

Management's Discussion and Analysis

of Financial Condition and Results of Operations

2002 HIGHLIGHTS

The net income of the Federal Home Loan Bank of San Francisco (Bank) was \$292.2 million in 2002, a decrease of \$132.4 million, or 31%, from \$424.6 million in 2001. This decrease was partially due to an \$81.7 million decrease associated with the effects of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (SFAS 133) (see "Interest Rate Exchange Agreements" on page 27). In accordance with SFAS 133, the Bank recognized a net loss of \$31.6 million in 2002 compared to a net gain of \$50.1 million in 2001 (net of applicable Resolution Funding Corporation [REFCORP] and Affordable Housing Program [AHP] assessments). The net loss and net gain reflected the net impact from fair value adjustments and other changes made under SFAS 133, and from fair value adjustments made on held-at-fair-value securities reclassified from held-to-maturity securities upon the adoption of SFAS 133. Net interest income decreased \$58.5 million, or \$43.0 million after assessments, primarily due to lower earnings on invested member capital resulting from the lower interest rate environment in 2002 compared to 2001, combined with a reduction in total member capital. These decreases were partially offset by improved earnings from the Bank's mortgage-backed securities (MBS) portfolio, which resulted from higher investment balances and profit spreads. Also contributing to the decrease in net income for 2002 was an expense of \$6.9 million, after assessments, associated with an arbitration award to a member. The Bank's return on equity (ROE) decreased 176 basis points, to 4.73% in 2002 from 6.49% in 2001. The Bank's annual dividend rate was 5.45% for 2002, compared to 5.99% in 2001.

Since the cumulative net gains or losses from fair value adjustments made in accordance with SFAS 133 and on held-at-fair-value securities are primarily a matter of timing, the net gains or losses will generally be reversed over the remaining contractual terms to maturity of the financial instruments and associated interest rate exchange agreements. Therefore, in accordance with the Bank's retained earnings policy, the Bank restricts retained earnings for any cumulative net gains (net of applicable assessments) resulting from cumulative fair value adjustments. Excluding the impact of SFAS 133

in 2002, net income for the year would have been \$323.8 million, a decrease of \$50.7 million relative to 2001, and ROE for the year would have been 5.29%, a decrease of 44 basis points relative to 2001. These declines are primarily a result of the significant decline in interest rates and lower total member capital during 2002, which together reduced earnings on invested member capital, partially offset by improved earnings from the Bank's MBS portfolio.

Total assets declined \$19.3 billion, or 14%, to \$116.1 billion as of December 31, 2002. This decrease was primarily due to a \$21.0 billion, or 21%, decrease in advances to \$81.2 billion. On an average basis, in 2002 the Bank's advances decreased \$17.5 billion, or 16%, to \$90.1 billion, and total assets decreased \$13.9 billion, or 10%, to \$125.2 billion, relative to 2001. In contrast, average held-to-maturity securities increased \$2.8 billion, or 19%, to \$17.7 billion, and average securities purchased under agreements to resell (resale agreements) increased \$1.2 billion, or 77%, to \$2.7 billion.

FINANCIAL PERFORMANCE

The Bank seeks to maintain a balance between its public policy mission and its ability to provide adequate returns on the capital supplied by its members. The Bank achieves this balance by delivering low-cost financing to help members meet the credit needs of their communities while paying members a market-rate dividend. The dividends paid by the Bank are largely the result of the Bank's earnings on invested member capital, while net earnings on member credit, MBS, and other investments are generally used to pay the Bank's operating expenses and assessments (with additional earnings, if any, also contributing to the dividend).

Reflecting the Bank's nature as a cooperative, the Bank's financial strategies are designed to enable the Bank to expand and contract in response to member credit needs. The Bank invests member capital 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.

To measure its financial performance, the Bank compares the "potential dividend yield" on its capital stock to a dividend benchmark. The "potential dividend yield" is current

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; a 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. 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 37.

