to our MEMBERS

Regulatory reform. Supervisory agreements. SEC registration. Accounting issues. Mortgage securitization authority. The quiet world of the Federal Home Loan Banks isn't so quiet anymore. We are not saying that the issues making the headlines aren't important – they are. We support a world class regulator for the housing GSEs. Accounting must be consistent with GAAP. SEC registration will lead to enhanced disclosure. Risk must be well managed and controlled. All of these things are critical, but there is something even more essential: we must never lose sight of the fact that the FHLBank System is achieving its basic mission. The FHLBank System works, and any changes to it must be thoroughly examined and understood to ensure that it will continue to work just as effectively in the future.

The FHLBanks are lenders of first resort, using their capital markets access to provide liquidity to member institutions at very low rates. The ability to borrow funds reliably, on short notice, and at capital market rates, is the principal benefit of FHLBank membership. Advances help members lower their funding costs, manage interest rate risk, and offer a greater variety of credit products to their customers. In addition, because members can rely on the FHLBanks as a source of standby liquidity, they can operate with lower liquidity levels than non-members. This, in turn, means that members can invest a larger portion of total assets in higher-yielding, community-based assets than their non-member counterparts can.

Over 8,000 insured financial institutions currently belong to the FHLBank System, up from approximately 2,000 in 1990. This impressive growth, which reflects the expansion of member eligibility to include commercial banks, credit unions, and insurance companies, occurred during a time of ongoing consolidation in the financial services sector and demonstrates the value of FHLBank membership. Thanks to its members, the FHLBank System continues to do the job it was designed to do—provide liquidity to portfolio lenders to help them meet the credit needs of their communities. As of June 2004, insured financial institutions (including both members and non-members) held $2.7 trillion in residential mortgage loans in portfolio, and the members of the FHLBanks had borrowed $564 billion in advances, supporting 21% of that total.

The FHLBank System's members are very diverse, serving a variety of customers and communities in many different ways. While the largest members borrow the most and make it possible for the FHLBanks to achieve sufficient scale to operate efficiently, most FHLBank members and most borrowing members are financial intermediaries of moderate size that do not have direct access to the capital markets. For example, commercial banks with total assets of $200 million or less account for 73% of all commercial banks, and nearly three-quarters of these banks have joined the FHLBank System. At yearend 2004, 67% of these smaller commercial bank members had advances outstanding, which represented over 75% of their total wholesale borrowings. Among savings institutions, 54% have total assets of $200 million or less, and 97% of them are FHLBank members. At yearend, 61% of these smaller savings institution members had advances outstanding, which represented over 94% of their total wholesale borrowings. Without the FHLBanks, these important community-based lenders would not have ready access to funding at capital market rates.

Time and again, the FHLBank System has demonstrated its ability to shrink and grow in response to member credit demand while maintaining its own financial safety and soundness. In fact, while recent attention has been directed to the size and growth of the FHLBank System, from 2001 through August 2003, several FHLBanks experienced significant contraction, in one case by almost 60%. From late 2003 on, the FHLBanks once again have grown rapidly. This ability to respond to rapid changes in member credit demand without disruption to the capital or housing markets is one of the principal macroeconomic stabilization benefits of the FHLBank System, one that was incorporated into its original design.

The FHLBank System has also proven to be flexible enough to expand its function to encompass community economic development. In recent years, the FHLBanks have begun accepting a much wider range of collateral from their members, particularly members that qualify as “community financial institutions” because of their smaller asset size.

When members pledge residential mortgages held in portfolio and other eligible loans as collateral for advances, they are able to use the borrowed money to make more loans, which in turn are used as collateral to borrow again. This process, in effect, “liquefies” the loans. As a result, member institutions can operate as portfolio lenders, meaning that they keep the mortgages that they originate on their books, rather than selling the loans to others.

Collateralization of advances, along with credit underwriting of members, also significantly reduces credit risk for the FHLBanks. In fact, none of the FHLBanks has ever experienced a credit loss on an advance.

By holding loans in portfolio, lenders retain and expand their long-term relationships with their customers and directly invest in their communities. Lenders also have greater flexibility and control over their underwriting decisions; they can adjust their guidelines to meet the needs of the surrounding communities rather than restrict loans to those that meet narrow secondary market guidelines. This consideration of intangibles, or “character lending,” can mean the difference between loan approval and rejection for many families and individuals. Home Mortgage Disclosure Act data have shown that FHLBank members originate mortgage loans to minorities and women applicants at higher rates than non-members. In addition, members are at the forefront of funding mortgages for working families. In California in 2003, the median home price was $367,630, and 71% of all loans originated by Bank members were below the median.

