsche Bundesbank	18,962,601				20,256		
c) KfW's own bond issues			9,195,855	**37,918,419**		9,232	37,621
Par value	9,870,077				9,582		
5. Shares and other non-fixed income securities				**14,187,090**			15,281
6. Investments				**514,078**			408
of which: in banks	36,174				28		
of which: in financial services institutions	0				0		
7. Shares in affiliated entities				**2,486,521**			2,391
of which: in banks	306,852				307		
of which: in financial services institutions	0				0		
8. Assets held in trust				**16,281,581**			16,399
of which: loans held in trust	16,191,290				16,314		
9. Intangible assets							
a) Concessions, industrial property rights and similar rights and values, as well as licenses to such rights and values			12,522	**12,522**			12
10. Tangible assets				**852,600**			813
11. Other assets				**9,229,706**			640
12. Deferred income				**2,391,938**			2,605
13. Special loss account consisting of provisions under Section 17 (4) of the D-Mark Balance Sheet Law				**26,557**			27
Total assets				**445,514,396**			**407,237**

Liabilities and Shareholders' Equity

				31 Dec. 2010			31 Dec. 2009
	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in millions	EUR in millions	EUR in millions
1. Liabilities to banks							
a) At call			11,223,744			2,084	
b) With agreed terms or periods of notice			8,291,750	**19,515,494**		10,390	12,474
2. Liabilities to customers							
a) Other funds							
aa) At call		556,851				412	
ab) With agreed terms or periods of notice		22,168,738	22,725,589	**22,725,589**		23,898	24,310
3. Certificated liabilities							
a) Bond issues			360,145,094	**360,145,094**		324,323	324,323
4. Liabilities held in trust				**16,281,581**			16,399
of which: loans held in trust	16,191,290				16,314		
5. Other liabilities				**72,020**			6,553
6. Deferred income				**6,427,026**			5,713
7. Provisions							
a) Provisions for pensions and similar commitments			746,915			655	
b) Other provisions			1,466,198	**2,213,113**		1,327	1,982
8. Obligatory charges under the D-Mark Balance Sheet Law				**265**			0
9. Subordinated liabilities				**3,246,589**			3,247
10. Fund for general bank risks				**600,000**			46
11. Equity							
a) Subscribed capital		3,750,000				3,750	
Uncalled outstanding contributions		(450,000)				(450)	
Paid-in subscribed capital			3,300,000				
of which: requested	0						
b) Capital reserves			5,946,989			5,947	
of which: promotional reserves of the ERP Special Fund	4,650,000				4,650		
Allocation	0				(307)		
c) Reserve from the ERP Special Fund			977,035			893	
Contractual appropriation of interest	84,206				45		
d) Retained earnings							
da) Statutory reserve under Section 10 (2) of the KfW Law		1,837,899				1,574	
db) Special reserve under Section 10 (3) of the KfW Law		2,178,096				1,928	
dc) Special reserve under Section 17 (4) of the D-Mark Balance Sheet Law		47,607	4,063,602			47	
e) Loss carried forward			0			(1,499)	
				14,287,626			**12,190**
Total liabilities				**445,514,396**			**407,237**
1. Contingent liabilities							
a) On guarentees			18,348,234	**18,348,234**		31,475	31,475
2. Other obligations							
a) Irrevocable loan commitments			60,766,474	**60,766,474**		43,758	43,758

INCOME STATEMENT OF KFW FOR THE PERIOD FROM 1 JANUARY – 31 DECEMBER 2010

Expenses

				2010			2009
	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in millions	EUR in millions	EUR in millions
1. Interest expenses				**9,207,222**			10,128
2. Contractual appropriation of interest to reserves from the ERP Special Fund				**84,206**			45
3. Commissions and similar charges payable				**208,440**			235
4. Net expenses from financial transactions				**0**			2
5. General administrative expenses							
a) Expenditure on personnel							
aa) Salaries and wages		274,022			249		
ab) Social security contributions, expenditure on pensions and support		61,312	335,334		45	295	
of which: for pensions	23,512				12		
b) Other administrative expenses			192,895	**528,229**		212	506
6. Depreciation and value adjustments on intangible assets and fixed assets				**26,613**			45
7. Other operating expenses				**118,215**			38
8. Write-offs of and value adjustments on loans and certain securities and increase of allowances for possible loan losses				**0**			7
9. Allocation to fund for general banking risks				**554,123**			0
10. Write-offs of and value adjustments on investments, shares in affiliated entities and securities treated as fixed assets				**0**			99
11. Extraordinary expenses				**74,520**			0
12. Taxes on income				**257**			11
13. Write-offs on the special loss account under Section 17 (4) of the D-Mark Balance Sheet Law				**45**			0
14. Profit				**2,013,034**			1,664
Total expenses				**12,814,905**			**12,781**
1. Profit				**2,013,034**			1,664
2. Loss carried forward from previous year				**– 1,499,231**			– 3,435
3. Withdrawal from capital reserves				**0**			306
4. Allocation to retained earnings							
a) to the statutory reserve under Section 10 (2) of the KfW Law			– 263,552			0	
b) to the special reserve under Section 10 (3) of the KfW Law			– 250,251	**– 513,803**		– 34	– 34
5. Distributable profit/loss				**0**			– 1,499

Income

				2010			2009
	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in millions	EUR in millions	EUR in millions
1. Interest income from							
a) Lending and money market transactions			11,027,940			11,376	
b) Fixed-income securities and debt register claims			542,696	**11,570,636**		853	12,229
2. Current income from							
a) Shares and other non-fixed income securities			80			33	
b) Investments			25,969			7	
c) Shares in affiliated entities			0	**26,049**		0	40
3. Commisions and similar service charges earned				**412,997**			434
4. Write-ups on loans and certain securities and release of allowances for possible loan losses				**527,129**			0
5. Income from release from fund for general banking risks				**0**			4
6. Write-ups on investments, shares in affiliated entities and securities treated as fixed assets				**150,381**			0
7. Other operating income				**127,714**			75
Total income				**12,814,905**			**12,781**

