

INTRODUCTION

At the Federal Home Loan Bank of San Francisco (Bank), our purpose is to enhance the availability of credit for residential mortgages and targeted community development by providing a readily available, low-cost source of funds for housing and community lenders. We are a wholesale bank—we link our customers to the worldwide capital markets and maintain a ready supply of liquidity so that funds are available when our customers need them. By providing needed liquidity and enhancing competition in the mortgage market, our credit and mortgage purchase programs benefit homebuyers and communities.

We are one of 12 regional Federal Home Loan Banks (FHLBanks) that serve the United States as part of the Federal Home Loan Bank System. Each FHLBank is a separate entity with its own board of directors, management, and employees. We operate under a federal charter and are a government-sponsored enterprise (GSE). We are regulated by the Federal Housing Finance Board (Finance Board), an independent federal agency. We are not a government agency and do not receive financial support from taxpayers. The U.S. government does not guarantee, directly or indirectly, the debt securities or other obligations of the Bank or the FHLBank System.

We have a unique, cooperative ownership structure. To access our products and services, a financial institution must be approved for membership and purchase capital stock in the Bank. The member's stock requirement is generally based on its use of Bank products, subject to a minimum membership requirement that reflects the value of having ready access to the Bank as a reliable source of low-cost funds. Bank stock can be issued, exchanged, redeemed, and repurchased only at its stated par value of \$100 per share. It is not publicly traded.

Our members are financial services firms that represent a number of different sectors. As of December 31, 2003, the Bank's membership comprised 233 commercial banks, 71 credit unions, 39 savings institutions, 9 thrift and loan companies, and 1 insurance company. Their principal places of business are located in Arizona, California, or Nevada, the three states that make up the 11th District of the FHLBank System, but many do business in other parts of the country. Members range in size from institutions with less than \$10 million in assets to the largest savings institution in the nation with assets of over \$200 billion.

Our primary business is making low-cost, collateralized loans, known as "advances," to our members. Advances may be fixed or adjustable rate, with terms ranging from one day to 30 years. We accept a wide range of collateral types, some of which cannot be pledged elsewhere or readily securitized. Members use advances to lower their funding costs, facilitate asset/liability management, manage interest rate risk, reduce on-balance sheet liquidity, offer a wider range of mortgage products to their customers, and improve profitability. Because members retain ownership of the loans they pledge to us, these loans do not have to meet the rigid investment criteria of the secondary market, which allows members greater underwriting flexibility and enables them to serve underserved communities more effectively.

To fund advances, the FHLBanks issue debt (consolidated obligation bonds and discount notes) through the FHLBank System's Office of Finance, which manages the issuance and servicing of consolidated obligations on behalf of the 12 FHLBanks. Because the FHLBanks' consolidated obligations are rated Aaa by Moody's Investors Service and AAA by Standard & Poor's, the FHLBanks are able to raise funds at rates that are close to U.S. Treasury security yields. Our modest administrative costs allow us to pass these low funding rates on to our members.

In addition to advances, we provide members with a competitive alternative to the traditional secondary mortgage market through our mortgage purchase program, the Mortgage Partnership Finance® (MPF®) Program. ("Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.) Members also benefit from our affordable housing and economic development programs, which provide grants and discounted loans that support their involvement in creating affordable housing and revitalizing communities.

OUR BUSINESS MODEL

Our unique purpose and structure have led us to develop a business model that is different from that of a typical financial services firm. Our business model is based on the premise that we maintain a balance between our obligation to provide adequate returns on the private capital provided by our members and our obligation to achieve our public policy mission to promote housing, homeownership, and community development. We achieve this balance by delivering low-cost credit to help members meet the credit needs

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 negatives 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; the Bank's new capital structure; membership changes; 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. This report, including 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 43.

of their communities while paying members a market-rate dividend. Reflecting our nature as a cooperative, our financial strategies are also designed to enable us to expand and contract our assets, liabilities, and capital in response to changes in membership composition and member credit needs.

The value of membership in the Bank derives primarily from two aspects:

- the relatively low rates at which members can borrow, as a result of our ability to raise funds in the capital markets at a low cost because of our AAA-rating and our status as a GSE, and
- the dividends we pay.