The FHLBanks have been successful in accomplishing their mission of supporting homeownership and residential mortgage finance for over 70 years. Together, the FHLBanks and their members have helped the United States achieve a record homeownership rate of 69% and become one of the best housed nations in the world. In the process, the FHLBanks have become an important source of liquidity to a majority of the nation’s insured financial institutions. Despite this stellar record, there are some calls to make changes to the FHLBank System, including privatization of the FHLBanks. Without a comprehensive vision and a clear understanding of the consequences that any changes to the FHLBank System could have on the housing markets and the economy, this is not the time to experiment on an FHLBank System that works.

Even as we ponder the big picture issues facing the FHLBank System in light of its value to members and their communities, the Federal Home Loan Bank of San Francisco remains focused on the day-to-day work that enables us to meet our members' funding needs, deliver a market-rate dividend, and remain financially strong.

In 2004, members of all sizes and charter types increased their demand for Bank credit significantly. We met this demand by providing funding at very competitive rates and increased our advances outstanding by 52%, reaching a record $140 billion by yearend. This, in turn, caused total assets to increase to $185 billion by yearend.

The absolute size of the Bank is not a measure of our success, but our ability to meet the funding needs of our members is. While most of the $48 billion increase in advances was driven by mortgage portfolio growth among our largest members, $9.5 billion represented borrowings from the other members. In all, 151 members increased their advance balances during the year.

We are pleased that we were able to manage this growth effectively and continue to pay dividends that were above our benchmark. Our dividend rate for 2004 was 4.07%, and the spread between the dividend and the dividend benchmark increased to 1.58% for 2004 from 1.50% for 2003.

We continued to expand our membership base during 2004. We welcomed 36 new members during the year, including 29 commercial banks, 4 credit unions, and 3 insurance companies, bringing the total number of members to 356.

In 2004, we awarded $44.2 million in Affordable Housing Program grants to 111 projects, sponsored by 43 different members, to support the creation of 7,075 units of affordable housing. Twenty-five members reserved $5.5 million in grants under our two homeownership set-aside programs, the Individual Development and Empowerment Account (IDEA) Program and the Workforce Initiative Subsidy for Homeownership (WISH) Program. In addition, members borrowed $1.0 billion in Community Investment Program (CIP) and Advances for Community Enterprise (ACE) Program advances in 2004, and we issued $108.8 million in CIP and ACE standby letters of credit during the year.

We managed the year's substantial growth while converting to our new capital plan, preparing to register our capital stock with the SEC, and remaining focused on maintaining a control environment that is intended to avoid adding risk to members through ownership of Bank stock.

One thing the headlines make clear is that it is not easy to manage a large, complex financial institution today. For this year's success, we would like to thank the Bank's management and staff, who strive on a daily basis to ensure that the Bank continues to work for our members and their communities.

We also thank our directors, who represent the members of this cooperative and the interests of our region so ably, bringing their broad experience and regional knowledge to bear on the wide range of issues facing the Bank. For their prior service on the board, we thank outgoing Chairman Robert N. Barone and outgoing Directors Frank P. Pekny and John T. Wasley. We welcome David A. Funk and Michael Roster to the board.

In addition, we thank the members of our Affordable Housing Advisory Council, who help us make our affordable housing and community investment programs more effective in meeting the diverse needs of our region. In particular, we thank outgoing members Monique Lawshé, Glenn D. Hayes, and Rodney E. Fernandez for their valuable insights over the years. We welcome Manuel H. Bernal, Robin R. Hughes, and Trinh LeCong to the Council. We would also like to express our sorrow at the death of David Ferguson, who had served on the Council for the last four years. David was a forthright, knowledgeable, and dedicated partner with the Bank and our members before and during his service on the Council.

In closing, we thank you, our members, for delivering the benefits of this cooperative to your neighborhoods and communities. Your membership in the Bank, your use of our products and services, your participation in our affordable housing and community investment programs–all of these contribute to our mutual success and the achievement of our housing mission, to ensuring that the FHLBank System works.

Timothy R. Chrisman
CHAIRMAN OF THE BOARD

Kenneth R. Harder
VICE CHAIRMAN OF THE BOARD

Dean Schultz
PRESIDENT AND CEO