

To Our Members

The meltdown in the housing and financial markets that began in 2007 accelerated dramatically in 2008, plunging the U.S. financial system into what some believe is its worst crisis since the 1930s. While there is sporadic evidence that the bottom to this crisis may be near, many procyclical forces are at work. Credit markets remain frozen, foreclosure filings are still on the rise, and companies are cutting costs and laying off workers, all of which may lead to further declines in real estate values and in commercial and consumer spending. Many financial institutions, large and small, are struggling to extend credit in this extraordinarily challenging environment.

In the last year, the federal government has intervened in the financial markets in a massive way, seeking to minimize the damage to both the national and global economies through a variety of specific transactions and broader programs. Some of these interventions have clearly been helpful, some have had mixed results, and some will require more time to assess. These stop-gap measures were necessary to address immediate threats to the financial system, but policymakers are beginning to consider longer-range proposals to address issues like systemic risk, regulatory reform, and oversight of certain sectors of the mortgage and capital markets that had previously been subject to little or no formal regulation.

There are many differing points of view about the root causes of the financial crisis, the actions that have been or could be taken to stabilize the markets and the economy, and the changes that must be made to prevent anything like this from ever occurring again. As these issues are analyzed and debated, it is crucial to keep in mind not only what has gone wrong, but also what has gone right. This crisis has clearly demonstrated the value of having a large, diversified base of community-oriented lenders serving our nation. It has also shown the importance of ensuring that those community-based lenders have access to stable, low-cost, flexible funding from the Federal Home Loan Banks.

The Federal Home Loan Bank of San Francisco has typically played a stabilizing, countercyclical role in tough times by acting as a reliable source of low-cost credit when other funding sources became too costly or disappeared entirely. In addition, our ability to adjust our capital level in response to changes in our member base and in our members' credit needs has enabled us to maintain our financial strength during all phases of the business cycle.

We have continued to play a vital, stabilizing role throughout the current crisis. In the second half of 2007, when the liquidity crisis first hit and other funding sources evaporated overnight, we continued to provide liquidity to our members, and advances increased significantly. In 2008, member demand for advances fluctuated as lending activity diminished in response to disruptions in the secondary market for residential mortgages, tighter underwriting standards, lender concerns about preserving capital, new federal lending programs, and a contracting economy. Despite some considerable challenges, we met member funding needs throughout

the year. During 2008, 213 members increased their borrowings from the Bank, while 113 members reduced their borrowings. Total advances outstanding decreased to \$235.7 billion at yearend 2008 from \$251.0 billion at yearend 2007, after reaching a peak of \$263.0 billion at September 30, 2008.

Fulfilling our primary mission of providing liquidity to members has not been easy. Several factors have made it more difficult to play a countercyclical role during the present crisis, including the severity and duration of the turmoil in the mortgage and financial markets; the precipitous drop in property values and the steep increase in delinquencies and foreclosures, particularly in Arizona, California, and Nevada, which have affected the value of mortgage loan and securities collateral; and the effect of the accounting rules for other-than temporary impairment of held-to-maturity securities. The initiatives and programs undertaken by the U.S. Treasury Department, the Federal Reserve, and the Federal Deposit Insurance Corporation to address the current crisis have had differing effects on the Bank, both positive and negative. As a consequence of all these factors, four essential elements of our business model have come under unusual stress at times during the crisis:

- Our ability to raise low-cost, long-term funds in the capital markets
- Our ability to meet member liquidity needs while ensuring that all advances remain fully collateralized
- Our ability to contract our capital in response to changes in our member base and in our members' credit needs
- Our ability to pay a market-rate dividend to our members

Capital Markets Access

Reliable access to low-cost funding in the capital markets is the cornerstone that enables us to fulfill our mission and implement our business model. For a variety of reasons, investors showed a general reluctance to buy longer-term obligations of the housing GSEs during the second half of 2008, although demand for short-term obligations remained strong. As a result, the FHLBanks experienced a significant increase in the cost of long-term debt compared to relevant market benchmarks. In response to these conditions, we met our liquidity needs primarily through the issuance of short-term discount notes during the second half of the year.

The funding challenges we faced in 2008 illustrated the complexity of the interrelationships among all financial market participants and showed how government actions and initiatives can reverberate throughout the marketplace. For example, following the conservatorships of Fannie

Mae and Freddie Mac, the cost of FHLBank debt actually increased relative to that of the other two housing GSEs, as some investors came to believe that Fannie Mae and Freddie Mac obligations had more explicit government support. The FDIC's temporary initiative to provide a 100% guarantee for senior unsecured debt newly issued by FDIC-insured institutions and their holding companies also put FHLBank debt at a competitive disadvantage.

Meeting the Funding Needs of Members Safely and Soundly

The AAA rating of the debt obligations of the Federal Home Loan Bank System and our ability to access the agency debt market depend on many factors, one of which is the fact that no FHLBank has ever experienced a credit loss on an advance. The Bank's careful and comprehensive approach to credit and collateral risk management is crucial to maintaining that track record, which in turn allows the Bank to provide low-cost advances to members. This component of our business model—effectively managing the credit and collateral risk of our advances business—has also been under great pressure in the current environment.

