

management's discussion and analysis of financial condition and results of operations

OVERVIEW

The net income of the Federal Home Loan Bank of San Francisco (Bank) increased \$48.0 million, or 13%, to \$424.6 million in 2001 from \$376.6 million in 2000. This increase was due to the effects of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (SFAS 133), which became effective on January 1, 2001 (see "Interest Rate Exchange Agreements" on page 28). The Bank recognized a net gain (net of applicable Resolution Funding Corporation [REFCORP] and Affordable Housing Program [AHP] assessments) of \$50.8 million in 2001, which reflected net gains from fair value adjustments made under SFAS 133 and net gains on held-at-fair-value securities reclassified from held-to-maturity securities upon the adoption of SFAS 133. As a result, the Bank's return on equity (ROE) increased 12 basis points, to 6.49% in 2001 from 6.37% in 2000. Since the net gains from fair value adjustments under SFAS 133 and on held-at-fair-value securities are primarily a matter of timing, the net gains will generally be reversed over the remaining contractual terms to maturity of the financial instruments and associated interest rate exchange agreements. Therefore, in accordance with the Bank's retained earnings policy, the Bank restricts retained earnings for any cumulative net gains (net of applicable assessments) resulting from cumulative fair value adjustments. Excluding the impact of these net gains, net income for 2001 would have been \$373.8 million, a decrease of \$2.8 million relative to 2000, and ROE for 2001 would have been 5.71%, a decrease of 66 basis points relative to 2000. These declines are primarily a result of the significant decline in interest rates during 2001, which reduced earnings on invested member capital.

The Bank paid an annual dividend of 5.99% for 2001, compared to 7.17% in 2000. This decrease primarily resulted from two factors: the supplemental payouts of retained earnings in 2000, which added 0.63% to the annual dividend yield, and the significant decline in the interest rate environment in 2001, which resulted in lower earnings on invested member capital.

Total assets declined \$4.8 billion, or 3%, to \$135.4 billion as of December 31, 2001. Advances decreased \$7.8 billion, or 7%, to \$102.3 billion. Partially offsetting the decline in advances, the Bank's investment in short-term interest-bearing deposits increased \$1.8 billion, securities purchased under agreements to resell increased \$1.8 billion, and held-to-maturity securities increased \$1.0 billion, as the Bank took advantage of favorable investment opportunities.

Statements contained in this report, including statements describing the objectives, projections, estimates, or predictions of the future of the Bank, may be "forward-looking statements." These statements may use forward-looking terms, such as "anticipates," "believes," "could," "estimates," "may," "should," "will," or their negative or other variations on these terms. The Bank cautions that, by their nature, forward-looking statements involve risk or uncertainty and that actual results could differ materially from those expressed or implied in these forward-looking statements or could affect the extent to which a particular objective, projection, estimate, or prediction

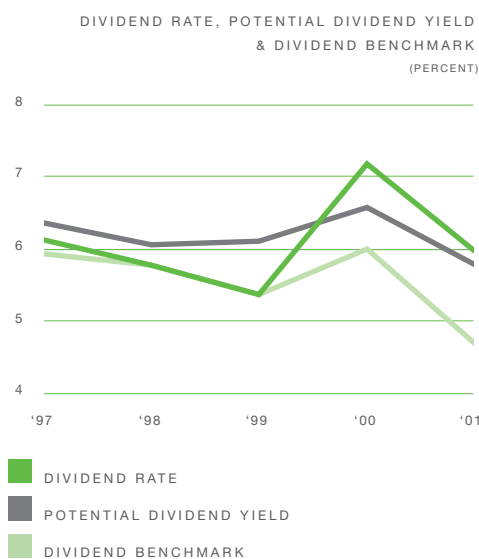
is realized. These forward-looking statements involve risks and uncertainties including, but not limited to, the following: economic and market conditions; volatility of market prices, rates, and indices; political, legislative, regulatory, or judicial events; a new capital structure; competitive forces; changes in investor demand for consolidated obligations and/or the terms of interest rate exchange agreements and similar agreements; and timing and volume of market activity. Management's discussion and analysis of financial condition and results of operations should be read in conjunction with the Bank's financial statements and notes, which begin on page 35.

FINANCIAL PERFORMANCE

On an average basis, the Bank's advances and total assets grew 8% in 2001 relative to 2000, to \$107.6 billion and \$139.1 billion, respectively. In addition, average interest-bearing deposits and average held-to-maturity securities increased to \$3.6 billion and \$14.9 billion, respectively.

As a cooperative, the Bank seeks to maintain a balance between its public policy mission and its ability to provide adequate returns on the capital supplied by its members. The Bank achieves this balance by delivering low-cost financing to help members meet the credit needs of their communities while paying members a market-rate dividend. The dividends paid by the Bank are largely the result of the Bank's earnings on invested member capital, while net earnings on member credit, mortgage-backed securities (MBS), and other investments are generally used to pay the Bank's operating expenses and assessments (with additional earnings, if any, also contributing to the dividend).

Reflecting the Bank's unique cooperative nature, the Bank's financial strategies are designed to enable the Bank to expand and contract in response to member credit needs. The Bank invests member capital in high-quality, short- and intermediate-term financial instruments. This strategy reduces the risk of loss if investments have to be liquidated to redeem excess capital stock.

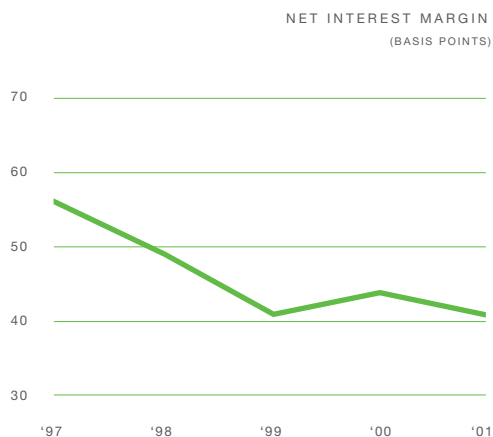


To measure its financial performance, the Bank compares the “potential dividend yield” on capital stock to a dividend benchmark. The “potential dividend yield” is current period earnings (excluding nonrecurring items and fair value adjustments) as a percentage of capital stock. The Bank’s dividend benchmark reflects the Bank’s capital investment strategy and is calculated as the average of two yields: the daily average of the overnight Federal funds effective rate and the four-year moving average of the four-year Treasury note yield. The spread between the potential dividend yield and the dividend benchmark represents the financial return on the members’ investment in Bank capital stock relative to the return on a comparable investment in short-term money market and intermediate-term Treasury investments.