NOTES

The financial statements for 2010 for KfW have been drawn up in accordance with the requirements of the German Commercial Code *(Handelsgesetzbuch – HGB)*, the Ordinance Regarding the Accounting System for Banks *(Kreditinstituts-Rechnungslegungsverordnung – RechKredV)* and the Law Concerning KfW. The special provisions of the D-Mark Balance Sheet Law *(D-Mark-Bilanzgesetz – DMBilG)* have also been observed. The changes in legislation due to the German Accounting Law Reform Act *(Bilanzrechtsmodernisierungsgesetz – BilMoG)* were also observed in full. The changes resulting from the first-time application do not constitute a breach of Sections 252 (1) No 6 (consistent valuation methods) 265 (1) (consistent form and presentation) and 284 (2) No 3 (departures from accounting policies) HGB. Prior-year figures were not adjusted with consideration of the changes of the balance sheet.

In the financial statements the reserves from the ERP Special Fund and the contractual allocation of interest income to these are shown separately, as is the allocation to the capital reserves, which is shown as a memo item. Information on individual items in the balance sheet, which may be provided either in the balance sheet or in the notes, is provided in the Notes.

A reconciliation of net income for the year to balance sheet profit was added to the income statement form.

Cash in hand, loans and advances to banks and customers, investments, shares in affiliated entities and the other assets have been shown at the lower of cost, par or market. Differences between notional amounts and lower disbursement amounts of receivables have been included in deferred income.

The securities held as a liquidity reserve are valued strictly at the lower of cost or market *(strenges Niederstwertpinzip)*, where they are not covered by off-balance sheet transactions. For securities held as fixed assets the modified lower of cost or market principle *(gemildertes Niederstwertprinzip)* has consistently been applied. In some cases, hedging relationships are recognised for securities and their interest hedges (primarily interest rate swaps). No allocation of securities to the trading stock has been made. The statutorily required write-ups were made. Structured securities with embedded derivatives are accounted for as a unit and are valued strictly at the lower of cost or market.

Fixed assets are shown at acquisition or production cost, reduced by straight line depreciation in accordance with the expected useful life of the items. Minor items are combined to form a collective item and are depreciated over a period of five years using the straight-line method.

Liabilities are shown at their settlement amount; differences between agreed higher repayment amounts and issue amounts have been included in the item Prepaid expenses and deferred charges.

Provisions for pensions and similar commitments were valued in accordance with actuarial principles on the basis of "Richttafeln 2005 G" by Dr Klaus Heubeck. The projected unit credit method was applied for KfW's calculations, with a discount rate of 5.15% in accordance with Section 253 (2) HGB, a rate of salary increases between 1% and 3% depending on collective wage agreement grades, a rate of pension increases between 1% and 2.5% depending on the pension scheme, and a fluctuation rate of 0.8% for all active staff members. Future wage and salary increases will range between 1.6% and 2.6% depending on collective wage agreement grades. Other provisions are recorded at the estimated expenditure required to settle the obligation, taking future price/cost increases into account. Provisions with a remaining term of more than one year are to be discounted at the market interest rate published by Deutsche Bundesbank.

Sufficient allowance has been made for risks, most of which are on loans as a result of the structure of KfW's business, through value adjustments. The allocations are shown in the item Write-offs of and value adjustments on loans and certain securities and increase of allowances for possible loan losses. The possibility for netting in the income statement in accordance with Section 340 c (2) and Section 340 f (3) HGB has been utilised. For non-performing loans, interest income is generally accrued based on the probability of collection.

NOTES TO THE ASSETS

Receivables from banks

	At call	Remaining term				Pro rata interest	Total
		Up to 3 months	More than 3 months to 1 year	More than 1 year to 5 years	More than 5 years		
	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions
31 Dec. 2010	**149**	**36,696**	**22,864**	**123,026**	**103,987**	**5,667**	**292,389**
31 Dec. 2009	*171*	*29,741*	*21,267*	*110,034*	*105,046*	*5,531*	*271,790*
of which (previous year):							
to affiliated entities						*17,828*	*(25,039)*
to entities, in which KfW holds a stake						*24*	*(27)*
without on-lending banks' liability						*4,247*	*(2,459)*
subordinated assets						*2,326*	*(2,177)*

Receivables from customers

	With no fixed maturity	Remaining term				Pro rata interest	Total
		Up to 3 months	More than 3 months to 1 year	More than 1 year to 5 years	More than 5 years		
	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions
31 Dec. 2010	**0**	**6,570**	**5,955**	**32,814**	**22,408**	**873**	**68,620**
31 Dec. 2009	*0*	*7,134*	*5,316*	*24,937*	*20,679*	*848*	*58,914*
of which (previous year):							
to affiliated entities						*814*	*(848)*
to entities, in which KfW holds a stake						*30*	*(29)*
subordinated assets						*6,337*	*(6,498)*

Bonds and other fixed-income securities

Amounts shown under Bonds and other fixed-income securities due in the year following the balance sheet date are as follows:

Due the following year

Balance sheet date	31 Dec. 2010	31 Dec. 2009
	EUR in millions	EUR in millions
Money market paper, bonds and notes	3,835	4,841
Par value	*3,825*	*4,876*
Own bond issues	96	697
Par value	*94*	*676*
Total	**3,931**	**5,538**
Par value	*3,919*	*5,552*

The item Bonds and other fixed-income securities includes:

	EUR in millions
Listed securities	35,706
Unlisted securities	2,212
Marketable securities	**37,918**

The item Bonds and other fixed-income securities contained subordinated securities with a book value of EUR 1 million as at the reporting date (previous year: no holdings).