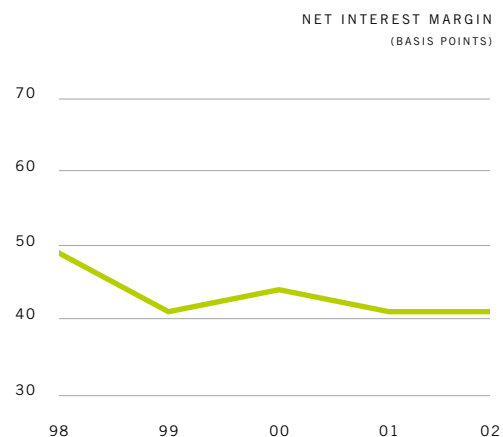
period earnings (excluding nonrecurring items and fair value adjustments) as a percentage of capital stock. The dividend benchmark reflects the Bank's capital investment strategy and is calculated as the average of two yields: the daily average of the overnight Federal funds effective rate and the four-year moving average of the four-year Treasury note yield. The spread between the potential dividend yield and the dividend benchmark represents the 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.



The spread to the dividend benchmark was 201 basis points for 2002 compared to 111 basis points for 2001. The Bank's potential dividend yield was 5.37% for 2002, a decrease of 43 basis points from 5.80% for 2001. The dividend benchmark was 3.36% for 2002, a decrease of 133 basis points from 4.69% for 2001. The dividend spread increased because of higher balances, leverage, and profit spreads on the MBS portfolio and the decline in market interest rates, as reflected in the dividend benchmark. Because of the effects of the REFCORP and AHP assessments, lower interest rates in 2002 resulted in a smaller decline in the post-assessment yield on invested capital relative to the decline of the dividend benchmark. This contributed to the increase in the spread of the potential dividend yield to the dividend benchmark in 2002 relative to 2001. An increase in interest rates would result in a corresponding reduction in the potential dividend spread. As a result of higher assessments, the increase in the potential dividend yield would be smaller than the increase in the dividend benchmark.

RESULTS OF OPERATIONS

Net Interest Income. Net interest income was \$495.8 million in 2002, a decrease of \$58.5 million, or 11%, from \$554.3 million in 2001. The decrease was primarily due to lower earnings on invested member capital resulting from lower interest rates in 2002 compared to 2001 and lower member capital, and, to a lesser degree, narrower profit spreads on advances and non-MBS investments. In addition, the effect of a \$14.4 billion decrease in average interest-earning assets contributed to the decrease in net interest income. These decreases were partially offset by improved earnings from the Bank's MBS portfolio resulting from higher investment balances and profit spreads. The net interest margin in 2002 remained unchanged at 41 basis points. The average yield on interest-earning assets in 2002 was 2.36%, compared to 4.50% in 2001, a decrease of 214 basis points. The average cost of interest-bearing liabilities decreased 226 basis points, to 2.06% in 2002 from 4.32% in 2001.



Other (Loss)/Income. Other (loss)/income was a net loss of \$27.7 million in 2002, a decrease of \$109.2 million compared to income totaling \$81.5 million in 2001. This decline was primarily due to fair value adjustments associated with derivatives and hedging activities, which decreased \$127.6 million, from a net gain of \$64.0 million in 2001 to a net loss of \$63.6 million in 2002. This decrease was partially offset by an increase of \$15.1 million resulting from fair value adjustments related to the Bank's held-at-fair-value securities and an increase of \$3.1 million in prepayment fees, as members

prepaid \$7.5 billion of advances in 2002 compared to \$1.9 billion in 2001. Other (loss)/income includes the amortization of deferred gains resulting from the 1999 sale of the Bank's office building in San Francisco, which totaled \$2.1 million in both 2002 and 2001, and fees earned on letters of credit of \$1.4 million in both 2002 and 2001. The remaining unamortized amount of the deferred gain on the sale of the building at December 31, 2002, was \$13.3 million.

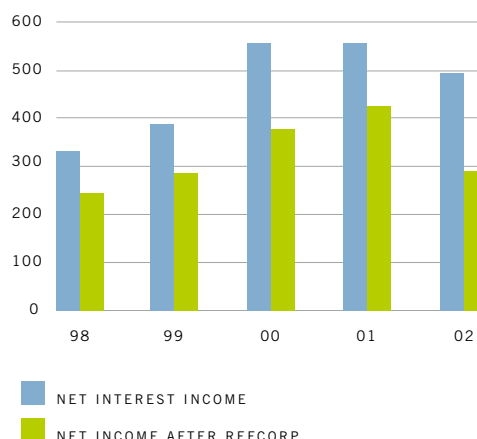
Other Expenses. Other expenses were \$70.4 million in 2002, an increase of \$14.9 million, or 27%, from \$55.5 million in 2001. This increase primarily resulted from a final court order confirming an arbitration decision awarding a member a refund of \$7.9 million in prepayment fees paid to the Bank in 1998 plus interest for a total amount of \$9.4 million. In addition, operating expenses increased \$4.8 million, or 10%, to \$53.6 million, in 2002, while average assets decreased 10%, to \$125.2 billion in 2002, leading to an increase in the Bank's ratio of operating expenses to average assets to 4.3 basis points in 2002 from 3.5 basis points in 2001.