The Bank’s potential dividend yield was 5.80% for 2001, 111 basis points above the dividend benchmark, and 6.57% for 2000, 56 basis points above the dividend benchmark. The increase in the spread to the dividend benchmark in 2001 is primarily the result of wider spreads earned on the MBS portfolio and the reduction in REFCORP and AHP assessments that would have occurred without the effects of SFAS 133.

RESULTS OF OPERATIONS

Net Interest Income. Net interest income decreased by \$0.3 million, or 0.05%, to \$554.3 million in 2001. The effect of an \$11.0 billion increase in average interest-earning assets was offset by the effect of a 3-basis-point decrease in the net interest margin, which declined to 41 basis points in 2001 from 44 basis points in 2000. This decline was primarily due to lower earnings on capital resulting from the significant drop in interest rates during 2001, and, to a lesser degree, narrower profit spreads on advances and investments. The narrower profit spreads were mainly due to the higher cost of Federal Home Loan Bank (FHLBank) discount notes relative to other market interest rates primarily because of an increase in the issuance of similar debt by federal agencies and the U.S. Treasury. These decreases were partially offset by improved earnings from the Bank’s MBS portfolio resulting from higher investment balances and spreads. The average yield on interest-earning assets in 2001 was 4.50%, compared to 6.44% in 2000, a decrease of 194 basis points. The average cost of interest-bearing liabilities decreased 202 basis points, to 4.32% in 2001 from 6.34% in 2000.



Other Income. Other income increased \$76.8 million to \$82.1 million in 2001 from \$5.3 million in 2000. Other income consists primarily of net gains on derivatives and hedging activities of \$64.0 million, net gains on held-at-fair-value securities of \$7.7 million, prepayment fees collected from members of \$6.0 million, and fees earned on letters of credit of \$0.9 million. Prepayment fees increased \$5.6 million in 2001. Members prepaid \$1.9 billion of advances in 2001, compared to \$0.9 billion in 2000. Other income also includes the amortization of the deferred gain resulting from the 1999 sale of the Bank’s office building in San Francisco, which totaled \$2.1 million in both 2001 and 2000. The remaining unamortized amount of the deferred gain on the sale of the building at December 31, 2001, was \$15.4 million.

Other Expenses. Other expenses increased to \$55.5 million in 2001 from \$48.7 million in 2000, primarily as a result of a \$6.0 million increase in operating expenses. Operating expenses increased 14% in 2001, while average assets increased 8%, leading to a slight increase in the Bank’s ratio of operating expenses to average assets from 3.3 basis points in 2000 to 3.5 basis points in 2001.

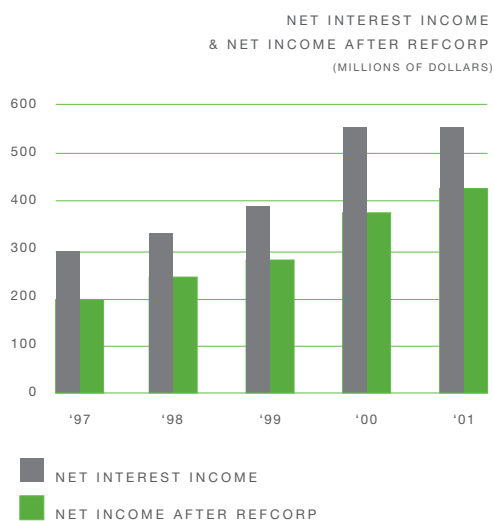
REFCORP and AHP Assessments. Effective January 1, 2000, the annual REFCORP obligation of the FHLBanks was modified by the Gramm-Leach-Bliley Act (GLB Act) from a fixed annual assessment of \$300 million for the 12 FHLBanks combined to 20% of each FHLBank’s net earnings (after AHP assessments). With the new assessment, the amount of the Bank’s REFCORP payments will rise and fall with its earnings. To the extent that the FHLBanks’ annual REFCORP payments are higher or lower than \$300 million, the term of the REFCORP obligation will be shortened or lengthened, respectively, so that the value of all payments made by the FHLBanks is equivalent to a \$300 million annual annuity with a final maturity date of April 15, 2030. The FHLBanks’ payments in 2000 shortened the remaining term of the REFCORP obligation to the first quarter of 2026, and the FHLBanks’ payments in 2001 further shortened the term to the second quarter of 2023.

Annually, the FHLBanks must set aside for their AHPs, in the aggregate, the greater of \$100 million or 10% of each year’s net income before charges for the AHP but after the assessment for REFCORP. To the extent that the aggregate 10% calculation is less than \$100 million, the shortfall is allocated among the FHLBanks based on the ratio of each FHLBank’s net income before AHP and REFCORP to the sum of the net incomes before AHP and REFCORP of the 12 FHLBanks combined. There was no shortfall in 2001 or 2000. The Bank set aside a record \$47.2 million for the AHP in 2001, compared to \$41.9 million in 2000, reflecting the higher earnings in 2001.

The Bank’s total REFCORP and AHP assessments equaled \$153.3 million in 2001, compared with \$136.0 million in 2000, resulting in an effective “tax” rate on preassessment income of 27% for both years. Excluding the fair value adjustments resulting from SFAS 133, the Bank’s total REFCORP and AHP assessments would have been \$135.0 million in 2001.

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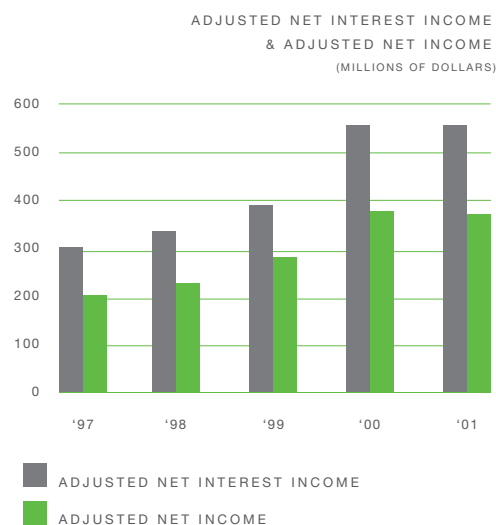
Net Income. Net income increased \$48.0 million, or 13%, to \$424.6 million in 2001 from \$376.6 million in 2000, and return on equity (ROE) increased 12 basis points, to 6.49% in 2001 from 6.37% in 2000, because of the recognition of net gains from fair value adjustments and on held-at-fair-value securities as a result of the adoption of SFAS 133 on January 1, 2001 (see "Interest Rate Exchange Agreements" on page 28). After subtracting the net effect of SFAS 133 for 2001 (a net gain of \$50.8 million, net of applicable assessments), net income for 2001 was \$373.8 million, a decrease of \$2.8 million, or 0.7% from the prior year, and ROE decreased 66 basis points to 5.71% for 2001. The decline in ROE was primarily attributable to lower earnings on member capital resulting from the significant decline in the interest rate environment during 2001 compared to 2000.