Repurchase agreements

Securities to the book value of EUR 791 million were sold under genuine repurchase (repo) agreements. The performance of the financial instruments sold resulted in financial asset collateral pledged in the amount of EUR 1 million. The terms and modalities of collateralisation and for the realisation of collateral follow common market practice.

Fixed assets

Fixed assets as at 31 December 2010

						Changes[1]	Residual book value	Residual book value
						2010	31 Dec. 2010	31 Dec. 2009
						(7)	(8)	(9)
						EUR in thousands	EUR in thousands	EUR in thousands
Investments						105,647	514,078	408,431
Shares in affiliated entities						95,744	2,486,521	2,390,777
Securities treated as fixed assets						– 267,598	26,619,642	26,887,240
Total						**– 66,207**	**29,620,241**	**29,686,448**

	Production/ production costs[2]	Inflows	Outflows	Transfers	Allocations	Write-offs/ adjustments		Residual book value	Residual book value
						Total	2010	31 Dec. 2010	31 Dec. 2009
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands
Intangible assets	17,769	4,658	17	0	0	9,888	3,898	12,522	11,761
Tangible assets[3]	1,011,298	71,957	9,758	0	0	220,897	22,715	852,600	812,589
Total	**1,029,067**	**76,615**	**9,775**	**0**	**0**	**230,785**	**26,613**	**865,122**	**824,350**
Total								**30,485,363**	**30,510,798**

[1] Including price changes
[2] The Relief Facility under Section 31 (6) of the Introductory Act to the German Commercial Code (Einführungsgesetz zum Handelsgesetzbuch – EGHGB) has been utilised.
[3] Of which as at 31 December 2010: – Total value of land and buildings used for the bank's activities EUR 817,175 thousand
– Total value of office furniture and equipment EUR 35,425 thousand

Bonds and other fixed-income securities, as well as shares and other non-fixed income securities, intended for permanent use for the business of the company and so usually held until maturity, have been included with the securities treated as fixed assets. They are shown separately in the accounts and valued following the modified lower of cost or market principle.

The book value of the marketable securities in fixed assets not valued at the lower of cost or market was EUR 26,391 million as at 31 December 2010. This includes investments in securities, whose book value of EUR 12,182 million was higher than the market value of EUR 11,289 million. Since these securities are to be held until maturity they were not written off.

The item Shares and other non-fixed income securities includes:

	EUR in millions
Listed securities	12,239
Unlisted securities	1,948
Marketable securities	**14,187**

Securities are fully included in current assets.

Disclosures on shareholdings

Name and domicile of company	Share held	Equity	Net income for the year
	in %	EUR in thousands	EUR in thousands
1. DEG Deutsche Investitions- und Entwicklungsgesellschaft mbH, Cologne[1)]	100.0	1,604,535	268,230
2. KfW Beteiligungsholding GmbH, Bonn[1)]	100.0	275,972	95,744
3. KfW IPEX-Beteiligungsholding GmbH, Frankfurt am Main[1)]	100.0	1,625,985	351
4. ASTRA Grundstücksgesellschaft mbH & Co. Bauträger KG, Frankfurt am Main[2)]	100.0	1,500	33
5. KfW International Finance Inc. i. L., Delaware USA	100.0	0	0
6. AF Eigenkapitalfonds für deutschen Mittelstand GmbH & Co. KG, Munich[3)]	49.0	–	–
7. Deutsche Post AG, Bonn[2)]	30.5	8,273,000	693,000
8. DENA – Deutsche Energie-Agentur GmbH, Berlin[2)]	26.0	4,861	1,113
9. Berliner Energie-Agentur GmbH, Berlin[2)]	25.0	3,285	405
10. Mittelstandsfonds Hamburg MHH GmbH & Co. KG, Hamburg[2)]	24.9	6,601	639
11. eCapital Technologies Fonds II GmbH & Co. KG, Münster[2)]	24.8	14,125	– 1,445
12. Post 2012 Carbon Credit Fund CV, Amsterdam, Netherlands[2)]	20.0	82	– 101
13. Galaxy S. à. r. l., Luxembourg, Luxembourg[2)]	20.0	67,702	– 34,967

[1)] Most recent available financial statements 2010
[2)] Most recent available financial statements 2009
[3)] Company established in 2010; financial statements are not yet available.

The item Investments includes:

	EUR in millions
Listed securities	0
Unlisted securities	61
Marketable securities	**61**

Shares in investment funds

	Share in total assets	Book values	Dividend payments	Redeemable daily
	%	EUR in thousands	EUR in thousands	
Fonds Atlantik	100.0	945,312	0	yes
Fonds Frankfurt I	100.0	999,331	0	yes
Galaxy S. à r. l. SICAR	20.0	16,724	0	no
Post 2012 Carbon Credit Fund CV	20.0	1,668	0	no
Europäischer Fonds für Südosteuropa S. A., SICAV-SIF	17.8	101,000	3,305	no
Green for Growth Fund, Southeast Europe S. A., SICAV-SIF	17.3	10,025	0	no
Fondo PPP Italia c/o Fondaco SGR S.p.A.	14.6	7,105	0	no
2020 European Fund for Energy, Climate Change and Infrastructure SICAV	14.1	1,200	0	no

The shares in investment funds held as at 31 December 2010 serve predominantly to strengthen and promote projects relating to climate protection, renewable energies and infrastructure expansion. Restrictions to daily redemptions are due to the funds' long-term orientation and the specific investors involved. These funds are mainly illiquid investment vehicle. None of the investments are impaired and are subject to a process of regular valuation.
The market values of "Fonds Atlantik" and "Fonds Frankfurt I" are each EUR 1.1 billion. Both funds are special funds which are subject to consolidation in the IFRS consolidated financial statements.