REFCORP and AHP Assessments. Effective January 1, 2000, the annual REFCORP obligation of the FHLBanks was modified by the Gramm-Leach-Bliley Act (GLB Act) from a fixed annual assessment of \$300 million for the 12 FHLBanks combined to 20% of each FHLBank's net earnings (after AHP assessments). With the new assessment, the amount of the Bank's REFCORP payments will rise and fall with its earnings. To the extent that the FHLBanks' annual REFCORP payments are higher or lower than \$300 million, the term of the REFCORP obligation will be shortened or lengthened, respectively, so that the value of all payments made by the FHLBanks is equivalent to a \$300 million annual annuity with a final maturity date of April 15, 2030. The Bank was assessed \$73.0 million in 2002 compared to \$106.1 million in 2001, reflecting lower earnings in 2002. The FHLBanks' payments in 2002 shortened the remaining term of the REFCORP obligation to the third quarter of 2021.

Annually, the FHLBanks must set aside for their AHPs, in the aggregate, the greater of \$100 million or 10% of each year's net income before charges for the AHP but after the assessment for REFCORP. To the extent that the aggregate 10% calculation is less than \$100 million, the shortfall is allocated among the FHLBanks based on the ratio of each FHLBank's net income before AHP and REFCORP to the sum of the net incomes before AHP and REFCORP of the 12 FHLBanks combined. There were no shortfalls in 2002 or 2001. The Bank set aside \$32.5 million for the AHP in 2002, compared to \$47.2 million in 2001, reflecting the lower earnings in 2002.

The Bank's total REFCORP and AHP assessments equaled \$105.5 million in 2002, compared with \$153.3 million in 2001, reflecting the Bank's effective "tax" rate on pre-assessment income of 27%.

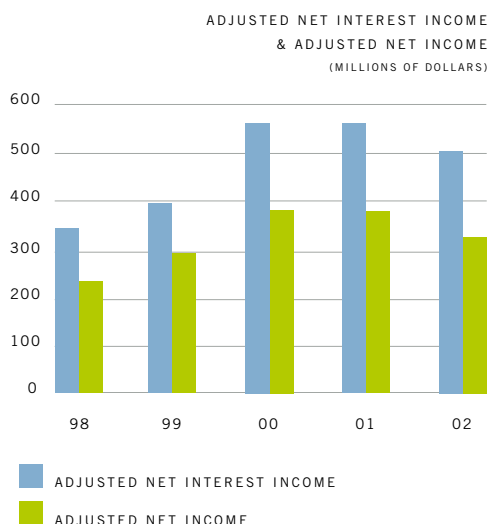
NET INTEREST INCOME
& NET INCOME AFTER REFCORP
(MILLIONS OF DOLLARS)



Net Income. Net income was \$292.2 million in 2002, a decrease of \$132.4 million, or 31%, from \$424.6 million in 2001, and return on equity (ROE) was 4.73% in 2002, a decrease of 176 basis points from 6.49% in 2001. After adjusting for the total net effect of SFAS 133 for 2002 and 2001 (a net loss of \$31.6 million and a net gain of \$50.1 million, respectively, net of applicable assessments), net income for 2002 would have been \$323.8 million, a decrease of \$50.7 million, or 14%, from \$374.5 million in 2001. As a result, ROE would have been 5.29% in 2002, a decrease of 44 basis points from 5.73% in 2001. Without the net effect of SFAS 133, the decline in ROE was primarily attributable to lower earnings on member capital resulting from the lower interest rates in 2002 compared to 2001, partially offset by improved earnings from the Bank's MBS portfolio resulting from higher investment balances and profit spreads.

