

To Our Members

We are very pleased to deliver this annual report to our members. During 2002, the Federal Home Loan Bank of San Francisco successfully managed its balance sheet to accommodate declining advance demand, increased its mortgage-backed securities portfolio, returned value to members through remaining an ever-present source of liquidity, provided advantageous advance pricing, and paid an excellent dividend.

We are very proud of what the Bank achieved in 2002, and we hope you will read the discussion and analysis immediately following this letter for a more detailed understanding of the year's activities and results.

In this letter we will discuss some trends and possible outcomes of real significance to all stakeholders in the Federal Home Loan Bank System, and particularly to the System's members. If you use the System and the Bank, or benefit from it in some less direct way, now is the time to consider how changes to the System could enhance or diminish the value of the Bank to your organization or institution. If you want to ensure the System's ongoing utility to your company, you should also give serious thought to participating in the current debates about the System's future.

For more than 70 years now, in one of those rare occasions when unintended consequences have not overwhelmed original intent, the System has aided housing lenders in making mortgages. It has done this through a unique structure of cooperative entities. There are 12 separate corporations that make up the System. They are joined together when they issue debt in the capital markets, debt on which all 12 are jointly and severally liable, through the Office of Finance. To some, this 12-cooperative structure may appear cumbersome and inefficient

when compared to the concept of a single Federal Home Loan Bank for the entire country. But it has the profound advantage of having worked for those 70 years, and very nearly flawlessly. Neither the investors in the System bonds nor the stockholders of the individual FHLBanks have ever suffered a credit loss on their investment in the System. And member financial institutions do not fear that it is competing with them. That is an unparalleled record.

All of this may be changing. There are numerous forces at work that may drive the System to consolidation into a single, massive, and very powerful government-sponsored enterprise, one that is engaged in a business and serving a function very different from the business and function it has historically performed, and more like those performed by the other two housing GSEs. By eliminating local control of the FHLBanks and undermining the regional nature of the System, it seems likely that such consolidation would reduce the System's responsiveness to the needs and priorities of local businesses and communities. While there may not be visible political support for consolidation at this time, it may become more attractive as other changes take place.

The System is facing several critical issues right now: the role of mortgage purchase programs, securitization authority for the FHLBanks, SEC registration, and multidistrict membership. The purpose of this letter is to ask you, the members of the Bank and the other stakeholders and beneficiaries of the present System structure, to step back and take a clear look at all of these issues in a global and integrated way. Rather than thinking about each incremental issue on a stand-alone basis and examining the incremental impact it may

have on an individual FHLBank, look at what may happen to the System as a whole if these issues are decided in a way that takes the System away from its current structure and mission.

Commentators have pointed out that the role played by the System has been changing. While for years the FHLBanks played a narrowly defined role – that of accessing the capital markets to raise funds to lend to their members, who in turn made mortgage loans to their customers – the FHLBanks are now involved in a much wider range of activities. Some of these activities result from legislative changes over the years. Others have occurred without explicit legislative authorization, but instead from regulatory or judicial action, or simply because the FHLBanks have done them, unchecked.

The most significant of these relatively new activities is the ownership of mortgage loans that have been purchased from members. This is a business that is likely to grow because there are strong economic incentives for FHLBanks to own mortgages and there are economic incentives for members to sell loans to FHLBanks. These incentives have led all 12 FHLBanks to establish mortgage purchase programs. Assuming the FHLBanks manage their mortgage portfolios well, mortgages should, in most circumstances, provide much higher returns than advances. However, with the higher returns come higher risks and earnings volatility from the significant prepayment risk inherent in mortgage assets. Nevertheless, an FHLBank that buys loans from its members will probably, over time, be able to pay higher dividends or charge lower prices for credit.

A possible outcome of this situation is that mortgages, as opposed to advances, will become

avored on FHLBank balance sheets and will become favored for funding. Another possible outcome is that it will become increasingly necessary to construct a single, nationwide way to participate in the mortgage purchase business, i.e., there will be pressure for some form of operational consolidation of the FHLBanks. If your company is an advance user, you may want to be on the alert for changes that could make advances less attractive in the future.