Adjusted Financial Performance. The Bank also calculates adjusted financial performance measures to provide a more meaningful comparison of the Bank's financial results over time. These measures reflect earnings before advance prepayment fees, certain extraordinary gains and losses associated with the early retirement of debt, and certain other nonrecurring gains and losses related to financial instruments, net of the current amortization of current and prior period nonrecurring items, in accordance with the Bank's retained earnings policy. These adjustments are made in order to recognize prepayment fees, debt retirement gains and losses, and other nonrecurring transactions over the periods remaining through the related instruments' original maturity dates. In addition, adjusted financial performance measures exclude the effects of any current period fair value adjustments (net of applicable assessments) resulting from the adoption of SFAS 133, because these effects are generally expected to reverse over time. These fair value adjustments include adjustments made in accordance with SFAS 133 and adjustments on held-at-fair-value securities reclassified from held-to-maturity securities

upon the adoption of SFAS 133. In addition, as a result of the GLB Act, beginning in 2000 the REFCORP assessment is classified as an expense and is included on the Bank's income statement. Before 2000, the REFCORP assessment was a charge to capital and did not appear on the income statement. Adjusted financial performance measures present the Bank's operating results after subtracting the REFCORP assessments for 1997 to 1999.

Adjusted net income decreased 2%, to \$375.2 million in 2001 from \$381.4 million in 2000. Adjusted ROE decreased by 72 basis points, to 5.74% in 2001 from 6.46% in 2000, primarily because of lower earnings on member capital resulting from the significant decline in interest rates in 2001.



Dividends. In 2001, the Bank paid \$386.6 million in dividends, an average annual rate of 5.99%. In 2000, dividends totaled \$416.3 million, an average annual rate of 7.17%. The decline in the dividend rate was primarily attributable to lower earnings on member capital resulting from the significant decline in interest rates in 2001 and to the supplemental payouts of retained earnings totaling \$36.9 million in 2000. All dividends except fractional shares were paid in the form of capital stock.

To provide financial flexibility and in anticipation of the possible effects of implementing SFAS 133, the Bank transferred certain amounts from unrestricted retained earnings to restricted retained earnings in 1999. During 1999, the Bank also transferred to restricted retained earnings the one-time gain of \$8.1 million from the spin-off/termination involving the Bank's cash balance plan and recognized gains totaling \$3.5 million from the sale of the Bank's office building, each net of applicable assessments. Retained earnings restricted by the Bank totaled \$27.9 million at December 31, 1999. In addition, the Bank retained earnings of \$22.3 million in unrestricted retained earnings in 1999.

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During the first quarter of 2000, the Bank paid out the unrestricted retained earnings as of December 31, 1999, which equaled \$25.4 million, adding 0.44% to the annual dividend yield. During the second quarter of 2000, in anticipation of SFAS 133, the Bank maintained approximately \$17.1 million of existing restricted retained earnings to offset the projected effect on capital of recognizing in other comprehensive income, a component of capital, the remaining unamortized balance of the deferred losses from certain interest rate exchange agreements previously terminated by the Bank. At that time, the Bank paid out the remaining \$11.5 million from previously restricted retained earnings, adding 0.19% to the annual dividend yield. If the Bank had not paid out these retained earnings, the Bank's dividend for 2000 would have been 6.54%.

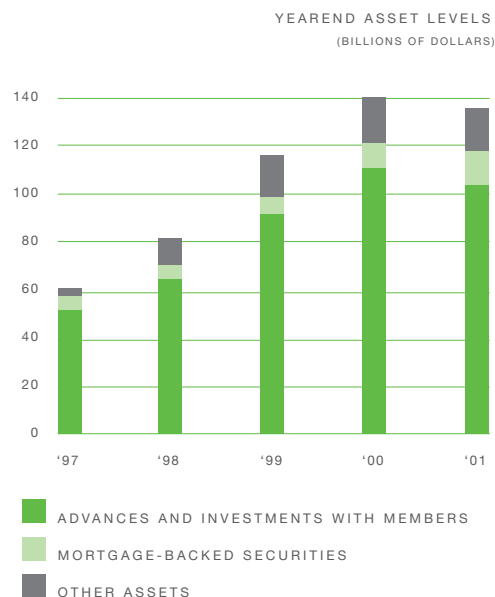
On June 22, 2000, the Federal Housing Finance Board (Finance Board) rescinded its dividend policy applicable to the FHLBanks. This rescission effectively eliminated the requirement that the FHLBanks set aside in restricted retained earnings that portion of income from prepayment fees that, if allocated on a pro rata basis over the original term to maturity of the advances prepaid, would be allocated to future dividend periods. Other gains and losses related to the termination of interest rate exchange agreements and early retirement of consolidated obligations were similarly treated. The Bank adopted a policy to continue the practice of restricting retained earnings generally consistent with the Finance Board's rescinded dividend policy. These restricted retained earnings may be transferred to unrestricted retained earnings on a pro rata basis over the original terms of the prepaid advances, interest rate exchange agreements, or consolidated obligations. Retained earnings restricted in accordance with these policies totaled \$6.5 million and \$7.1 million at December 31, 2001 and 2000, respectively.

Also in accordance with the retained earnings policy of the Bank, as of January 1, 2001, the Bank restricts retained earnings for any cumulative net fair value gains in earnings (net of applicable assessments) resulting from SFAS 133. Since these cumulative net gains are primarily a matter of timing, the gains will generally reverse over the remaining contractual terms to maturity of the financial instruments and associated interest rate exchange agreements. Restricted retained earnings may be adjusted as these cumulative net gains are reversed, resulting in substantially the same dividend payout as there would have been without the effects of SFAS 133. Retained earnings restricted in accordance with this policy totaled \$50.8 million at December 31, 2001.

FINANCIAL CONDITION

Total assets decreased 3% during the year, to \$135.4 billion at December 31, 2001, from \$140.2 billion at December 31, 2000, while average total assets rose 8%, to \$139.1 billion in 2001 from \$128.4 billion in 2000.

Advances. Advances outstanding decreased 7% in 2001, to \$102.3 billion at December 31, 2001, from \$110.0 billion at December 31, 2000. However, average advances increased 8%



compared to the prior year, to \$107.6 billion in 2001 from \$100.0 billion in 2000. Advances outstanding at December 31, 2001, included fair value adjustments of \$0.9 billion. Members increased their Bank borrowings during the first quarter, primarily with long-term adjustable rate and fixed rate advances. As the nation's economy slowed and members experienced strong retail deposit growth coupled with attractive alternative sources of funds, advance demand started to taper off during the second quarter of 2001. The Bank's largest members accounted for most of the decrease from the prior yearend. In total, 120 members increased their advance borrowings from yearend 2000 to yearend 2001, while 71 members decreased their advance borrowings.