Unlike most financial institutions, our dividends represent a large portion of our earnings. In addition, our earnings are largely the result of earnings on the capital stock issued to our members, while net earnings on member advances, mortgage loans, mortgage-backed securities (MBS), and other investments are generally used to pay our operating expenses and other costs (with additional earnings, if any, also contributing to the dividend).

Here's how it works:

- Each member is required to buy a certain amount of capital stock to join the Bank. Above a certain threshold, this requirement is proportional to the member's use of advances and sales of mortgage loans to the Bank under the MPF Program.
- The Bank invests the proceeds from the sale of capital stock 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 when a member reduces its use of Bank products or withdraws from membership. These investments provide the Bank with a market-rate yield, which may be returned to the members through the dividend.
- The capital is leveraged through the issuance of FHLBank System debt.
- Most of the funds raised through debt issuance are loaned to members as advances at a nominal mark-up over the Bank's cost of debt.
- The remainder of the funds raised through debt issuance is used to maintain the Bank's liquidity and investment portfolios (primarily mortgage-backed securities and mortgage loans) to provide financial flexibility and income.
- The net interest income from advances and the liquidity and investment portfolios is used to pay operating expenses and other costs and to help keep advance prices low while enabling the Bank to pay a market-rate dividend.

Our capital grows when members purchase additional stock to support their advance borrowings and the mortgage loans they have sold to the Bank, when members that are not using Bank products (or are using them to a small degree) experience an increase in their membership stock requirement because of asset growth, and when new members join the Bank.

This business model has worked well by requiring members to provide capital to support their activities with the Bank. Our Board of Directors has adopted a policy that balances the trade-off between credit prices and potential dividends. We target the potential dividend, which moves with interest rates, to approximate the yield on a short-term bond fund and hold credit prices down to provide lower borrowing rates to our members. This policy is intended to provide all members with a market rate of return on their stock and to reward borrowing members by providing low advance rates.

In keeping with this business model, we measure our financial performance by comparing the potential dividend yield on our capital stock to a dividend benchmark. The potential dividend yield is current period earnings (excluding fair value adjustments and other adjustments for nonrecurring items) stated as a percentage of total capital stock. The dividend benchmark reflects our strategy for investing the capital provided by members. It 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 difference between the potential dividend yield and the dividend benchmark represents the incremental financial return on the members' investment in Bank capital stock relative to the return on a comparable investment in Federal funds and intermediate-term Treasury investments.

PRODUCTS AND SERVICES

Advances. We offer a wide array of fixed and adjustable rate loans, called advances, with maturities ranging from one day to 30 years. We offer both standard and customized advance structures, including option-embedded advances and amortizing advances.

All advances must be fully collateralized. To secure advances, members may pledge one- to four-family residential mortgage loans, multifamily mortgage loans, mortgage-backed securities, U.S. government and agency securities, deposits in the Bank, and certain other real estate-related collateral, such as commercial real estate loans. We may also accept secured small business, small farm, and small agribusiness loans as collateral from members that are community financial institutions.

To determine the maximum amount and term of the advances we will lend to a member, we assess the member's credit-worthiness and financial condition. We also value the collateral pledged to the Bank and conduct periodic collateral reviews to establish the amount we will lend against each collateral type for each member. We require delivery of all securities collateral, and we may also require delivery of loan collateral under certain conditions (for example, from a newly formed institution or when a member's credit-worthiness deteriorates).

As of December 31, 2003, we had \$92.3 billion of advances outstanding. The value of all collateral pledged by members as of that date was \$167.8 billion. Based on the collateral held as security for advances, our policies and procedures for managing credit risk, and the fact that we have never had a credit loss on an advance, we have not established a loan loss allowance for advances.

Our advance products are designed to help members compete effectively in their markets and meet the credit needs of their communities. For lenders that choose to retain the mortgage loans they originate as assets (portfolio lenders), advances may serve as a funding source for a variety of conforming and nonconforming mortgages. As a result, advances support a variety of housing markets, including those focused on low- and moderate-income households. For members that sell or securitize mortgages and other assets, advances can provide interim funding.

