

Outlook.

Anticipated Economic Performance.

The economic indicators are good at the start of 2011. The most important leading indicator for the German economy, the ifo Institute's Business Climate Index, climbed to a record high of 111.2 points in January 2011. The interest environment remains good in spite of the recent rise in yields for investors. The dynamic economic growth in the emerging markets is also expected to act as a stimulus for German exports in 2011. Consumer spending by private households should benefit from the improved situation on the labor market. Hence, the LBBW Board of Managing Directors is optimistic for 2011 and is anticipating growth in gross domestic product in Germany of 2.5% after adjustment for calendar effects.

The corresponding growth is expected to be weaker for the euro area at 1.7%. Many member states are struggling with high debt, and unlike Germany they are benefiting little from the recovery of the global economy. The economy in the US will continue to pick up the pace with the tailwind of low interest rates and an extension of tax relief in the amount of USD 600 billion; gross domestic product is expected to increase by 3.4%. Overall, the global economy is forecast to grow by 4.7% in 2011 after 4.9% in 2010. The slight slowdown in economic momentum will probably be due to the more moderate economic growth in China, which feels compelled to apply the brakes to its economy with a more restrictive fiscal policy in light of increasing inflation pressure. Economic growth of around 9% is anticipated for China in 2011 after 10.3% in 2010.

Regardless of the positive overall prospects, the risks for 2011 are considerable. Around 37% of German exports of EUR 952 billion went to the euro area from January to December 2010. Thus, the partner states of the euro area are the most important destination for German exports. In light of this, an escalation of the debt crisis in the euro nations with the possible insolvency of a state would significantly impair the German economy. Resolving the debt crisis in the euro area will therefore be a crucial factor for its economic performance in 2011. No headwind is expected from the central banks for the time being. Neither the Fed nor the ECB have signaled that they will be reining in their monetary policies to date. However, the ECB could abandon this restraint as soon as a solution is found for the lingering euro debt crisis and the central bank is freed of its responsibility to ensure financial market stability.

Mainly as a result of the rise in commodity prices, inflation risks in the euro area increased at the start of 2011. At 2.2% in December 2010, the rate of inflation in the euro area was already above the threshold of 2.0% considered compatible with price stability. In the opinion of LBBW's Board of Managing Directors, the average rate of inflation in the euro area over 2011 will be slightly above the ECB's standard for price stability at 2.2%. LBBW is forecasting a rise in the inflation rate for Germany from 1.1% to 2.0%.

Industry and Competitive Situation.

The German banking sector made good progress in its recovery from the financial market crisis in the year under review and should continue this process as well.

However, this recovery was impaired by the debt crisis in some member states of the European Monetary Union, which is still adding to uncertainty. This showed that risks and contagion effects can arise from the interaction of the government and financial sectors, which could hamper the further stabilization of the sector. In view of the high refinancing requirements of both governments and banks in the coming years, this is particularly true as regards the possibility of the two sides increasingly competing for funds.

Economic growth in Germany, which is expected to be stable but slower as against 2010, should prop up earnings trends in the German banking sector over the next two years. Thereby, intensity of competition for customers of good credit standing in both retail and corporate banking is expected to remain high. In addition to the challenges in refinancing, there may still be some risks and uncertainty for the development of banks in the area of certain foreign receivables and banks' own securities portfolios (especially structured securities) that were entered into before the crisis. However, many banks have already reduced these holdings, some of them in light of the requirements of the EU commission and modified business models. This trend is also set to continue in 2011.

The industry's stricter future regulatory framework continued to take shape in 2010. Even though there is still some uncertainty with regard to the details yet to be determined and ongoing discussions, it is clear that the regulatory requirements on banks will increase tangibly.

The new Basel III regulations resolved in principle at the G20 summit meeting in Seoul in November 2010, which now have to be endorsed in European and national law respectively, provide for higher equity requirements, more stringent liquidity provisions and debt caps to be met in stages until 2019. The new regulations entail considerable adjustment on the part of the banks. While the sector's capital requirements should increase significantly in the coming years, a trend towards declining returns on equity at banks is anticipated. However, German banks have already implemented some of the adjustments by strengthening their capital situations in the process of dealing with the financial market crisis and as a result of reducing their risk assets. In addition, German banks – except for development banks – will face additional costs from 2011 in the form of the bank levy introduced as part of the German Bank Restructuring Act at the end of 2010, which is intended to establish the requirements for an ordered restructuring and possibly the winding-up of banks.

In addition to these regulatory changes already resolved, other projects are being discussed that could add to the burdens to be borne by banks, including in particular the plans to reform deposit protection at a European level, European restructuring regulations and the European or German financial transaction tax.

The LBBW Group's Business Strategy, Opportunities and Risks.

The key pillars of LBBW's business model have been included in its restructuring plan and were approved by the EU Commission. This also includes the planned reduction of total assets and costs. The implementation of the EU restructuring process is proceeding according to plan and expected to be concluded in 2013. Thus, 2011 and 2012 will be dominated by the implementation of the planned measures for LBBW.