Other assets

Other assets mainly comprise the difference in the currency conversion of derivatives (EUR 8,601 million) used in the context of management of the foreign currency positions. It also includes the claim of EUR 601 million against the Federal Agency for Special Tasks associated with Unification (BvS), due to the transfer to KfW of the insurance business of SinA. The compensation claim is offset by insurance provisions in the same amount.

Prepaid expenses and deferred charges

The differences contained in the item Prepaid expenses and deferred charges between the repayment amount and the lower issue amount of liabilities amount to EUR 829 million (previous year: EUR 726 million).

NOTES TO THE LIABILITIES

Maturities structure of borrowed funds

	At call	Remaining term				Pro rata interest	Total
		Up to 3 months	More than 3 months to 1 year	More than 1 year to 5 years	More than 5 years		
	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions
Liabilities to banks with agreed term or period of notice							
As at 31 Dec. 2010	**11,224**	**1,431**	**74**	**1,263**	**1,074**	**4,449**	**19,515**
As at 31 Dec. 2009	*2,084*	*3,195*	*263*	*1,665*	*1,104*	*4,163*	*12,474*
Liabilities to customers – Other borrowed funds with agreed term or period of notice							
As at 31 Dec. 2010	**557**	**4,145**	**4,005**	**10,907**	**2,763**	**349**	**22,726**
As at 31 Dec. 2009	*412*	*4,462*	*1,787*	*15,240*	*2,084*	*325*	*24,310*
As at 31 Dec. 2010	**11,781**	**5,576**	**4,079**	**12,170**	**3,837**	**4,798**	**42,241**
in %	**28**	**13**	**10**	**29**	**9**	**11**	**100**
							Due in the following year
Certified liabilities – Bonds issued							
As at 31 Dec. 2010							**89,158**
As at 31 Dec. 2009							*75,983*

Liabilities to affiliated entities and entities in which KfW holds a stake

	Certificated and non-certificated liabilities			
	To affiliated entities		To entities in which KfW holds a stake	
	2010	2009	2010	2009
	EUR in millions	EUR in millions	EUR in millions	EUR in millions
Liabilities to banks	63	*43*	0	*0*
Liabilities to customers	165	*203*	0	*0*
Certificated liabilities	50	*0*	0	*0*
Total	**278**	*246*	**0**	*0*

Deferred income

The item Deferred income includes discounts on receivables totalling EUR 2,460 million (previous year: EUR 2,327 million).

Provisions

Apart from the provisions for pensions and similar commitments amounting to a total of EUR 747 million, as at 31 December 2010, other provisions of EUR 1,466 million are reported which mainly relate to the insurance provisions in connection with the transfer to KfW of the insurance business of SinA, provisions for covering future interest charges resulting from the transfer of the ERP Special Fund as well as risk provisions for lending business of KfW.

In the case of provisions with a remaining term of more than one year and a recognition value as at 31 December 2010 of EUR 222 million, KfW exercised the option in accordance with Article 67 (1) Sentence 4 of the Introductory Act to the German Commercial Code (EGHGB). The present value after discounting at the applicable Deutsche Bundesbank interest rate totals EUR 95 million.

Expenses of EUR 37 million resulting from interest accrued on provisions for pensions and similar commitments are recorded under the item Interest expense.

Subordinated liabilities

As part of the new legislation governing ERP economic promotion as at 1 July 2007, the ERP Special Fund provided a subordinated loan to KfW in the amount of EUR 3,247 million. The loan consists of three tranches with different fixed-interest periods. The period during which capital is tied up ends for all tranches as at 31 December 2017. Interest is charged on the tranches at a rate of 4.5 % p. a.

KfW is not obligated to repay the subordinated loan ahead of schedule. The terms of subordination of this loan are in line with the requirements of the German Banking Act *(Kreditwesengesetz - KWG)*.

Interest expenses for the subordinated loan amounted to EUR 146 million.

Equity

	31 Dec. 2009	Net income for the year	Other changes	31 Dec. 2010
	EUR in millions	EUR in millions	EUR in millions	EUR in millions
KfW's subscribed capital	3,750	0	0	3,750
Uncalled outstanding contributions	– 450	0	0	– 450
Capital reserves	5,947	0	0	5,947
Promotional reserves of the ERP Special Fund	4,650	0	0	4,650
Reserves from the ERP Special Fund	893	0	84	977
Retained earnings				
a) Statutory reserve under Section 10 (2) KfW Law	1,574	264	0	1,838
b) Special reserve under Section 10 (3) KfW Law	1,927	250	0	2,178
c) Special reserve under Section 17 (4) D-Mark Balance Sheet Law	48	0	0	48
Loss carried forward	– 3,163	1,499	1,664	0
Net income for the year	1,664	0	– 1,664	0
Equity	**12,190**	**2,013**	**84**	**14,288**

The promotional reserves of the ERP Special Fund relate to the amount transferred into the capital reserve by the ERP Special Fund as part of the reorganisation of the ERP economic promotion programme in financial year 2007. The net income for 2010 fully offset the losses carried forward. In addition, EUR 514 million were allocated to retained earnings. As at year-end 2010, KfW's equity amounted to EUR 14,288 million.