Our credit products also help members with asset-liability management. Members can use a variety of advance types, with different maturities and payment characteristics, to match the characteristics of their assets and reduce their interest rate risk. We offer advances that are callable at the member's option and advances with embedded caps and floors, which can reduce the interest rate risk associated with holding fixed rate mortgage loans and adjustable rate mortgage loans with embedded caps in portfolio.

Standby Letters of Credit. We also provide members with standby letters of credit to support certain obligations of the members to third parties. Members may use standby letters of credit to facilitate residential housing finance and community lending or for liquidity and asset-liability management. Our underwriting and collateral requirements for standby letters of credit are the same as the underwriting and collateral requirements for advances. As of December 31, 2003, we had \$1.0 billion in standby letters of credit outstanding.

Mortgage Loans. To provide our members with an alternative to holding conforming fixed rate residential mortgage loans in portfolio or selling them into the secondary market, we began purchasing mortgage loans from members under the MPF Program in 2002. Under the program, we buy qualifying 15-, 20-, and 30-year conventional conforming and government-guaranteed fixed rate mortgage loans on single-family residential properties. We may sell participations in all or a portion of the purchased loans to one or more of the other FHLBanks. We manage the liquidity, interest rate, and prepayment risk of the loans held, while the member manages the origination and servicing activities. We share the credit risk of the loans with the member—we assume the first loss obligation limited by a First Loss Account (FLA), and the member assumes credit losses in excess of the FLA, up to the amount of the credit enhancement obligation specified in the master agreement. The amount of the credit enhancement is calculated so that any credit losses to the Bank

(excluding special hazard losses) in excess of the enhancement are limited to those expected from an equivalent investment with a long-term credit rating of AA. The participating member receives a credit enhancement fee from us for managing this portion of the credit risk in the loans.

Affordable Housing Program. Through our Affordable Housing Program (AHP), we provide subsidies to assist in the purchase, construction, or rehabilitation of housing for households earning up to 80% of the median income for the area in which they live. Each year, we set aside approximately 10% of the current year's net income for the AHP, to be awarded in the following year. All subsidies are funded to affordable housing sponsors or developers through our members in the form of direct grants or discounted advances. Since 1990, we have provided nearly \$318 million in AHP grants, which have resulted in the creation of approximately 61,000 affordable homes.

Approximately 80% of our annual AHP subsidy is allocated to our competitive AHP, in which applications for specific owner-occupied and rental housing projects are submitted by members and are evaluated and scored by the Bank in a competitive process that occurs twice a year. The remaining 20% is offered to homebuyers through two homeownership set-aside programs, in which members reserve funds to be used as matching grants for eligible homebuyers.

Discounted Credit Programs. We offer two discounted credit programs that may be used in conjunction with advances and standby letters of credit. The Community Investment Program may be used to fund mortgages for low- and moderate-income households, to finance first-time homebuyer programs, to create and maintain affordable housing, and to support other lending activities related to housing for moderate-income families. The Advances for Community Enterprise (ACE) Program may be used to fund projects and activities that create or retain jobs or provide services or other benefits for low- and moderate-income people and communities. ACE funds may be used to support community lending and economic development, including small business, community facilities, and public works projects.

FUNDING SOURCES

Debt Financing. We obtain most of our funds from the sale to the public of the FHLBanks' debt instruments (consolidated obligations), which consist of bonds and discount notes. Consolidated obligations are the joint and several obligations of all the FHLBanks and are sold to the public through the Office of Finance using authorized securities dealers. Although consolidated obligations are backed only by the financial resources of the 12 FHLBanks and are not guaranteed by the U.S. government, the capital markets have traditionally treated the FHLBanks' consolidated obligations as "federal agency" debt, providing the FHLBanks with access to funding at relatively favorable rates. Moody's has rated the consolidated obligations Aaa/P-1, and Standard & Poor's has rated them AAA/A-1+.

Finance Board regulations govern the issuance of debt on behalf of the FHLBanks and related activities. The regulations authorize the FHLBanks to issue consolidated obligations through the Office of Finance under the authority of section 11(a) of the FHLB Act. Through December 31, 2000, the Finance Board issued consolidated obligations on behalf of the FHLBanks through the Office of Finance. All of the FHLBanks are jointly and severally liable for the consolidated obligations.