Throughout the present crisis, we have balanced the potentially conflicting goals of meeting the liquidity needs of individual members and ensuring the safety and soundness of the Bank for the sake of all members. Falling property values and rising delinquency and foreclosure rates have caused steep declines in the market value of the assets members pledge as collateral, and many member financial institutions have experienced deterioration in their creditworthiness.

By statute, the Bank is required to ensure that advances are fully collateralized. Throughout 2008, we adjusted our credit and collateral terms to address general market conditions and the specific circumstances of individual members. We believe these adjustments were necessary to protect our members' collective investment in the Bank. The crisis in the housing and mortgage markets has battered the three states that make up the 11th District, as property values have plummeted and delinquency and foreclosure rates have soared throughout Arizona, California, and Nevada. The Bank's credit and collateral terms are intended to address the heightened risk facing lenders with concentrations of mortgage assets in our district and other hard-hit areas.

We recognize the pressure our collateral valuation process places on our members, especially in times like these, when our members must demonstrate to their regulators that they have adequate contingent liquidity in this volatile environment. Throughout 2008, we worked with individual members to identify opportunities to increase the borrowing capacity of their collateral. In the coming year, we may have to make additional adjustments to our credit and collateral terms in response to market conditions, and we will continue to work with members to facilitate their ability to borrow from the Bank.

The Bank must always be prepared for the risk of member failures. In 2008, nine of the Bank's members were placed into receivership or liquidated, including two large members, Washington Mutual Bank and IndyMac Bank, F.S.B. During the third quarter, JPMorgan Chase Bank, National Association, a nonmember, assumed the outstanding advances and acquired the associated Bank capital stock of Washington Mutual Bank. The advances and associated capital stock of IndyMac Bank, F.S.B., were transferred to IndyMac Federal Bank, FSB, during the third quarter, with the FDIC appointed as conservator. During the first quarter of 2009, OneWest Bank, FSB, became a member of the Bank, assumed the outstanding advances of IndyMac Federal Bank, FSB, and acquired the associated Bank capital stock. Of the remaining seven institutions, two had advances outstanding that were transferred to a nonmember, while the rest had no advances or repaid the advances prior to yearend.

The Impact of OTTI

During the fourth quarter of 2008, ongoing stresses in the credit markets, substantial declines in real estate values, and increasing weakness in the U.S. economy continued to affect the loan collateral underlying certain non-agency mortgage-backed securities (MBS) in our held-to-maturity securities portfolio. As a consequence, the Bank was required to write down 15 non-agency MBS to fair value, resulting in an other-than-temporary impairment (OTTI) charge on the securities of \$590 million. Because of the severe lack of liquidity in the MBS market, which adversely affected MBS valuations, the OTTI fair value charge on the affected securities was far greater than the estimated credit losses on the 15 securities, which totaled \$27 million.

The Bank has both the ability and intent to hold these securities to maturity. We expect to recover most of the amount written down, as the difference between the OTTI charge and the estimated credit losses contributes to our net interest income over the remaining lives of the securities. Nevertheless, application of the OTTI accounting rules resulted in a substantial decline in net income and retained earnings. Our net income for 2008 was \$461 million, compared with net income of \$652 million for 2007. For the fourth quarter of 2008, we had a net loss of \$103 million. Retained earnings, which had grown to \$280 million at September 30, 2008, dropped to \$176 million at December 31, 2008.

In anticipation of a potential OTTI charge for the fourth quarter, the Bank decided not to pay a fourth quarter dividend or repurchase excess capital stock in January 2009 in order to continue building retained earnings and to preserve capital. As a result of this decision, the Bank's dividend rate for 2008 was 3.93%, compared to 5.20% for 2007.

As of December 31, 2008, the Bank was in compliance with all of its regulatory capital requirements. The Bank's total capital-to-assets ratio was 4.21%, exceeding the 4.00% requirement, and its risk-based capital was \$13.5 billion, well in excess of its \$8.6 billion requirement.

The OTTI accounting rules have put severe stress on two critical components of our business model—our ability to expand and contract Bank capital in response to changing member credit needs and our ability to pay a market-rate dividend to our members. The potential for future OTTI charges in the current distressed MBS market may continue to limit our ability to repurchase excess capital stock and to pay dividends. The Financial Accounting Standards Board recently issued new staff positions to provide additional guidance regarding fair value measurements and impairments of securities. We expect that the new standards will result in lower OTTI charges in net income because only credit-related losses will be reflected in net income, while non-credit-related losses will be reflected in other comprehensive income.