Investments. The Bank invests in both short- and long-term instruments to maintain liquidity and provide additional earnings. The short-term investment portfolio is primarily composed of Federal funds sold, securities purchased under agreements to resell (resale agreements), negotiable certificates of deposit (interest-bearing deposits in banks), and commercial paper. In determining the amount of assets to invest in each class of securities, the Bank considers the yield, liquidity, and credit quality of each instrument. The long-term investment portfolio, which is composed of MBS and, to a small degree, other housing-related investments, provides the Bank with higher returns than those available in the short-term money markets. Certain of the fixed and adjustable rate MBS in which the Bank invests are guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae and are collateralized by residential mortgages. The Bank also invests in publicly registered, AAA-rated non-agency MBS that are also collateralized by residential mortgages. In addition, the Bank invests in housing finance agency bonds, all of which are AAA-rated adjustable rate mortgage revenue bonds (federally taxable) that are collateralized by pools of residential mortgages.

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AVERAGE BALANCE SHEETS

| (DOLLARS IN MILLIONS) | 2001 | | | 2000 | | | 1999 | | |
|--|-----------------|--------------------------|--------------|-----------------|--------------------------|--------------|-----------------|--------------------------|--------------|
| | AVERAGE BALANCE | INTEREST INCOME/ EXPENSE | AVERAGE RATE | AVERAGE BALANCE | INTEREST INCOME/ EXPENSE | AVERAGE RATE | AVERAGE BALANCE | INTEREST INCOME/ EXPENSE | AVERAGE RATE |
| Assets | | | | | | | | | |
| Interest-earning assets: | | | | | | | | | |
| Interest-bearing deposits in banks | \$ 3,636.0 | \$ 142.4 | 3.92% | \$ 2,007.0 | \$ 131.1 | 6.53% | \$ 1,306.2 | \$ 68.5 | 5.24% |
| Resale agreements | 1,544.9 | 63.9 | 4.13 | 1,523.9 | 93.9 | 6.16 | 2,091.2 | 110.9 | 5.31 |
| Federal funds sold | 8,436.0 | 349.3 | 4.14 | 8,564.7 | 549.1 | 6.41 | 6,813.9 | 354.5 | 5.20 |
| Held-to-maturity securities ¹ | 14,896.3 | 828.9 | 5.56 | 13,710.6 | 898.0 | 6.55 | 9,128.3 | 524.8 | 5.75 |
| Held-at-fair-value securities | 584.3 | 27.7 | 4.74 | — | — | — | — | — | — |
| Advances ¹ | 107,605.3 | 4,735.9 | 4.40 | 99,959.9 | 6,431.3 | 6.43 | 74,689.3 | 3,970.1 | 5.32 |
| Loans to other FHLBanks | 26.8 | 0.8 | 3.15 | 10.1 | 0.7 | 6.91 | 8.2 | 0.4 | 4.87 |
| Total interest-earning assets | 136,729.6 | 6,148.9 | 4.50 | 125,776.2 | 8,104.1 | 6.44 | 94,037.1 | 5,029.2 | 5.35 |
| Other assets ² | 2,357.1 | — | — | 2,582.9 | — | — | 1,878.3 | — | — |
| Total Assets | \$139,086.7 | \$6,148.9 | 4.42% | \$128,359.1 | \$8,104.1 | 6.31% | \$95,915.4 | \$5,029.2 | 5.24% |
| Liabilities and Capital | | | | | | | | | |
| Interest-bearing liabilities: | | | | | | | | | |
| Consolidated obligations: | | | | | | | | | |
| Bonds ¹ | \$ 94,358.6 | \$4,064.3 | 4.31% | \$ 86,908.7 | \$5,527.1 | 6.36% | \$76,170.9 | \$3,962.1 | 5.20% |
| Discount notes ¹ | 34,782.6 | 1,514.0 | 4.35 | 31,739.5 | 1,996.8 | 6.29 | 12,253.8 | 666.1 | 5.44 |
| Deposits | 480.2 | 16.0 | 3.33 | 221.5 | 13.5 | 6.10 | 237.2 | 11.5 | 4.87 |
| Borrowings from other FHLBanks | 2.1 | 0.1 | 3.80 | — | — | — | — | — | — |
| Other borrowings | 6.1 | 0.2 | 3.58 | 202.7 | 12.1 | 5.92 | 48.0 | 2.5 | 5.14 |
| Total interest-bearing liabilities | 129,629.6 | 5,594.6 | 4.32 | 119,072.4 | 7,549.5 | 6.34 | 88,709.9 | 4,642.2 | 5.23 |
| Other Liabilities ² | 2,912.1 | — | — | 3,379.1 | — | — | 2,364.4 | — | — |
| Total Liabilities | 132,541.7 | 5,594.6 | 4.22 | 122,451.5 | 7,549.5 | 6.17 | 91,074.3 | 4,642.2 | 5.10 |
| Capital | 6,545.0 | — | — | 5,907.6 | — | — | 4,841.1 | — | — |
| Total Liabilities and Capital | \$139,086.7 | \$5,594.6 | 4.02% | \$128,359.1 | \$7,549.5 | 5.88% | \$95,915.4 | \$4,642.2 | 4.84% |
| Net Interest Income | \$ 554.3 | | | | \$ 554.6 | | | | \$ 387.0 |
| Net Interest Spread | | | 0.18% | | | 0.10% | | | 0.12% |
| Net Interest Margin ³ | | | 0.41% | | | 0.44% | | | 0.41% |
| Total Average Assets/Capital Ratio | 21.3x | | | | 21.7x | | | | 19.8x |
| Interest-Earning Assets/ Interest-Bearing Liabilities | 1.1x | | | | 1.1x | | | | 1.1x |

¹ Interest income/expense and average rates include the interest effect of associated interest rate exchange agreements.

² Includes forward settling transactions and fair value adjustments in accordance with SFAS 133.

³ Net interest margin is net interest income divided by average interest-earning assets.

The fixed rate, long-term investments are subject to prepayment risk, and the adjustable rate long-term investments are subject to interest rate cap risk. The Bank has managed these risks by (1) funding the fixed rate MBS with non-callable and callable debt, and (2) purchasing certain investments that are structured with interest rate exchange agreements, creating synthetic, floating rate assets that may have lifetime interest rate caps but do not have periodic interest rate caps. This structure provides the Bank with a stable income stream over a range of interest rates.