Adjusted Financial Performance. The Bank also calculates adjusted financial performance measures to provide a more meaningful comparison of the Bank's financial results over time. These measures reflect earnings before advance prepayment fees and certain nonrecurring gains and losses associated with advance prepayments, including certain gains and losses associated with the early retirement of debt, net of the current amortization of current and prior period non-recurring items collectively (net nonrecurring items, net of amortization), in accordance with the Bank's retained earnings policy. These adjustments are made in order to recognize prepayment fees, debt retirement gains and losses, and other nonrecurring transactions over the periods remaining through the related instruments' original maturity dates. In addition, adjusted financial performance measures exclude the effects of any current period adjustments (net of applicable assessments) resulting from the adoption of SFAS 133, because these effects are generally expected to reverse over time. These adjustments include fair value adjustments and the effects of other changes made in accordance with SFAS 133 and fair

value adjustments on held-at-fair value securities reclassified from held-to-maturity securities upon the adoption of SFAS 133. In addition, as a result of the GLB Act, beginning in 2000 the REFCORP assessment is classified as an expense and is included on the Bank's income statement. Before 2000, the REFCORP assessment was a charge to capital and did not appear on the income statement. Adjusted financial performance measures present the Bank's operating results after subtracting the REFCORP assessments for 1998 and 1999.



Adjusted net income was \$324.3 million, a decrease of \$51.6 million, or 14% from \$375.9 million in 2001. Adjusted ROE was 5.30%, a decrease of 45 basis points from 5.75% in 2001, primarily because of lower earnings on member capital resulting from the significant decline in interest rates in 2002, partially offset by improved earnings from the Bank's MBS portfolio resulting from higher investment balances and profit spreads.

RECONCILIATION OF NET INCOME TO ADJUSTED NET INCOME

(IN MILLIONS)	2002	2001	2000
Net income	\$292.2	\$424.6	\$376.6
Net nonrecurring items, net of amortization	0.5	1.4	4.8
Fair value adjustments, net	31.6	(50.1)	—
Adjusted net income	\$324.3	\$375.9	\$381.4

Dividends. The Bank's annual dividend rate was 5.45% for 2002, compared to 5.99% in 2001. The decline in the dividend rate was primarily attributable to lower earnings on member capital resulting from the continued lower interest rate environment in 2002, partially offset by improved earnings from the Bank's MBS portfolio resulting from higher investment balances and profit spreads. All dividends except fractional shares were paid in the form of capital stock.

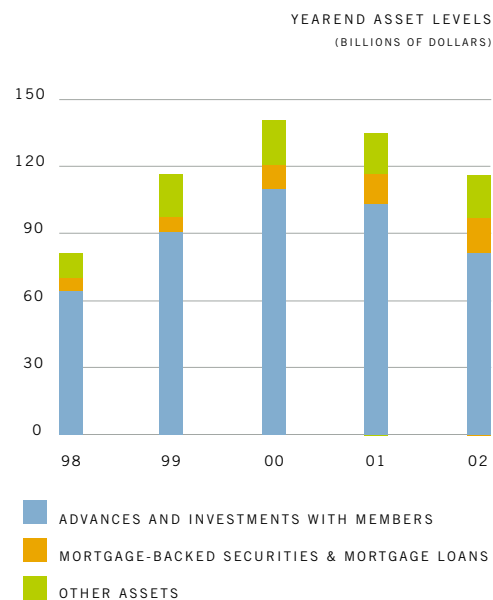
In accordance with the retained earnings policy of the Bank, the Bank restricts retained earnings for that portion of income

from prepayment fees that, if allocated on a pro rata basis over the original term to maturity of the advances prepaid, would be allocated to future dividend periods. Other gains and losses related to the termination of interest rate exchange agreements and the early retirement of consolidated obligations associated with prepaid advances are similarly treated. Retained earnings restricted in accordance with these policies totaled \$6.6 million, \$6.5 million, and \$7.1 million at December 31, 2002, 2001, and 2000, respectively.

Also in accordance with the retained earnings policy of the Bank, as of January 1, 2001, the Bank restricts retained earnings for any cumulative net fair value gains in earnings (net of applicable assessments) resulting from SFAS 133. Since these cumulative net gains are primarily a matter of timing, the gains will generally reverse over the remaining contractual terms to maturity of the financial instruments and associated interest rate exchange agreements. Restricted retained earnings will be adjusted as these cumulative net gains are reversed, resulting in substantially the same possible dividend payout as there would have been without the effects of SFAS 133 provided that the cumulative net effect of SFAS 133 since inception is positive. Retained earnings restricted in accordance with this policy totaled \$18.8 million and \$50.8 million at December 31, 2002 and 2001, respectively. The decrease in 2002 was due to the payout of \$32.0 million from restricted retained earnings to offset the net losses associated with SFAS 133 during 2002. This payout contributed 53 basis points to the dividend.