Directly related to the mortgage purchase programs is the drive to get securitization authority for the FHLBanks. The FHLBanks do not issue capital into the markets like normal private corporations; they must raise capital from their members. They will need capital to support mortgage purchases. At the same time, if an FHLBank is in the business of purchasing mortgages, it is important to maintain that business in an ongoing manner. In other words, customers will expect to be able to sell loans when they choose. In anticipation of the eventuality that capital will not be available when needed, some FHLBanks are seeking authority to securitize mortgages. Is it likely that 12 separate FHLBanks will get into the business of securitizing mortgages, or will the System move to consolidation to create and sell the securities more efficiently?

In addition to examining the implications of changes in FHLBank balance sheets, the System is debating several other major issues.

As we write this letter, it is unresolved whether the FHLBanks will register their stock with the Securities and Exchange Commission, and whether the System as a whole, presumably through the Office of Finance, will register its debt in some form. Registration of FHLBank stock was urged by

the U.S. Department of the Treasury as a means of improving the flow of information to investors in FHLBank System-issued debt. No FHLBank is resisting enhanced disclosure; instead all support it. However, if the purpose of registration is enhanced disclosure, then let it come about through a disclosure regime managed and administered by the Federal Housing Finance Board. The benefit of that approach is that safety and soundness and disclosure regulation would be administered by the same regulator, a regulator that is already familiar with the unique structure of the System.

However, the primary concern for some FHLBanks, including this one, is that it is not clear how SEC registration may affect the System. Will complying with the SEC's requirements for registration allow the FHLBanks to do business in the future as they do it today? Will bondholders' need to receive combined financial information on the System as a whole force the System toward consolidation?

Another critical issue is that of multidistrict membership. The Bank has opposed multidistrict membership because we have concerns about increasing competition among the FHLBanks. Competition is a good thing when governed by the checks and balances inherent in a true market system, where success is rewarded through increases in the value of an enterprise's equity. Competition among the FHLBanks is more problematic, since they do not have equity that is priced at market, and they share joint and several liability for all debt issued by the System. FHLBanks that win this competition may ultimately lose, as they pay the debts of the FHLBanks that were less successful.

In addition, given that all FHLBanks raise funds the same way, no FHLBank can have a lasting pricing advantage over any other FHLBank. Because the FHLBanks won't be able to compete effectively on price, we are concerned that competition will occur in collateral and credit standards, increasing risk throughout the System. Proponents of multidistrict membership argue that regulation and self-regulation can address this issue. We are not so sure.

Multidistrict membership again raises the issue of consolidation. If membership is separated from charter location, what reason is there for 12 FHLBanks? In the absence of a regional focus based on member charters, isn't it more likely that administrative difficulties and other issues will render the current structure irrelevant?

The mortgage purchase programs are here to stay, and the forces set in motion by those programs will have a lasting effect on the System. The other three issues are under debate right now, but each one is being discussed as a separate, independent issue. However, if they are all decided in the direction of change from the existing structure, we will end up with a very different System. The question is, how radically do we want the System to change? By examining the issues before us in an integrated way and looking at their long-term implications, we may find good reasons for seeking to accommodate change within the existing structure.

The point we wish to make to you – the members, borrowers, and stakeholders in the System – is that as the System evolves, you must be vigilant to protect what you find valuable in your relationship with the Bank. By working together to define the issues clearly, to anticipate possible unintended

consequences, and to explore alternate ways to maintain the value of the System to its members, we may be able to preserve the essential benefits that the System now delivers to local financial institutions and their communities.

In closing, we thank the Bank's directors for their leadership of the Bank. In particular, we would like to acknowledge the contributions of outgoing directors Roberta Achtenberg, Daniel R. Ortega, Jr., Charles R. Rinehart, Herbert M. Sandler, and Richard H. Terzian, and welcome new board members Timothy R. Chrisman, Frank P. Pekny, Connie R. Wilhelm, and Charlene Gonzales Zettel.

We thank the members of our Affordable Housing Advisory Council, who contribute so much to the accomplishment of the Bank's fundamental purpose of serving our communities. We also thank the Bank's employees for their dedication and hard work.

Finally, we thank you, the Bank's members, for using Bank resources to provide credit to your customers and neighborhoods, for working with us to improve those resources, and for taking an interest in protecting the long-term value of the Federal Home Loan Bank System to you and to the communities you serve.



D. Tad Lowrey

VICE CHAIRMAN OF THE BOARD



Mary Lee Widener

CHAIRMAN OF THE BOARD



Dean Schultz

PRESIDENT AND CEO