In accordance with the provisions of SFAS 133, the interest rate exchange agreements associated with held-to-maturity securities are non-hedge qualifying. As a result, the transition provisions of SFAS 133 allowed the Bank to transfer any security classified as held-to-maturity to trading (or "held-at-fair-value"). Therefore, the Bank transferred its portfolio of economically hedged MBS to the held-at-fair-value securities category so that fair value gains or losses on the MBS will partly offset the losses or gains on the associated interest rate exchange agreements. During 2001, this designation allowed the Bank to mark certain

MBS to fair value (for a \$7.7 million gain) to offset the mark-to-fair value of the associated interest rate exchange agreements (a \$6.6 million loss), for a net gain of \$1.1 million.

The Bank's MBS portfolio, including MBS held at fair value, increased 28% in 2001, to \$13.8 billion, or approximately 202% of capital, at December 31, 2001, from \$10.8 billion, or approximately 171% of capital, at December 31, 2000. The Bank took advantage of the surge in MBS supply resulting from the increase in mortgage refinancings to increase its MBS portfolio in 2001. However, the increase in the Bank's capital and the rapid pay-down of existing MBS investments resulted in balances below the maximum authorized level of 300% of capital.

The Bank's total non-MBS investment portfolio increased to \$18.4 billion as of December 31, 2001, from \$16.2 billion as of December 31, 2000. Interest-bearing deposits in banks increased \$1.8 billion, resale agreements increased \$1.8 billion, housing finance agency bonds increased \$0.6 billion, and Federal funds sold increased \$0.1 billion, while commercial paper decreased \$2.1 billion.

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CHANGE IN NET INTEREST INCOME: RATE/VOLUME ANALYSIS

2001 Compared to 2000

| (IN MILLIONS) | INCREASE/ (DECREASE) | ATTRIBUTABLE TO CHANGES IN ¹ | |
|---|-------------------------|--|------------------|
| | | AVERAGE VOLUME | AVERAGE RATE |
| Interest-earning assets: | | | |
| Interest-bearing deposits in banks | \$ 11.3 | \$ 64.1 | \$ (52.8) |
| Resale agreements | (30.0) | 2.3 | (32.3) |
| Federal funds sold | (199.8) | (7.1) | (192.7) |
| Held-to-maturity securities ² | (69.1) | 65.2 | (134.3) |
| Held-at-fair-value securities | 27.7 | 26.5 | 1.2 |
| Advances ² | (1,695.4) | 292.2 | (1,987.6) |
| Loans to other FHLBanks | 0.1 | 0.5 | (0.4) |
| Total interest-earning assets | (1,955.2) | 443.7 | (2,398.9) |
| Interest-bearing liabilities: | | | |
| Consolidated obligations: | | | |
| Bonds ² | (1,462.8) | 283.5 | (1,746.3) |
| Discount notes ² | (482.8) | 121.3 | (604.1) |
| Deposits | 2.5 | 8.7 | (6.2) |
| Borrowings from other FHLBanks | 0.1 | 0.1 | — |
| Other borrowings | (11.9) | (7.3) | (4.6) |
| Total interest-bearing liabilities | (1,954.9) | 406.3 | (2,361.2) |
| Net Interest Income | \$ (0.3) | \$ 37.4 | \$ (37.7) |

2000 Compared to 1999

| (IN MILLIONS) | INCREASE/ (DECREASE) | ATTRIBUTABLE TO CHANGES IN ¹ | |
|---|-------------------------|--|-----------------|
| | | AVERAGE VOLUME | AVERAGE RATE |
| Interest-earning assets: | | | |
| Interest-bearing deposits in banks | \$ 62.6 | \$ 45.0 | \$ 17.6 |
| Resale agreements | (17.0) | (34.8) | 17.8 |
| Federal funds sold | 194.6 | 110.1 | 84.5 |
| Held-to-maturity securities ² | 373.2 | 297.4 | 75.8 |
| Advances ² | 2,461.2 | 1,600.8 | 860.4 |
| Loans to other FHLBanks | 0.3 | 0.1 | 0.2 |
| Total interest-earning assets | 3,074.9 | 2,018.6 | 1,056.3 |
| Interest-bearing liabilities: | | | |
| Consolidated obligations: | | | |
| Bonds ² | 1,565.0 | 667.1 | 897.9 |
| Discount notes ² | 1,330.7 | 1,215.2 | 115.5 |
| Deposits | 2.0 | (1.0) | 3.0 |
| Other borrowings | 9.6 | 9.1 | 0.5 |
| Total interest-bearing liabilities | 2,907.3 | 1,890.4 | 1,016.9 |
| Net Interest Income | \$ 167.6 | \$ 128.2 | \$ 39.4 |

¹ Combined rate/volume variances, a third element of the calculation, are allocated to the rate and volume variances based on their relative size.

² Interest income/expense and average rates include the interest effect of associated interest rate exchange agreements.

Borrowings. The Bank funds its assets through the use of FHLBank consolidated obligation bonds and discount notes, which are the joint and several obligations of the 12 FHLBanks. These instruments financed 93% and 92% of the Bank's average total assets in 2001 and 2000, respectively. Consolidated obligation bonds are long-term, while discount notes are short-term instruments. The Bank uses interest rate exchange agreements to change the effective interest rate terms on many of its consolidated obligation bonds and discount notes.

Consistent with the decline in the Bank's total assets, total consolidated obligations outstanding decreased 3% in 2001, to \$125.9 billion at December 31, 2001, from \$129.5 billion at December 31, 2000. However, average consolidated obligations in 2001 were

\$129.1 billion, 10% above the \$118.6 billion average in 2000, consistent with the trend for average advances noted above. Consolidated obligations outstanding at December 31, 2001, included fair value adjustments of \$0.9 billion.

To meet the specific needs of certain investors, fixed and adjustable rate consolidated obligation bonds may contain embedded call options or other features that result in complex coupon payment terms. When such consolidated obligation bonds are issued, the Bank simultaneously enters into interest rate exchange agreements with features that offset the complex features of the bonds and, in effect, convert the bonds to conventional adjustable rate instruments tied to an index, such as the London Interbank Offered Rate (LIBOR). During 2001 and 2000, the Bank used fixed rate callable bonds that were usually offset with interest rate exchange agreements with a call feature mirroring the option embedded in the callable bond. This combined structure enabled the Bank to meet its funding needs at costs not generally attainable solely through the issuance of non-callable debt.

Capital and Capital Ratios. Each member is required to purchase Bank stock based on the amount of its residential mortgage loans or its outstanding Bank advances. Average capital during 2001 was \$6.5 billion, an 11% increase from \$5.9 billion in 2000. This increase was due to capital stock purchases by new members and additional capital stock purchases by existing members to support additional borrowings early in the year. This increase was net of redemptions of capital stock, which primarily resulted from the Bank's mandatory surplus capital stock redemption policy. Surplus capital is defined as any excess stock holdings above 115% of a member's statutory capital stock requirement, excluding stock dividends earned and credited for the current year. In accordance with this policy, the Bank redeemed \$363.4 million and \$378.8 million in surplus capital stock during 2001 and 2000, respectively.