OTHER REQUIRED NOTES TO THE LIABILITIES

Contingent liabilities

The liabilities under guarantees and warranties total EUR 18,348 million. Of the total amount as at 31 December 2010, EUR 15,380 million was attributable to platform securitisations, predominantly PROMISE/PROVIDE transactions.
Banks can synthetically transfer credit risks from SME loan portfolios or private housing loans to the capital market using the securitisation platforms PROMISE/PROVIDE. As at the balance sheet date the volume securitised via the platforms totalled EUR 15,380 million, of which EUR 14,748 million was collateralised by credit default swaps or credit-linked notes. KfW has retained risks from senior tranches with respect to the remaining EUR 632 million.
The risk of losses in this platform business is decisively defined by the quality of the securitised portfolios. In this business KfW transfers tranches with higher probability of default to the capital market and only retains senior tranches with the best credit quality. Therefore the risk of losses on the part of KfW is considered to be minor.

Liabilities under guarantees and warranties also included guarantees for special loans of EUR 955 million, guarantees for aircraft finance of EUR 480 million, guarantees for housing construction of EUR 176 million and guarantees for ship and shipyard financing of EUR 174 million.
The risk of losses from these transactions is provided for by making portfolio and individual provisions for loan losses.

Other obligations

Irrevocable loan commitments total EUR 60,766 million, of which EUR 31,879 million is attributable to investment finance, with the majority relating to KfW Mittelstandsbank (EUR 12,563 million) and KfW Privatkundenbank (EUR 11,751 million), EUR 6,893 million to export and project finance, EUR 5,131 million to loans to promote developing countries, EUR 146 million to loan securitisations and EUR 305 million to guarantees.
Further irrevocable loan commitments are predominantly attributable to Germany's share of the credit facility established for the Republic of Greece by the EU member states, provided by KfW.
The risk of losses from these transactions is provided for by making portfolio and individual provisions for loan losses.

Assets and liabilities held in trust

The trust items reported mainly concern receivables from and liabilities to customers. KfW's assets held in trust include loans on a trust basis of EUR 16,191 million.

NOTES TO THE INCOME STATEMENT

Additions to the fund for general banking risks

The fund for general banking risks was increased by EUR 554 million in financial year 2010 to EUR 600 million. This is reported in a special item on the income statement. In previous years, changes in the fund for general banking risks were included in the item Write-offs and value adjustments on loans and certain securities and increase of allowances for possible loan losses, as this was always viewed as a part of the risk provisions. In 2010 the allocation to the fund for general banking risks aims to protect the bank against general business-specific risks. The presentation of previous year figures was adjusted accordingly.

Extraordinary expenses

Extraordinary expenses result from the first-time adoption of the BilMoG requirements. Transition effects of EUR 75 million are attributable to the adjustment of provisions for pensions and similar commitments resulting from the application of the parameters described under Accounting policies and the discounting of long-term provisions at the interest rates published by the Deutsche Bundesbank.

Geographical markets

As KfW has no foreign branch offices the total amounts reported under certain income items in accordance with Section 34 (2) No 1 RechKredV were not broken down by region.

OTHER REQUIRED NOTES

Assets and debts in foreign currencies

The assets and debts in foreign currencies and the cash transactions not completed on the balance sheet date have been converted into euros at the exchange rates quoted on the balance sheet date. Irrevocable loan commitments, for which forward transactions were concluded, were converted at the hedging rate.

The bank applies the principal of specific cover in terms of Section 340 h HGB in conjunction with Section 256 a HGB.

In accordance with Sections 277 (5) Sentence 2 and 340 h of the HGB, expenditure on and income from currency conversion have been reported as gross figures under Other operating expenses (EUR 33 million) and Other operating income (EUR 40 million).

Revaluations of provisions for loan losses in foreign currencies were included in the items Other operating expenses or Other operating income.

As at 31 December 2010, total assets in foreign currencies were EUR 47 billion, converted in accordance with Section 340h HGB. Total debts in foreign currencies were EUR 224 billion.

Other financial commitments and free facilities

The bank has remaining payment obligations totalling EUR 487 million in connection with equity finance operations.

Liquidity facilities in the context of monetary policy transactions with the Deutsche Bundesbank which have not yet been exhausted are available to KfW.

Derivatives reporting

KfW uses the following forward transactions/derivative products, mainly to hedge against the risk of changes in interest and exchange rates, and other price and credit risks:

1. Interest rate forward transactions/derivative products
   - Interest rate swaps
   - Interest rate options, swaptions
   - Caps and floors

2. Currency-related forward transactions/derivative products
   - Cross-currency swaps
   - FX swaps
   - Spot exchange deals
   - Forward exchange deals

3. Share-price related and other price risk-related forward transactions/derivative products
   - Share options
   - Carbon Fund forward purchases and sales

4. Credit derivatives
   - Single name credit default swaps

The following presentation of derivatives transactions is in accordance with the requirements of Section 285 No 19 HGB. It discloses the positive and negative market values of the derivatives positions as at 31 December 2010.

All types of contracts are marked to market. In cases where market prices were not available for derivatives instruments, values were established by means of market parameters based on generally acknowledged option price models and present value estimates.

Purchased and written options are classified as other assets or other liabilities in the amounts paid as premiums.