LBBW is forecasting an improvement of the general conditions for the financial sector in 2011, which will positively influence its core business. Overall, a rise in operating income is expected compared to 2010. In spite of the first-time payment of the bank levy in 2011, administrative expenses are expected to remain on a constant level. This is the result of systematic cost management focusing on a strict reduction of other administrative costs and also on the planned downsizing of staff. Allowances for losses on loans and advances are expected to remain stable on a year-on-year base. Overall, LBBW expects a clearly positive result for the Group in 2011 again. Given these general conditions, the remaining write-offs in silent partners' contributions and profit participation rights due to the 2009 loss participation are expected to be reversed and deferrals on interest payments are also expected to be caught up in the coming years (depending on the individual contractual terms and conditions of the instruments).

LBBW's investment volume planned for 2011 results mainly from the implementation of the EU restructuring plan, the legal and regulatory requirements and the measures to boost sales. The Tier 1 capital ratio at LBBW is expected to remain stable at a good level in 2011 and 2012.

In particular, there are material planning risks in a renewed instability on the financial markets and the resulting consequences. Currently, the biggest uncertainty factor is the debt crisis in some Member States of the European Monetary Union, which could also disrupt confidence in financial market stability and the banking system. Furthermore, an unexpected abrupt economic slowdown could lead to a further increase in the allowance for losses on loans and advances.

The tightened regulatory measures initiated in the wake of the financial market crisis and the emerging changes in accounting standards will also influence the future development of LBBW. As the exact nature of the new regulatory and accounting policies is not yet final in many respects, future developments are still dominated by a high level of uncertainty. Overall, however, it is becoming clear that the regulatory initiatives of the Basel Committee and German legislation will lead to greater liquidity and capital requirements and to some extent considerable expenses owing to the bank levy in the coming years. The consequences of the current initiatives of the International Accounting Standard Board (IASB) and their future effects on regulatory ratios cannot be conclusively assessed at this time. Nonetheless, LBBW has already launched corresponding measures to comply with the anticipated legal requirements.

The planned development of the operating segments over the coming years – particularly in 2011 and 2012 – is described below.

In SME business, LBBW's Corporates segment will continue to focus on companies in the core markets of BW-Bank, Rheinland-Pfalz Bank and Sachsen Bank. Measures planned in support of this include the further expansion of the principal bank function, which has proved extraordinarily important to SMEs in recent years. Thus, this business area will continue a stable share of LBBW Group's earnings in the future. Given the positive economic performance last year, demand for financing is expected to rise for corporate resources and investments. Further growth is anticipated in export finance and commercial international business for 2011. In connection with the economic recovery, customers shall be increasingly supported in hedging and managing their risks via interest, currency and commodities management products. Services provided to large customers will still be restricted to selected customers in German-speaking countries. Going forward, real estate financing business will also focus on the core markets Germany, the US and the UK, where it will concentrate on selected property types.

In its Retail Clients segment, LBBW will also concentrate on expanding business with high net worth customers in Baden-Württemberg, Rhineland-Palatinate and Saxony in future and further increase its services for high net worth wealth management customers at its Stuttgart and Mannheim locations. LBBW will continue to operate as a savings bank in the Stuttgart area under the BW-Bank brand and offers its retail banking customers an extensive range of financial services with a comprehensive network of branches. Driven by the high demand for secure investment products, further growth in conventional deposit business is forecast, particularly if interest rates rise. Following the significant declines during the financial market crisis, securities business is believed to see a gradual recovery. Further growth is being targeted for building savings, insurance and investment products following the solid sales performance in the reported year. In lending business, however, persistently strong competition and thus further margin pressure are expected.

The further expansion of customer-driven capital markets business is a top priority for the Financial Markets segment in the coming years. Thus, the share of steady earnings contributions in this segment should increase further. Nonetheless, the volatility on the financial markets will continue to affect earnings in this segment. Accompanying the ongoing recovery in the real economy, market confidence should also return and demand for investment and hedging products should increase on the capital market. However, it must be assumed that the markets for structured credit products will not benefit as much. At present, there is no end in sight to customer reluctance in this product segment.

In its core markets of Baden-Württemberg, Rhineland-Palatinate and Saxony, LBBW will continue to be the central bank for the savings banks. The savings banks are also a key customer segment of the LBBW Group. In addition to joint market cultivation – for instance in corporate banking – the provision of services for the savings banks accounts for a significant share of activities within the Sparkassen-Finanzgruppe. The intensification of cooperation with savings banks within the contractual service partnership is a fundamental goal. This will continue to be characterized by a close level of cooperation, particularly in the areas of liquidity and funding.

The reorientation of the business model will ensure the sound and profitable future viability of LBBW. For this reason, a great deal of effort will have to be dedicated to the systematic implementation of all resolved measures in the coming years, whereby the first successes have already been witnessed today.

In spite of the various future challenges, LBBW will continue to be a capable and reliable business partner for its customers.