The Finance Board's regulations effective through June 30, 2000, prohibited the issuance of consolidated obligations and other unsecured senior liabilities above 20 times the FHLBanks' aggregate total capital. The Finance Board's Financial Management Policy also applied this limit on an FHLBank-by-FHLBank basis. This leverage limitation was temporarily increased to 25 times an FHLBank's total capital through June 30, 2000, provided certain conditions were met, to facilitate Year 2000-related lending. On June 2, 2000, the Finance Board adopted a final rule amending the FHLBanks' leverage limit requirements. Effective July 1, 2000, each FHLBank's leverage limit is based on a ratio of assets to capital, rather than a ratio of liabilities to capital. The final rule generally limits each FHLBank's assets to no more than 21 times capital. However, an FHLBank may have total assets in an amount no greater than 25 times its capital as long as its non-mortgage assets, after deducting deposits and capital, do not exceed 11% of its assets. As of December 31, 2001, the Bank's total assets to capital and non-mortgage assets to total assets ratios were 19.9x and 8.07%, respectively. The Bank's advances and mortgage-related assets averaged 18.4 times capital in 2001. In addition, the Bank's non-mortgage

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investments and other non-interest-bearing, non-mortgage assets averaged 2.9 times capital. The Bank's average ratio of total assets to capital was 21.3x in 2001. The 11%-of-assets limit that applies to non-mortgage assets when total assets exceed 21 times capital has not restricted the Bank's ability to maintain the target amount of liquid investments necessary to meet its operating needs and the credit needs of members.

The GLB Act imposes new minimum leverage and risk-based capital requirements on the 12 FHLBanks and requires each FHLBank to implement a new capital structure to replace the current structure. The Bank submitted its proposed capital plan to the Finance Board for approval on October 29, 2001. Until the Bank fully implements its capital plan, the existing capital requirements will remain in effect. See "Recent Developments" on page 30.

Letters of Credit. The Bank issues standby letters of credit on behalf of members to support their obligations to third parties with off-balance sheet risk. The contractual amounts of letters of credit are not recorded as assets or liabilities on the balance sheet. The amounts outstanding as of December 31, 2001 and 2000, were \$841.5 million and \$682.7 million, respectively. The fees earned by the Bank in connection with letters of credit are recorded as other income when received.

Interest Rate Exchange Agreements. The Bank enters into various types of transactions that involve interest rate exchange agreements (interest rate swap, cap, and floor agreements) to adjust the interest rate sensitivity of consolidated obligations to approximate more closely the interest rate sensitivity of assets (both advances and investments) or to adjust the interest rate sensitivity of advances or investments to approximate more closely the interest rate sensitivity of liabilities. In addition, the Bank uses interest rate exchange agreements to manage embedded options in assets and liabilities, to hedge the market value of existing assets and liabilities and anticipated transactions, to hedge the prepayment risk of prepayable instruments, and to reduce funding costs. The Bank also provides a variety of products to meet the specific needs of borrowers. Because the financial characteristics of many of these products may not be consistent with the Bank's desired interest rate risk profile, the Bank uses interest rate exchange agreements to modify the financial characteristics of its products to meet the Bank's specific interest rate risk objectives. These instruments are generally negotiated, with terms tailored to meet the specific needs of the Bank and the customer. The Bank may also act as an intermediary between members and third parties for interest rate exchange agreement transactions.

Interest income and expense from interest rate exchange agreements used for risk management purposes are recorded with interest on the associated instrument whether or not the transactions qualify for hedge accounting treatment under SFAS 133. Interest income and expense from interest rate exchange agreements in which the Bank acts as an intermediary are recorded as other income.

As of December 31, 2001, the notional amount of the Bank's interest rate exchange agreements, primarily interest rate swaps, was \$144.7 billion. Of this amount, \$98.6 billion was associated with consolidated obligations, \$44.8 billion was associated with advances, \$0.5 billion was associated with MBS, and \$0.8 billion was associated with intermediated transactions. As of December 31, 2000, the notional amount of the Bank's interest rate exchange agreements, primarily interest rate swaps, was \$156.9 billion. Of this amount, \$109.2 billion was associated with consolidated obligations, \$45.9 billion was associated with advances, \$0.7 billion was associated with MBS, and \$1.1 billion was associated with intermediated transactions.

On January 1, 2001, the Bank adopted SFAS 133, which requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. The gains and losses on derivative instruments that are designated as cash flow hedges are reported in other comprehensive income and will be recognized as earnings in the periods in which earnings are affected by the cash flows of the hedged items. The ineffective portion of all hedges is recognized in current period earnings.

In anticipation of SFAS 133, in 1999 and 1998 the Bank terminated certain interest rate exchange agreements that were hedging existing and anticipated future issuances of discount notes. The Bank realized losses of \$32.3 million and \$13.3 million in 1999 and 1998, respectively, on these terminations. Under SFAS 133, the Bank would have been required to mark these agreements to market on January 1, 2001, and periodically thereafter. The amount of the resulting gains and losses to be recorded in other comprehensive income would have varied depending on interest rates. The Bank eliminated this accounting uncertainty by terminating the agreements and replacing them, in part, with certain fixed rate bonds, which will not have accounting volatility under SFAS 133. Because the future issuance of discount notes remains probable, the Bank deferred these losses and was amortizing them into interest expense over the remaining terms of the original interest rate swap agreements. The unamortized amount of these deferred hedging losses at December 31, 2000, was \$17.1 million and was included in the carrying amount of discount notes.

In accordance with the transition provisions of SFAS 133, the Bank recognized in other comprehensive income the remaining unamortized balance of these deferred hedging losses, \$17.1 million, as part of the cumulative effect of adopting SFAS 133 on January 1, 2001. Previously, the Bank had retained \$17.1 million in restricted retained earnings to offset the effect of these deferred losses on capital. During 2001, \$12.2 million of the deferred hedging losses was recognized in interest expense, and the Bank transferred \$12.2 million to unrestricted retained earnings to offset the amortization of the deferred hedging losses.

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The unamortized amount of these losses at December 31, 2001, was \$4.8 million and was included in accumulated other comprehensive loss.

In addition, a loss of \$2.5 million was charged to January 2001 earnings as part of the cumulative effect of adopting SFAS 133. This loss reflected unrealized gains of \$7.1 million related to the transfer of held-to-maturity securities to held-at-fair-value securities and unrealized net losses of \$9.6 million from the remaining cumulative effect of adjustments related to fair value hedges and transactions not meeting the requirements for fair value or cash flow hedges under SFAS 133.