Volumes	Par values 31 Dec. 2010 EUR in millions	Par values 31 Dec. 2009 EUR in millions	Market values positive 31 Dec. 2010 EUR in millions	Market values negative 31 Dec. 2010 EUR in millions
Contracts with interest rate risks				
Interest rate swaps	456,050	405,162	15,767	15,265
Interest rate options				
Purchases	44	0	1	0
Sales	44	500	0	1
Caps and floors[1]	376	472	0	0
Total	**456,514**	**406,134**	**15,768**	**15,266**
Contracts with currency risks				
Cross-currency swaps	199,993	159,826	14,037	7,245
FX swaps	24,946	28,688	217	243
Forward exchange deals	600	108	11	12
Spot exchange deals	0	0	0	0
Total	**225,539**	**188,622**	**14,265**	**7,500**
Share and other price risks[1]	906	628	6	4
Credit derivatives[2]				
Purchases	290	1,770	2	0
Sales	0	382	0	0
Total	**290**	**2,152**	**2**	**0**

[1] Derivative financial instruments are shown without embedded derivatives.
[2] Here: Single name credit default swaps

Par values	Interest risks[1]		Currency risks		Other price risks[1]		Credit derivatives[2]	
	31 Dec. 2010	31 Dec. 2009	31 Dec. 2010	31 Dec. 2009	31 Dec. 2010	31 Dec. 2009	31 Dec. 2010	31 Dec. 2009
	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions	EUR in millions
Remaining term of								
up to 3 months	23,900	13,065	40,452	34,978	4	5	90	530
3 months to 1 year	33,990	34,907	18,222	22,260	3	4	0	592
1 year to 5 years	216,328	196,422	105,091	93,516	888	619	200	1,030
more than 5 years	182,296	161,740	61,774	37,868	11	0	0	0
Total	**456,514**	**406,134**	**225,539**	**188,622**	**906**	**628**	**290**	**2,152**

[1] Derivative financial instruments are shown without embedded derivatives
[2] Here: Single name credit default swaps

Counterparties	Par values	Par values	Market values positive	Market values negative
	31 Dec. 2010	31 Dec. 2009	31 Dec. 2010	31 Dec. 2010
	EUR in millions	EUR in millions	EUR in millions	EUR in millions
OECD-banks	639,756	568,106	28,081	21,025
Banks outside the OECD	37	39	0	4
Other counterparties	33,111	28,260	1,496	1,629
Public authorities	10,345	1,131	464	112
Total	683,249	597,536	30,041	22,770

The following section describes hedging relationships in accordance with the BilMoG requirements in the terms of Sections 254 and 285 No 23 HGB.

The table lists the volume of securities held as fixed assets and as a liquidity reserve, which are hedged against interest rate and equity risks as at the reporting date.

	Book values	Par values	Market values
	EUR in millions	EUR in millions	EUR in millions
Securities held as fixed assets			
Bonds and other fixed-income securities	15,814	15,240	15,709
Securities held as liquidity reserves			
Bonds and other fixed-income securities	10,821	11,397	11,212
Shares and other non-fixed income securities	12,239	–	11,784
Total	38,874	26,637	38,705

KfW only uses derivatives to hedge open exposure.

The option to perform hedge accounting for economic hedges is exercised with KfW's own holdings of securities and forward purchases of CO_2 certificates as designated hedged item. The net hedge presentation method is applied to the effective portion of the hedge.

Part of the securities held as fixed assets are hedged against interest rate changes using micro hedges (primarily interest rate swaps) for fixed-income securities. In economic terms, this results in variable-rate bonds.
Due to identical parameters of hedged item and hedging instrument, the offsetting effect is evidenced both prospectively and retrospectively using the critical term match method.
The use of the modified lower of cost or market principle for the fixed assets only shows permanent losses in value on the income statement.

Fixed-income securities held as a liquidity reserve are also hedged against interest rate changes using micro hedges (primarily interest rate swaps). Any ineffectiveness of the hedge is reported in earnings immediately. In addition, hedging relationships are recognised as part of the repurchase of own issues, with matching certificated liabilities as hedging instruments. Shares held as a result of privatisation transactions with the Federal Republic of Germany (Deutsche Telekom AG and Deutsche Post AG) were hedged against exchange rate changes through contractual arrangements with the Federal Government.

The forward purchases of CO_2 certificates (nominal value EUR 160 million) are hedged against the risk of changes in market price using corresponding forward sales (nominal value EUR 152 million) as part of a portfolio. Measuring this exposure using market data as at the balance sheet date yields net unrealised gains of EUR 4 million.

Due to the negative correlation between changes in value and the hedged risks, changes in value and cash flows of hedged items and hedging instruments largely offset one another as at the reporting date. With regard to the intention to maintain the hedging relationships, the hedges can be expected to continue to almost fully offset the hedged risks until their designated maturities.

Alongside the hedging relationships in terms of Section 254 HGB, derivative financial instruments used to hedge interest rate risks in the banking book, and the interest-bearing hedged items are included in asset liability management. KfW manages the interest margin or market value of all interest-bearing transactions in the banking book as a whole. A positive present value was calculated as at 31 December 2010 and therefore no provision for anticipated losses from onerous contracts was necessary.

Loans in the name of third parties for third party account

Loans in the name of third parties and for third party account totalled EUR 3,583 million as at 31 December 2010.

Personnel

The average number of employees including temporary staff and students on our degree programme, but excluding the Executive Board and trainees is calculated based on the levels at the end of each quarter of the reporting year.