The Office of Finance has responsibility for facilitating and approving the issuance of the consolidated obligations. It also services all outstanding FHLBank debt, serves as a source of information for the FHLBanks on capital market developments, and prepares the FHLBanks' combined quarterly and annual financial statements. In addition, it administers the Resolution Funding Corporation (REFCORP) and the Financing Corporation (FICO), two corporations established by Congress in the 1980s to provide funding for the resolution and disposition of insolvent savings institutions.

Consolidated Obligation Bonds – Consolidated obligation bonds satisfy term funding requirements and are issued under various programs. Typically, the maturities of these securities range from 1 to 15 years, but the maturities are not subject to any statutory or regulatory limit. The bonds can be fixed or adjustable rate and callable or non-callable. They are issued and distributed daily through negotiated or competitively bid transactions with approved underwriters or selling group members.

Consolidated Obligation Discount Notes – The FHLBanks also sell consolidated obligation discount notes to provide short-term funds for advances to members and for other investments. These securities have maturities up to 360 days and are offered daily through a consolidated obligation discount-note selling group and through other authorized securities dealers. Discount notes are sold at a discount and mature at par.

USE OF INTEREST RATE EXCHANGE AGREEMENTS

We use interest rate exchange agreements (exchange agreements), also known as “derivatives,” as part of our interest rate risk management and funding strategies to reduce identified risks inherent in our normal course of business. Exchange agreements include interest rate swaps (including callable swaps and putable swaps), swaptions, interest rate cap and floor agreements, and futures and forward contracts. The Finance Board's regulations, its Financial Management Policy, and the Bank's Risk Management Policy all establish guidelines for our use of exchange agreements. These regulations and policies prohibit trading in exchange agreements for profit and any other speculative use of these instruments. They also limit the amount of credit risk allowable from exchange agreements.

We primarily use exchange agreements to manage our exposure to changes in interest rates. The goal of our interest rate risk management strategy is not to eliminate interest

rate risk, but to manage it within appropriate limits. One key way we manage interest rate risk is to acquire and maintain a portfolio of assets and liabilities, which, together with their associated exchange agreements, are conservatively matched with respect to the expected maturities or repricings of the assets and the liabilities. We may also use exchange agreements to adjust the effective maturity, repricing frequency, or option characteristics of financial instruments (like advances and outstanding bonds) to achieve risk management objectives. From time to time, we may also use exchange agreements to act as a counterparty to member institutions for their own risk management activities.

At December 31, 2003, the total notional amount of our outstanding exchange agreements was \$126.8 billion. One important point about the risk of exchange agreements is that the contractual or notional amount of an exchange agreement is not a measure of the amount of credit risk from that transaction. The notional amount serves as a basis for calculating periodic interest payments or cash flows.

We are subject to credit risk in all derivatives transactions because of the potential nonperformance by the derivative counterparty. We reduce this credit risk by executing derivatives transactions only with highly rated financial institutions. In addition, the legal agreements governing our derivatives transactions require the credit exposure of all derivative transactions with each counterparty to be netted and require each counterparty to deliver high quality collateral to us once a specified unsecured net exposure is reached. At December 31, 2003, the maximum credit exposure of the Bank was approximately \$266 million; after delivery of required collateral the unsecured net credit exposure was approximately \$50 million.

The market risk of derivatives can only be measured meaningfully on a portfolio basis, taking into account the entire balance sheet and all derivatives transactions. The market risk of the derivatives and the hedged items is included in the measurement of our duration gap (the difference between the expected weighted average maturities of our assets and liabilities), which was 0.6 months at December 31, 2003. This low interest rate risk profile reflects our conservative asset-liability mix.

CAPITAL

From its enactment in 1932, the FHLB Act provided for a subscription-based capital structure for the FHLBanks. The amount of capital stock that each FHLBank issued was determined by a statutory formula establishing how much FHLBank stock each member was required to purchase. With the enactment of the Gramm-Leach-Bliley Act of 1999 (GLB Act), Congress replaced the statutory subscription-based member stock purchase formula with requirements for total capital, leverage capital, and risk-based capital for the FHLBanks and required the FHLBanks to develop new capital plans to replace the previous statutory structure.