The ongoing impact of SFAS 133 on the Bank cannot be predicted, and the Bank's retained earnings in the future may not be sufficient to offset the impact of SFAS 133. As a result, the effects of SFAS 133 may lead to increased volatility in future earnings and dividends.

RISK MANAGEMENT

Liquidity. The Bank is required to maintain liquidity in accordance with certain regulations, with the Finance Board's Financial Management Policy, and with the Bank's own liquidity policy. The Bank needs liquidity to satisfy member demand for short- and long-term funds, repay maturing consolidated obligations, and meet other obligations. In their asset/liability management planning, members may look to the Bank to provide standby liquidity. The Bank seeks to be in a position to meet its customers' credit and liquidity needs without maintaining excessive holdings of low-yielding liquid investments or being forced to incur unnecessarily high borrowing costs. The Bank's primary sources of liquidity are short-term investments and the issuance of new consolidated obligation bonds and discount notes. Other short-term borrowings, such as Federal funds purchased, securities sold under agreements to repurchase, and loans from other FHLBanks, also provide liquidity. The Bank maintains contingency liquidity plans designed to enable it to meet its obligations and the liquidity needs of members in the event of operational disruptions at the Bank or the Office of Finance (the FHLBanks' fiscal agent for issuing consolidated obligations) or short-term capital market disruptions.

Interest Rate Risk. Underlying the Bank's financial performance is a multifaceted asset/liability management strategy. The Bank monitors and evaluates the potential effects of interest rate movements on earnings and the market value of equity. Asset/liability strategies are adjusted to manage interest rate risk within prescribed policy limits and guidelines. The Bank's financial policies and guidelines establish limits for net interest income sensitivity to interest rate changes, interest rate index basis relationship changes, periodic and cumulative repricing gaps, and the sensitivity of the market value of equity to interest rate changes (duration of equity). The Bank also complies with the duration of equity limits and other limits set forth in the Finance Board's Financial Management Policy.

One measure of interest rate risk is the extent to which the interest rates on the Bank's assets and liabilities reprice at different

times. The following table shows the interest rate sensitivity of assets and liabilities by repricing periods. The periodic gaps shown in this table represent the net difference between total asset and liability repricings, including the impact of interest rate exchange agreements, for a specified time period. For example, the periodic gap for the "6 months or less" time period indicates that as of December 31, 2001, there were \$3.3 billion more assets than liabilities repricing during the 6-month period beginning on December 31, 2001. As shown in this table, the Bank's repricing gaps, by design, are concentrated in the "6 months or less" category, and, to a lesser degree, the "1 to 5 years" category.

INTEREST RATE SENSITIVITY

For the Year Ended December 31, 2001

| (IN MILLIONS) | INTEREST RATE SENSITIVITY PERIOD | | | |
|--------------------------------------|----------------------------------|-----------------------|-----------------|-----------------|
| | 6 MONTHS OR LESS | 6 MONTHS TO 1 YEAR | 1 TO 5 YEARS | OVER 5 YEARS |
| Assets | | | | |
| Investments | \$22,825 | \$ 1,529 | \$ 5,041 | \$ 2,784 |
| Advances | 62,910 | 11,312 | 25,479 | 2,554 |
| Other assets | 922 | — | — | — |
| Total Assets | \$86,657 | \$12,841 | \$30,520 | \$ 5,338 |
| Liabilities | | | | |
| Consolidated obligations | \$61,229 | \$15,019 | \$44,221 | \$ 5,471 |
| Deposits | 751 | — | — | — |
| Other borrowings | 200 | — | — | — |
| Other liabilities | 1,453 | — | — | 202 |
| Total Liabilities | \$63,633 | \$15,019 | \$44,221 | \$ 5,673 |
| Interest Rate | | | | |
| Exchange Agreements | (19,694) | 3,061 | 15,324 | 1,309 |
| Periodic Gap/Invested Capital | \$ 3,330 | \$ 883 | \$ 1,623 | \$ 974 |

The following table shows the estimated percentage change in the market value of equity (the net value of all assets, liabilities, and off-balance sheet items) that would result from a 100-basis-point change in interest rates under different interest rate scenarios. At December 31, 2001, the estimated percentage change in the Bank's market value of equity was 2.0%. If interest rates rose 100 basis points, the Bank's market value of equity would be expected to decline approximately 2.0%, and if interest rates fell 100 basis points, the Bank's market value of equity would be expected to increase approximately 2.0%. If interest rates had been 200 basis points higher at December 31, 2001, a 100-basis-point additional shift in interest rates would be expected to either decrease or increase (depending on the direction of the interest rate movement) the Bank's market value of equity by approximately 2.6%. If interest rates had been 200 basis points lower at December 31, 2001, a 100-basis-point additional shift in interest rates would be expected to alter the Bank's market value of equity by approximately 0.9%.

MARKET VALUE OF EQUITY SENSITIVITY

As of December 31, 2001

| INTEREST RATE SCENARIO | AVERAGE PERCENTAGE CHANGE IN THE MARKET VALUE OF EQUITY | |
|-------------------------------------|--|--|
| | PER 100-BASIS-POINT CHANGE IN INTEREST RATES | |
| Actual rates at December 31, 2001 | 2.0% | |
| Rates start 200 basis points higher | 2.6% | |
| Rates start 200 basis points lower | 0.9% | |

Credit Risk. The Bank closely monitors the creditworthiness of the institutions to which it lends funds. The Bank also places great importance on the quality of the assets that are pledged as collateral by its customers. The Bank emphasizes credit monitoring and collateral asset review and valuation to manage the credit risk associated with its lending activities. It also has procedures to assess the mortgage underwriting and documentation standards of its borrowing members. In addition, the Bank has collateral policies and restricted lending procedures in place to manage its exposure to those customers that experience difficulty in meeting their capital requirements or other standards of creditworthiness. The Bank has not experienced any losses on credit extended to any member or other counterparty since its inception. Based on the collateral held as security and prior repayment history, no allowance for losses is deemed necessary by management.

The Bank has adopted exposure limits for investments that ensure diversification and liquidity. These policies restrict the amounts and terms of the Bank's investment holdings according to the Bank's own capital position as well as the capital and creditworthiness of the counterparty. In addition, the Bank's investments include AAA-rated non-agency MBS; MBS that are guaranteed by government-sponsored enterprises (Fannie Mae, Freddie Mac, and Ginnie Mae); and housing finance agency bonds, which are AAA-rated mortgage revenue bonds (federally taxable) that are collateralized by pools of residential mortgages.

