To Our Members

Participants in the housing and financial markets were severely challenged in 2009 by the ongoing downturn in the economy, rising unemployment, declining property values, and increasing delinquency and foreclosure rates on residential mortgages and other real estate assets. The three states in our district—Arizona, California, and Nevada—remained among the hardest hit in the nation. By the end of the year, we began to see some signs of improvement in the overall economy, as the financial markets appeared to stabilize and some economic indicators moved in a favorable direction. "Guarded optimism" now seems to be the watchword of the day, but there is ongoing debate about the shape and speed of economic recovery. Even though many believe that the recession ended in 2009, its effects are continuing to be felt in homes and businesses across the country and are continuing to affect people's lives and livelihoods.

Like so many other organizations, the Federal Home Loan Bank of San Francisco felt the impact of the difficult environment in 2009. While the effects were significant, the Bank's performance also reflected the resilience of its cooperative structure and basic business model.

The Bank's net income for 2009 was $515 million, compared with net income of $461 million for 2008. Net income for 2009 reflected an other-than-temporary impairment (OTTI) charge related to credit of $608 million on some of the private-label residential mortgage-backed securities (PLRMBS) in the Bank's held-to-maturity securities portfolio. Net income for 2008 reflected an OTTI charge of $590 million on certain PLRMBS, which included a credit-related charge of $20 million and a non-credit-related charge of $570 million.

In early 2009, the Financial Accounting Standards Board issued additional guidance related to the recognition and presentation of OTTI. The Bank adopted this guidance as of January 1, 2009, and recognized the cumulative effect of initially applying the OTTI guidance, totaling $570 million, as an increase in retained earnings at January 1, 2009, with a corresponding decrease in accumulated other comprehensive income.

The credit-related OTTI charges of $608 million for 2009 resulted from projected credit losses on the mortgage loan collateral underlying the Bank's PLRMBS. Each quarter, the Bank updates its OTTI analysis to reflect current and anticipated housing market conditions and updated information on the loans underlying the PLRMBS and revises the assumptions in its collateral loss projection models based on more recent information. The increases in projected collateral loss rates in the Bank's OTTI analyses during 2009 reflect increases in projected loan defaults and in the projected severity of losses on defaulted loans. Several factors contributed to these increases, including lower forecasted housing prices and greater-than-expected deterioration in the credit quality of the loan collateral underlying the PLRMBS.

Because of uncertainty regarding the potential for additional credit-related OTTI losses on our PLRMBS, we focused on enhancing our capital strength in 2009. To help build retained earnings, we only paid dividends for the second and fourth quarters of 2009. The dividend rate for 2009 was 0.28% (annualized), compared to 3.93% for 2008. In addition, to preserve capital, we did not repurchase any excess capital stock in 2009.

These actions have been effective in strengthening the Bank's capital position. Retained earnings increased markedly, from $176 million at the end of 2008 to $1.2 billion at the end of 2009. While $129 million of this growth reflected an increase in cumulative net gains resulting from valuation adjustments, most of it reflected amounts set aside for the buildup of retained earnings to protect members' paid-in capital from the potential effects of various risks, including the risk of higher-than-anticipated credit losses related to other-than-temporary impairment of PLRMBS. The current target for the buildup amount is $1.8 billion, and the amount of restricted retained earnings designated for the buildup totaled $1.1 billion at the end of 2009.

As of December 31, 2009, the Bank exceeded all of its regulatory capital requirements. The Bank's total regulatory capital ratio was 7.60%, well above the 4.00% requirement, and its risk-based capital was $14.7 billion, more than double its $6.2 billion requirement.

We understand how important the payment of dividends and the repurchase of excess capital stock are to our members, and both are extremely high priorities for the Bank. We will continue to monitor the condition of our PLRMBS portfolio, our overall financial performance and retained earnings, developments in the mortgage and credit markets, and other relevant information as the basis for determining the status of dividends and capital stock repurchases.

The ownership structure of the Federal Home Loan Banks has attracted attention in the last few years, as policymakers debate the future structure of the housing finance system and the role of government-sponsored enterprises in housing finance. Unlike the other housing GSEs, the FHLBanks have always been

owned by their customers, through a cooperative and decentralized structure that allows the FHLBanks to balance their public policy mission and their commitments to their member shareholders, through which the FHLBanks achieve their mission. This cooperative ownership model has provided structural integrity to the FHLBank System.

Another important attribute of the Bank's business model is the ability to expand and contract in response to the changing credit needs of members. After rising dramatically at the height of the liquidity crisis in 2008, advances have returned to pre-crisis levels. By the end of 2009, advances had decreased to $133.6 billion, down from $235.7 billion at the end of 2008.

Many factors contributed to the drop in advance demand, including a decline in member lending activity in response to a contracting economy, tighter underwriting standards, and members' efforts to preserve and build capital. Members also had ample deposits and access to a number of other funding options, including a variety of government lending programs. In addition, the financial condition of many members deteriorated in 2009, and some members reduced their Bank borrowings in response to changes the Bank made to their credit and collateral terms. Economic conditions in the last few years also contributed to the failure of a number of Bank members, which resulted in the repayment of some advances and the transfer of some advances to nonmember financial institutions that are not eligible to obtain new advances or renew advances as they mature.