FINANCIAL CONDITION

Total assets were \$116.1 billion at December 31, 2002, a decrease of \$19.3 billion, or 14%, from \$135.4 billion at December 31, 2001. Average total assets were \$125.2 billion in 2002, a decrease of \$13.9 billion, or 10%, compared to \$139.1 billion in 2001.



AVERAGE BALANCE SHEETS

(DOLLARS IN MILLIONS)	2002			2001			2000		
	AVERAGE BALANCE	INTEREST INCOME/ EXPENSE	AVERAGE RATE	AVERAGE BALANCE	INTEREST INCOME/ EXPENSE	AVERAGE RATE	AVERAGE BALANCE	INTEREST INCOME/ EXPENSE	AVERAGE RATE
Assets									
Interest-earning assets:									
Interest-bearing deposits in banks	\$ 4,405.0	\$ 78.3	1.78%	\$ 3,636.0	\$ 142.4	3.92%	\$ 2,007.0	\$ 131.1	6.53%
Resale agreements	2,731.8	47.9	1.75	1,544.9	63.9	4.13	1,523.9	93.9	6.16
Federal funds sold	6,787.9	119.2	1.76	8,436.0	349.3	4.14	8,564.7	549.1	6.41
Held-to-maturity securities	17,748.7	819.7	4.62	14,896.3	828.9	5.56	13,710.6	898.0	6.55
Held-at-fair-value securities ¹	513.3	10.8	2.10	584.3	27.7	4.74	—	—	—
Mortgage loans	31.6	1.6	5.07	—	—	—	—	—	—
Advances ¹	90,095.3	1,815.4	2.01	107,605.3	4,735.9	4.40	99,959.9	6,431.3	6.43
Loans to other FHLBanks	18.9	0.3	1.59	26.8	0.8	3.15	10.1	0.7	6.91
Total interest-earning assets	122,332.5	2,893.2	2.36	136,729.6	6,148.9	4.50	125,776.2	8,104.1	6.44
Other assets ²	2,860.2			2,382.4			2,592.7		
Total Assets	\$ 125,192.7	\$ 2,893.2	2.31%	\$ 139,112.0	\$ 6,148.9	4.42%	\$ 128,368.9	\$ 8,104.1	6.31%
Liabilities and Capital									
Interest-bearing liabilities:									
Consolidated obligations:									
Bonds ¹	\$ 99,395.1	\$ 2,076.2	2.09%	\$ 94,383.3	\$ 4,064.3	4.31%	\$ 86,917.2	\$ 5,527.1	6.36%
Discount notes ¹	16,192.3	313.6	1.94	34,783.2	1,514.0	4.35	31,740.8	1,996.8	6.29
Deposits	503.3	7.2	1.43	480.2	16.0	3.33	221.5	13.5	6.10
Borrowings from other FHLBank	3.8	0.1	2.60	2.1	0.1	3.80	—	—	—
Other borrowings	9.2	0.1	1.08	6.1	0.2	3.58	202.7	12.1	5.92
Total interest-bearing liabilities	116,103.7	2,397.2	2.06	129,654.9	5,594.6	4.32	119,082.2	7,549.5	6.34
Other liabilities ²	2,914.7			2,912.1			3,379.1		
Total Liabilities	119,018.4	2,397.2	2.01	132,567.0	5,594.6	4.22	122,461.3	7,549.5	6.16
Capital	6,174.3			6,545.0			5,907.6		
Total Liabilities and Capital	\$ 125,192.7	\$ 2,397.2	1.91%	\$ 139,112.0	\$ 5,594.6	4.02%	\$ 128,368.9	\$ 7,549.5	5.88%
Net Interest Income	\$ 496.0			\$ 554.3			\$ 554.6		
Net Interest Spread	0.30%			0.18%			0.10%		
Net Interest Margin³	0.41%			0.41%			0.44%		
Total Average Assets/Capital Ratio	20.3x			21.3x			21.7x		
Interest-Earning Assets/ Interest-Bearing Liabilities	1.1x			1.1x			1.1x		

¹ Interest income/expense and average rates include the effect of associated interest rate exchange agreements.