	2010	2009
Employees (female)	1,745	1,627
Employees (male)	1,798	1,694
Staff not covered by collective agreements	2,441	2,289
Staff covered by collective agreements	1,102	1,032
Total	**3,543**	**3,321**

COMPENSATION AND LOANS TO MEMBERS OF THE EXECUTIVE BOARD AND THE BOARD OF SUPERVISORY DIRECTORS

Annual compensation 2010

	Salary	Variable compensation	Other compensation[1]	Total
	EUR in thousands	EUR in thousands	EUR in thousands	EUR in thousands
Dr Ulrich Schröder (Chief Executive Officer)	660.0	160.0	177.2	997.2
Dr Günther Bräunig	466.6	0.0	26.0	492.6
Dr Norbert Kloppenburg	466.6	0.0	52.0	518.7
Bernd Loewen	480.0	0.0	283.6	763.6
Dr Axel Nawrath	466.0	0.0	107.6	573.6
Total	2,539.2	160.0	646.5	3,345.8

[1] *Other compensation mostly comprises the use of company cars, security expenses and insurance premiums and the taxes and social security payments of these amounts. Remuneration for supervisory board mandates in subsidiaries is also included.*

Compensation to members of the Board of Supervisory Directors totalled EUR 176 thousand. This amount is composed as follows:
Compensation for the members of the Board of Supervisory Directors is EUR 5 thousand p.a. Members of the Loan Approval, Executive and Audit Committees receive EUR 0.6 thousand p.a. Members who join during the year receive their compensation on a pro-rata basis. With the last revision in May 2010, compensation to members of the Federal Government who are members of the Board of Supervisory Directors pursuant to Section 7 (1) No 2 KfW Law was set at EUR 0.00 for the first time for financial year 2010. Compensation for the Chairman of the Board of Supervisory Directors and his deputy was also set at EUR 0.00.

Provisions in the amount of EUR 45,359 thousand had been set up as at 31 December 2010 for obligations under pension arrangements for retired members of the Executive Board and their surviving dependents. The regular compensation totalled EUR 4,026 thousand.

The total amount of loans granted to members of the Executive Board was EUR 81 thousand as at 31 December 2010. Interest rates were between 3 % p.a. and 4 % p.a.

Auditor's fees

KfW has utilised the option under Section 285 No 17 HGB and refers to the breakdown of auditor fees in the consolidated financial statements of KfW Bankengruppe.

Group affiliation

KfW is included in the consolidated financial statements of KfW Bankengruppe, Frankfurt am Main, as at 31 December 2010. The consolidated financial statements are prepared in accordance with International Financial Reporting Standards (IFRS) and published in German in the electronic Federal Gazette *(Bundesanzeiger)*.

Mandates held by statutory representatives or other employees in supervisory boards of major joint stock companies in accordance with Section 267 (3) of the German Commercial Code

Dr Ulrich Schröder (Chief Executive Officer)
DEG – Deutsche Investitions- und Entwicklungsgesellschaft mbH, Cologne

Deutsche Post AG, Bonn

Deutsche Telekom AG, Bonn

KfW IPEX-Bank GmbH, Frankfurt am Main

Dr Günther Bräunig
Deutsche Pfandbriefbank AG, Munich

Hypo Real Estate Holding AG, Munich

Dr Norbert Kloppenburg
DEG – Deutsche Investitions- und Entwicklungsgesellschaft mbH, Cologne

DFS Deutsche Flugsicherung GmbH, Langen

KfW IPEX-Bank GmbH, Frankfurt am Main

Dr Lutz-Christian Funke
IKB – Deutsche Industriebank AG, Düsseldorf

Doris Köhn
ProCredit Holding AG, Frankfurt am Main

MEMBERS OF THE BOARD OF SUPERVISORY DIRECTORS

Dr Wolfgang Schäuble
Federal Minister of Finance
Chairman
(from 1 January 2011)
Deputy Chairman
(from 1 January 2010 until 31 December 2010)

Rainer Brüderle
Federal Minister of Economics and Technology
Deputy Chairman
(from 1 January 2011)
Chairman
(from 1 January 2010 until 31 December 2010)

Ilse Aigner
Federal Minister of Food,
Agriculture and Consumer Protection

Norbert Barthle
Member of the German Bundestag
Member appointed by the German Bundestag
(from 1 January 2011)

Jan Bettink
President of the Verband
Deutscher Pfandbriefbanken
Representative of the mortgage banks
(from 1 January 2011)

Anton F. Börner
President of the Federation
of German Wholesale and Foreign Trade
Representative of trade

Volker Bouffier
Minister President of the State of Hesse
Member appointed by the German Bundesrat
(from 1 January 2011)

Christian Brand
Chairman of the Board of Managing Directors
L-Bank, Landeskreditbank Baden-Württemberg
Representative of the mortgage banks
(until 31 December 2010)

Frank Bsirske
Chairman of ver.di – Vereinigte
Dienstleistungsgewerkschaft
Representative of the trade unions

Prof. Dr Hans Heinrich Driftmann
President of the Association of German
Chambers of Industry and Commerce (DIHK)
Representative of industry

Ingeborg Esser
Managing Director
Federal Association of German Housing and
Real Estate Enterprises (GdW)
Representative of the housing industry
(from 1 January 2011)

Georg Fahrenschon
Minister of Finance of the Free State of Bavaria
Member appointed by the German Bundesrat
(from 1 January 2011)

Prof. Dr Kurt Faltlhauser
Former Minister of Finance of the
Free State of Bavaria
Member appointed by the German Bundesrat
(until 31 December 2010)

Axel Gedaschko
Former Senator
Office of Economic Affairs and Employment
Member appointed by the German Bundesrat
(until 31 October 2010)

Heinrich Haasis
President of the Deutscher Sparkassen-
und Giroverband
Representative of the savings banks

Hubertus Heil
Member of the German Bundestag
Member appointed by the German Bundestag

Gerhard P. Hofmann
Member of the Board of Managing Directors of the
Bundesverband der Deutschen
Volksbanken und Raiffeisenbanken e.V. (BVR)
Representative of the cooperative banks

Bartholomäus Kalb
Member of the German Bundestag
Member appointed by the German Bundestag