The Bank has also adopted credit policies and exposure limits for derivatives and off-balance sheet credit exposure. Under these policies, the amount of unsecured credit that may be extended to an individual counterparty is the lower of (1) an amount commensurate with the counterparty's capital and its credit quality, as determined by rating agency credit ratings of the counterparty's debt securities or deposits, or (2) an absolute credit exposure limit. In addition, the Bank has entered into master netting arrangements and bilateral security agreements with all active non-member derivative counterparties that provide for delivery of collateral at specified levels to limit net credit exposure from these derivatives. (See "Recent Developments" on this page for a discussion of the Finance Board's new rule on unsecured credit limits.)

Concentration Risk. At December 31, 2001, the Bank had a concentration of advances totaling \$79.0 billion outstanding to three members, representing 78% of total advances outstanding (45%, 22%, and 11%, respectively). At December 31, 2000, the Bank had a concentration of advances totaling \$89.2 billion outstanding to three members, representing 81% of total advances outstanding (44%, 24%, and 13%, respectively). Of the total capital stock outstanding at December 31, 2001, three members held 49.5 million shares, representing 74% of total capital stock outstanding (41%, 22%, and 11%, respectively). At December 31, 2000, three members held 48.3 million shares,

representing 77% of total capital stock outstanding (42%, 22%, and 13%, respectively). The Bank manages concentration risk by, among other things, closely monitoring the credit and collateral quality and financial trends of the institutions to which it lends funds, charging market-based prepayment fees on most advances, and monitoring and managing the risks associated with any potential departure of a large member and the resulting capital redemption.

RECENT DEVELOPMENTS

Capital Requirements for FHLBanks. On January 30, 2001, the Finance Board published a final rule to implement a new capital structure for the FHLBanks, as required by the GLB Act. The rule established risk-based and leverage capital requirements for the FHLBanks, addressed different classes of stock that an FHLBank may issue and the rights and preferences that may be associated with each class of stock, and required each FHLBank to submit a capital plan to the Finance Board for approval. The Bank submitted its proposed capital plan to the Finance Board on October 29, 2001. The Finance Board has announced its intention to consider the Bank's proposed capital plan at its meeting on June 12, 2002; however, there is no assurance that the capital plan will be approved on that date. The Bank intends to implement its capital plan through an exchange of stock and will provide all members with a description of the capital plan and other pertinent information after receiving approval of its capital plan from the Finance Board. Until the Bank fully implements its new capital plan, the current requirements for Bank capital stock remain in effect.

Unsecured Credit Limits. In December 2001, the Finance Board amended its rules governing the amount of unsecured credit that an FHLBank may extend to a particular counterparty. The amendments require an FHLBank to base the credit limit on the long-term credit rating of the counterparty, set the amount of unsecured credit that may be extended to a government-sponsored enterprise at the level allowed under an FHLBank's Financial Management Policy, adjust the limits for sales of overnight Federal funds and limits for unsecured credit extended to groups of affiliated counterparties, address how unsecured credit limits should be applied to certain housing finance agency bonds, and clarify how an FHLBank should calculate its credit exposures from on- and off-balance sheet items and derivative contracts. The amendments become effective March 27, 2002. The Bank does not anticipate that the changes will have significant effects on its investment and hedging activities or on the profits or costs associated with those activities.

Multiple Federal Home Loan Bank Memberships. In October 2001, the Finance Board published a solicitation of comments on the implications for the FHLBank System raised by the structural changes that have been occurring in its membership base. The solicitation was prompted by the submission of petitions requesting that the Finance Board permit a single depository institution to become a member of two FHLBanks concurrently.

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New Business Activity. In February 2001, the Finance Board consented to the Bank's participation in the Mortgage Partnership Finance® Program, a mortgage loan purchase program administered by the Federal Home Loan Bank of Chicago. The Bank began offering the MPF® Program to its members in 2001 and expects to begin purchasing loans in 2002. ("Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.)

COMPARISON OF 2000 TO 1999

Net income was \$376.6 million in 2000, compared to \$332.6 million in 1999. Net interest income increased to \$554.6 million in 2000 from \$387.0 million in 1999 as a result of a 34% increase in average interest-earning assets outstanding during the year and a 3-basis-point increase in the net interest margin. The increase in the net interest margin was primarily due to significant growth in advances, investments, and capital, combined with higher interest rates earned on invested capital and higher advance profit spreads.

Other income was \$5.3 million in 2000 and \$20.0 million in 1999. The Bank collected \$0.4 million in prepayment fees in 2000, compared to \$2.1 million in 1999, although more advances were prepaid in 2000. During 1999, the Bank recognized one-time gains of \$10.5 million from the spin-off/termination involving the Bank's cash balance plan and \$3.6 million from the sale of the Bank's building.

Other expenses increased to \$48.7 million in 2000 from \$44.1 million in 1999, primarily as a result of a \$4.0 million increase in operating expenses. While operating expenses increased 10% in 2000, average assets increased 34%, leading to a decline in the Bank's ratio of operating expenses to average assets from 4.0 basis points in 1999 to 3.3 basis points in 2000.

The Bank's total REFCORP and AHP assessments equaled \$136.0 million in 2000 and \$79.4 million in 1999. These amounts reflected effective "tax" rates on income of 27% and 22%, respectively. Effective January 1, 2000, the FHLBanks' annual REFCORP obligation was modified by the GLB Act from a fixed annual assessment of \$300 million for the 12 FHLBanks combined to 20% of each FHLBank's net earnings (after AHP assessments). As a result of this change and higher earnings in 2000, the Bank's REFCORP assessment increased \$46.4 million, to \$94.1 million in 2000 from \$47.7 million in 1999. In accordance with the GLB Act, the REFCORP assessment for 2000 was classified as an expense and included on the Bank's income statement, while the REFCORP assessment for 1999 and prior years was a charge to capital and did not appear on the income statement. The Bank set aside \$41.9 million for the AHP in 2000, compared to \$31.7 million in 1999. The increase in the AHP assessment reflected higher earnings in 2000.

Adjusted net interest income increased 42%, to \$560.5 million in 2000 from \$394.0 million in 1999. This increase was the primary reason adjusted net income rose 13%, to \$381.4 million in 2000 from \$337.1 million in 1999.

In 2000, the Bank paid a total of \$416.3 million in dividends, an average annual rate of 7.17%. The 2000 dividends included \$36.9 million in payouts from retained earnings, which added 0.63% to the annual dividend yield. Without the payments, the Bank's dividend for 2000 would have been 6.54%, 118 basis points higher than in 1999, when dividends totaled \$254.5 million and the average annual rate was 5.36%. All dividends except fractional shares were paid in the form of capital stock.