Membership Growth

The key motivator that drives financial institutions to join the Bank is reliable access to low-cost, short- and long-term credit that can be customized to meet their housing finance and other business needs. Bank advances are not only used for immediate liquidity or as a stable source of contingent liquidity, they are also a valuable tool for asset/liability management and interest rate risk management. During 2008, membership in the Bank grew from 405 members to 430 members. At yearend 2008, the Bank's membership included 293 commercial banks, 98 credit unions, 26 savings institutions, 10 thrift and loan companies, and 3 insurance companies.

Targeted Programs

In 2008, the Bank awarded \$79.5 million in Affordable Housing Program (AHP) grants to support 164 projects in Arizona, California, Nevada, and nine other states served by the Bank's members. The grants will leverage over \$1.5 billion in total development costs to create 9,344 affordable rental and homeownership opportunities for low- and moderate-income families and individuals. The 2008 amount is the highest ever awarded by the Bank in a single year, reflecting the Bank's strong financial performance in 2007. Lower earnings in 2008, chiefly caused by the OTTI charge, have unfortunately reduced the amount available for the 2009 AHP to \$53 million. Without the non-credit-related portion of the OTTI charge, the Bank would have been able to set aside approximately \$99 million for the 2009 AHP.

The Bank reached a significant AHP milestone in 2008, as the total amount of funds awarded since the program's inception passed the \$500 million mark. These funds, over \$530 million in all, will create close to 89,000 homes for low- and moderate-income households throughout the 11th District and in other regions served by our members.

The Bank also allocated \$7.8 million in homeownership set-aside grants to 32 members in 2008 under the Workforce Initiative Subsidy for Homeownership Program (WISH) and the Individual Development and Empowerment Account (IDEA) Program, which are both funded through the Affordable Housing Program.

Members borrowed over \$400 million in discounted advances under the Community Investment Program and the Advances for Community Enterprise program in 2008 to support their efforts to fund affordable housing and community economic development. The Bank also provided \$226 million in standby letters of credit under the two programs, including several for non-housing-related tax exempt bonds to finance an industrial development project and construction of three community facilities.

To facilitate member efforts to help struggling homeowners, in 2008 the Bank developed two new targeted programs. The Homeownership Preservation Advance Program, introduced in March 2008, has provided \$5 million in discounted advances to modify or refinance mortgages for homeowners at risk of losing their homes as a result of default or delinquency. Under the Homeownership Preservation Subsidy Program, introduced in September 2008, members have reserved \$4 million in matching grants to help restructure or refinance unaffordable mortgages into affordable fixed rate 30-year loans. With Arizona, California, and Nevada at the epicenter of the foreclosure crisis, we anticipate offering additional foreclosure prevention tools and solutions that can work in conjunction with national, state, and local programs to stabilize neighborhoods and keep qualified homeowners in their homes.

Funded at the discretion of our Board of Directors, the Access to Housing and Economic Assistance for Development (AHEAD) Program provides valuable early-stage funding to innovative affordable housing and economic development initiatives. In 2008, we awarded \$500,000 to 20 programs with a variety of goals, ranging from small business incubation and job training to financial literacy and foreclosure prevention. In response to the strong demand for these predevelopment grants, the Board has doubled the funding available for AHEAD in 2009 to \$1 million.

Preserving a System That Works

Since the current market turmoil began in the summer of 2007, the FHLBanks have been a powerfully stabilizing force in the economy, providing billions of dollars of liquidity to financial institutions throughout the nation. The policy decisions made this year will not only affect the resolution of the current crisis, but will lay the foundation for the future. We hope these decisions will create a more resilient and sustainable financial infrastructure, one that builds in appropriate levels of accountability and supervision and eliminates incentives that foster excessive leverage and risk-taking, but does not stifle innovation or stem the flow of credit to our communities.

We believe the Federal Home Loan Banks will play a crucial role as part of this resilient and sustainable financial infrastructure. Policymakers must not lose sight of the unique characteristics of the Federal Home Loan Bank System that have made it successful in the past and that should

be preserved: its self-capitalizing, cooperative ownership structure; its ready access to the capital markets; its ability to expand and contract its capital with changes in member demand for advances; its ability to provide credit to members on a secured basis; and its ability to fund the Affordable Housing Program and pay a reasonable return to members on the private capital they invest in the FHLBanks.

In closing, we thank our Board of Directors, Affordable Housing Advisory Council, management, and staff for their hard work and dedication in a volatile and challenging time.

Above all, we thank you, our members. We know that some of the actions we have taken to strengthen the Bank in the past year have been difficult for you. We thank you for your patience and understanding as we work through the issues that led us to suspend the dividend and halt the repurchase of excess capital stock. We will continue to focus on providing liquidity to members while we work to maintain the Bank's core economic performance and rebuild retained earnings, and we will keep you informed of our progress. As always, our primary objective is to provide you with the liquidity you need to meet the credit needs of your community, while maintaining the Bank's long-term financial strength and protecting your investment in the Bank.

Sincerely,



Timothy R. Chrisman
Chairman



James P. Giralдин
Vice Chairman



Dean Schultz
President and
Chief Executive Officer