By design, the Bank's balance sheet is structured to adapt to fluctuations in advance demand, even on a large scale. Just as the Bank was able to expand its lending considerably in a short period of time at the height of the liquidity crisis, the Bank was able to adjust its balance sheet to the decline in advances, reducing its consolidated obligations and other liabilities as advances balances decreased. Total liabilities decreased from $311.5 billion at the end of 2008 to $186.6 billion at the end of 2009.

One aspect of the expansion-contraction pattern has changed, however. In the past, the Bank would normally have repurchased the excess capital stock associated with repaid and prepaid advances to reduce capital as the balance sheet contracted and maintain a relatively stable return on our members' investment in the Bank. As discussed above, the Bank's decision not to repurchase excess capital stock over the last five quarters has resulted in high balances of excess capital stock. Our business model works most effectively when capital stock expands and contracts with the level of member activity. Repurchasing excess capital stock benefits our members, maximizes the overall value of Bank membership, and enhances our ability to achieve our mission. For these reasons, the resumption of excess capital stock repurchases is a very high priority for the Bank.

Although aggregate demand for advances declined in 2009, the Bank continued to meet the ongoing and sometimes expanding credit needs of individual members throughout the year, with a particular focus on meeting those needs in a safe and sound manner. Our access to low-cost funding through the agency debt markets depends on a number of factors, one of which is our strong track record in credit and collateral risk management. In 2009, we continued to balance the twin goals of meeting the liquidity needs of individual members and protecting the interests of all members by focusing on making advances safely and soundly. We adjusted credit and collateral terms during the year, as needed, to reflect changes in collateral values and the mortgage and credit markets, while striving to be responsive to the needs of individual members.

In 2009, the twentieth year of the Affordable Housing Program, the Bank awarded $65.5 million in Affordable Housing Program grants to support 90 projects in Arizona, California, Nevada, and six other states served by the Bank's members. The grants, awarded in two competitive rounds during the year, will support $1.4 billion in total development to create 5,900 affordable rental and homeownership opportunities for low- and moderate-income families and individuals.

Our Affordable Housing Program also funds two first-time homebuyer programs—the Workforce Initiative Subsidy for Homeownership (WISH) Program and the Individual Development and Empowerment Account (IDEA) Program. In 2009, the Bank allocated $10 million to 31 members to provide matching grants of up to $15,000 per homebuyer.

As we celebrate the twentieth anniversary of the Affordable Housing Program, we are pleased to note that the Bank has awarded over $600 million in grants through our members to support the creation of 94,000 affordable homes in the program's first 20 years. Nationwide, the Affordable Housing Program of the 12 Federal Home Loan Banks is one of the largest private sources of grant funding for affordable housing.

In 2009, the Bank doubled the amount of funding available under the Access to Housing and Economic Assistance for Development (AHEAD) Program to $1 million. These grants will support 33 innovative housing and economic development projects during the critical conception and early development phases. These diverse projects will address a variety of needs, including foreclosure prevention, financial literacy, entrepreneurial training, and healthcare savings, to promote community stability and economic achievement in low- to moderate-income communities.

Throughout 2009, the Federal Home Loan Bank of San Francisco adapted to difficult, ever-changing circumstances while focusing on its primary mission—to provide the funding, liquidity, and risk management tools needed by our members to meet the credit needs of their communities. In the coming months and years, different challenges will arise for our members—such as the interest rate risk posed by a rising interest rate environment. We hope members will look to us for solutions to some of the financial and business risks they face.

The Federal Home Loan Bank System was conceived in 1932 by people responding to a financial and economic crisis far greater than the one we have been experiencing. Perhaps it should not be a surprise that when they designed the Federal Home Loan Banks, they incorporated the key attributes that continue to provide structural integrity and strength to the Federal Home Loan Bank System today—cooperative ownership by our customers, the ability to expand and contract the balance sheet in response to changes in membership composition and member credit needs, low-risk collateralized lending as our primary activity, and joint and several liability for our debt obligations that enhances our ready access to the capital markets. As the future of the mortgage finance system in America is debated and possible alternatives are weighed, it is important to remember what has worked well in the past, so that those elements can be preserved and enhanced in the future.

In closing, we thank our Board of Directors, Affordable Housing Advisory Council, management, and staff for their vigorous efforts to achieve the Bank's mission and their abiding commitment to meeting the needs of our members.

Most of all, we thank you, our members. In 2009, we took a number of actions that, while necessary to strengthen the Bank's financial position, were difficult for you. We appreciate your understanding and patience as we continue to focus on maintaining the Bank's long-term financial strength and on protecting your investment in the Bank. Above all, we will work to provide you with the funding and risk management tools you need to meet the credit needs of your communities and help spur recovery throughout our district and in the other regions of the country you serve.

Sincerely,

Timothy R. Chrisman
Chairman

Scott C. Syphax
Vice Chairman

Dean Schultz
President and
Chief Executive Officer