Roland Koch
Former Minister President of the State of Hesse
Member appointed by the German Bundesrat
(until 31 December 2010)

Dr h.c. Jürgen Koppelin
Member of the German Bundestag
Member appointed by the German Bundestag

Monika Kuban
Permanent deputy of the Managing Director
of the Deutscher Städtetag
Representative of the municipalities

Karoline Linnert
Mayor
Senator for Finance
of the Free Hanseatic City of Bremen
Member appointed by the German Bundesrat

Dr Helmut Linssen
Former Minister of Finance
of the State of North Rhine-Westphalia
Member appointed by the German Bundesrat
(until 24 August 2010)

Dr Gesine Lötzsch
Member of the German Bundestag
Member appointed by the German Bundestag

Stefan Mappus
Minister President
of the State of Baden-Württemberg
Member appointed by the German Bundesrat
(from 1 January 2011)

Claus Matecki
Member of the Executive Board of the
Confederation of German Trade Unions (DGB)
Representative of the trade unions

Dr Michael Meister
Member of the German Bundestag
Member appointed by the German Bundestag

Franz-Josef Möllenberg
Chairman of the Trade Union
Nahrung-Genuss-Gaststätten
Representative of the trade unions

Hartmut Möllring
Minister of Finance of the State of Lower Saxony
Member appointed by the German Bundesrat
(until 31 December 2010)

Dirk Niebel
Federal Minister for Economic Cooperation and
Development

Dr Peter Ramsauer
Federal Minister for Transport, Building and Urban
Affairs

Dr Norbert Röttgen
Federal Minister for the Environment,
Nature Conservation and Nuclear Safety

Alexander Rychter
Director of the Verband der Wohnungs- und
Immobilienwirtschaft Rheinland-Westfalen e.V.
Representative of the housing industry
(until 31 December 2010)

Christine Scheel
Member of the German Bundestag
Member appointed by the German Bundestag
(until 31 December 2010)

Hanns-Eberhard Schleyer
Former Secretary General of the
Zentralverband des Deutschen Handwerks
Representative of the skilled crafts

Andreas Schmitz
President of the Bundesverband
deutscher Banken e.V.
Chairman of the Management Board
of HSBC Trinkaus & Burkhardt AG
Representative of the commercial banks

Dr Werner Schnappauf
Director General of the Executive Board of the
Bundesverband der Deutschen Industrie e.V. (BDI)
Representative of industry

Carsten Schneider
Member of the German Bundestag
Member appointed by the German Bundestag

Michael Sommer
Chairman of the Confederation
of German Trade Unions
Representative of the trade unions

Gerd Sonnleitner
President of the Deutscher Bauernverband e.V.
Representative of agriculture

Marion Walsmann
Minister for Federal and European Affairs and
Head of the State Chancellery
of the Free State of Thuringia
Member appointed by the German Bundesrat

Dr Norbert Walter-Borjans
Minister of Finance
of the State of North Rhine-Westphalia
Member appointed by the German Bundesrat
(from 15 October 2010)

Dr Guido Westerwelle
Federal Minister for Foreign Affairs

EXECUTIVE BOARD

Dr Ulrich Schröder
Chief Executive Officer

Dr Günther Bräunig

Dr Norbert Kloppenburg

Bernd Loewen

Dr Axel Nawrath

Dr Ulrich Schröder
(Chief Executive Officer)

Dr Günther Bräunig

Dr Norbert Kloppenburg

Bernd Loewen

Dr Axel Nawrath

Frankfurt am Main, 31 January 2011

AUDITOR'S REPORT

We have audited the annual financial statements, comprising the balance sheet, the income statement and the notes to the financial statements, together with the bookkeeping system, and the management report of the KfW, Frankfurt am Main, for the financial year from 1 January to 31 December 2010. The maintenance of the books and records and the preparation of the annual financial statements and the management report in accordance with German commercial law and the regulation and supplementary provisions of the law concerning KfW (KfW Law) are the responsibility of the Company's Managing Board. Our responsibility is to express an opinion on the annual financial statements, together with the bookkeeping system, and the management report based on our audit.

We conducted our audit of the annual financial statements in accordance with § 317 HGB *(„Handelsgesetzbuch"*: "German Commercial Code") and German generally accepted standards for the audit of financial statements promulgated by the Institut der Wirtschaftsprüfer (Institute of Public Auditors in Germany) (IDW). Those standards require that we plan and perform the audit such that misstatements materially affecting the presentation of the net assets, financial position and results of operations in the annual financial statements in accordance with (German) principles of proper accounting and in the management report are detected with reasonable assurance. Knowledge of the business activities and the economic and legal environment of the Company and expectations as to possible misstatements are taken into account in the determination of audit procedures. The effectiveness of the accounting-related internal control system and the evidence supporting the disclosures in the books and records, the annual financial statements and the management report are examined primarily on a test basis within the framework of the audit. The audit includes assessing the accounting principles used and significant estimates made by the Company's Managing Board, as well as evaluating the overall presentation of the annual financial statements and management report. We believe that our audit provides a reasonable basis for our opinion.

Our audit has not led to any reservations.

In our opinion, based on the findings of our audit, the annual financial statements comply with the legal requirements and the supplementary provisions of the KfW Law and give a true and fair view of the net assets, financial position and results of operations of the Company in accordance with (German) principles of proper accounting. The management report is consistent with the annual financial statements and as a whole provides a suitable view of the Company's position and suitably presents the opportunities and risks of future development.

Frankfurt am Main, 8 March 2011

KPMG AG
Wirtschaftsprüfungsgesellschaft

Mock
Wirtschaftsprüfer
(German Public Auditor)

Schweitzer
Wirtschaftsprüfer
(German Public Auditor)

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