We will implement our new capital plan on April 1, 2004. In general, the capital plan requires each member to own stock in an amount equal to the greater of a membership stock requirement or an activity-based stock requirement. We may adjust these requirements from time to time within limits established in the capital plan.

The new capital plan is similar to the prior capital structure because it bases the stock purchase requirement on the level of activity a member has with the Bank, subject to a minimum membership requirement that reflects the value of having access to the Bank as a reliable funding source.

Bank stock cannot be publicly traded, and it can be issued, exchanged, redeemed, and repurchased only at its stated par value of \$100 per share. Under our new capital plan, capital stock may be redeemed upon five years' notice, subject to certain conditions. In addition, the Bank has the discretion to repurchase excess stock from members. Overall, we expect the new plan to result in a similar level of total capital. Ranges we have built into the capital plan will allow us to adjust the stock purchase requirement to meet our regulatory capital requirements, if necessary.

Until we fully implement our capital plan, the current capital rules remain in effect. For more information on capital requirements, see Note 13 in the Notes to the Financial Statements.

COMPETITION

Demand for Bank advances is affected by many factors, including the availability and cost of other sources of funding for members, including retail deposits. We compete with our members' other suppliers of wholesale funding, both secured and unsecured. These suppliers may include securities dealers, commercial banks, and, in certain circumstances, other FHLBanks. (Under the FHLB Act and Finance Board regulations, affiliated institutions may be members of different FHLBanks.)

Members may have access to alternative funding sources through sales of securities under agreements to resell. Larger members may have access to many more funding alternatives, including independent access to the national and global credit markets. The availability of alternative funding sources for members can significantly influence the demand for our advances and can vary as a result of many factors, including, among others, market conditions, members' creditworthiness, and the availability of collateral.

We also compete, primarily with Fannie Mae and Freddie Mac, for the purchase of mortgage loans from members. We compete primarily on the basis of price, products, structures, and services offered.

The FHLBanks also compete with the U.S. Treasury Department, Fannie Mae, Freddie Mac, and other GSEs, as well as corporate, sovereign, and supranational entities, for funds raised through the issuance of unsecured debt in the national and global debt markets. Increases in the supply of competing debt products may, in the absence of increases in demand, result in higher debt costs or lesser amounts of debt issued at the same cost than otherwise would be the case.

ADVANCES CONCENTRATION

For the advances-related business, at December 31, 2003, we had a concentration of advances totaling \$62.0 billion outstanding to three members, representing 67% of total advances outstanding. At December 31, 2002, we had a concentration of advances totaling \$58.1 billion outstanding to three members, representing 72% of total advances outstanding. Advances held by these three members generated \$1.1 billion or 59%, \$1.9 billion or 67%, and \$4.0 billion or 76% of advances interest income before the impact of interest rate exchange agreements for the years ending December 31, 2003, 2002, and 2001, respectively.

Because of this concentration in advances, we have implemented specific credit and collateral review procedures for these members. In addition, we analyze the implications for our financial management and profitability if we were to lose the advances business of one or more of these customers.

REGULATORY OVERSIGHT, AUDITS, AND EXAMINATIONS

The FHLBanks are supervised and regulated by the Finance Board, which is an independent agency in the executive branch of the U.S. government. The Finance Board ensures that the FHLBanks carry out their housing and community development finance mission, remain adequately capitalized and able to raise funds in the capital markets, and operate in a safe and sound manner. The Finance Board also establishes regulations governing the operations of the FHLBanks.

The Finance Board is supported entirely by assessments from the 12 FHLBanks. To assess the safety and soundness of the Bank, the Finance Board conducts an annual on-site examination of the Bank and off-site reviews of its financial operations. In addition, the Bank is required to submit monthly financial information on the condition and results of operations of the Bank to the Finance Board.

The Bank has an audit committee of the Board of Directors and an internal audit department. An independent public accounting firm audits the Bank's annual financial statements. The independent accountant conducts these audits following Generally Accepted Auditing Standards of the United States of America and Government Auditing Standards issued by the Comptroller General. The Bank, the Finance Board, and Congress all receive the audit reports. The Bank must submit annual management reports to Congress, the President of the United States, the Office of Management and Budget, and the Comptroller General.