² Includes forward settling transactions and fair value adjustments in accordance with SFAS 133 for hedged cash items.

³ Net interest margin is net interest income divided by average interest-earning assets.

CHANGE IN NET INTEREST INCOME: RATE/VOLUME ANALYSIS
2002 COMPARED TO 2001

(IN MILLIONS)	INCREASE/ (DECREASE)	ATTRIBUTABLE TO CHANGES IN ¹	
		AVERAGE VOLUME	AVERAGE RATE
Interest-earning assets:			
Interest-bearing deposits in banks	\$ (64.1)	\$ 12.2	\$ (76.3)
Resale agreements	(16.0)	20.4	(36.4)
Federal funds sold	(230.1)	(33.8)	(196.3)
Held-to-maturity securities	(9.2)	131.7	(140.9)
Held-at-fair-value securities ²	(16.9)	(1.9)	(15.0)
Mortgage loans	1.6	1.6	—
Advances ²	(2,920.5)	(412.5)	(2,508.0)
Loans to other FHLBanks	(0.5)	(0.1)	(0.4)
Total interest-earning assets	(3,255.7)	(282.4)	(2,973.3)
Interest-bearing liabilities:			
Consolidated obligations:			
Bonds ²	(1,988.1)	31.6	(2,019.7)
Discount notes ²	(1,200.4)	(387.3)	(813.1)
Deposits	(8.8)	0.1	(8.9)
Other borrowings	(0.1)	—	(0.1)
Total interest-bearing liabilities	(3,197.4)	(355.6)	(2,841.8)
Net Interest Income Before Mortgage Loan Loss Provision	\$ (58.3)	\$ 73.2	\$ (131.5)

2001 COMPARED TO 2000

(IN MILLIONS)	INCREASE/ (DECREASE)	ATTRIBUTABLE TO CHANGES IN ¹	
		AVERAGE VOLUME	AVERAGE RATE
Interest-earning assets:			
Interest-bearing deposits in banks	\$ 11.3	\$ 64.1	\$ (52.8)
Resale agreements	(30.0)	2.3	(32.3)
Federal funds sold	(199.8)	(7.1)	(192.7)
Held-to-maturity securities	(69.1)	65.2	(134.3)
Held-at-fair-value securities ²	27.7	26.5	1.2
Advances ²	(1,695.4)	292.2	(1,987.6)
Loans to other FHLBanks	0.1	0.5	(0.4)
Total interest-earning assets	(1,955.2)	443.7	(2,398.9)
Interest-bearing liabilities:			
Consolidated obligations:			
Bonds ²	(1,462.8)	284.2	(1,747.0)
Discount notes ²	(482.8)	121.3	(604.1)
Deposits	2.5	8.7	(6.2)
Borrowings from other FHLBanks	0.1	0.1	—
Other borrowings	(11.9)	(7.3)	(4.6)
Total interest-bearing liabilities	(1,954.9)	407.0	(2,361.9)
Net Interest Income	\$ (0.3)	\$ 36.7	\$ (37.0)

¹ Combined rate/volume variances, a third element of the calculation, are allocated to the rate and volume variances based on their relative size.

² Interest income/expense and average rates include the interest effect of associated interest rate exchange agreements.

Advances. Advances outstanding were \$81.2 billion at December 31, 2002, a decrease of \$21.0 billion, or 21%, from \$102.2 billion at December 31, 2001. Average advances were \$90.1 billion in 2002, a decrease of \$17.5 billion, or 16%, from \$107.6 billion in 2001. Advances outstanding at December 31, 2002 and 2001, included fair value adjustments of \$1.0 billion and \$0.9 billion, respectively. The decline in advances outstanding was primarily the result of several members' strong retail deposit growth and mortgage

prepayments. The Bank's largest members accounted for most of the decline in advances. Under current economic conditions, the Bank anticipates that this trend could continue in the near future. In total, 148 members increased their advance borrowings from yearend 2001 to yearend 2002, while 59 members decreased their advance borrowings.

Mortgage Partnership Finance® (MPF®) Program. In 2001, the Bank began offering members the opportunity to participate in the MPF Program to provide them with a competitive alternative to the traditional secondary mortgage market. ("Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.) Under this program, the Bank buys conventional conforming and government-guaranteed fixed rate mortgage loans from members and pays them a monthly credit enhancement fee for managing the credit risk of the loans. At December 31, 2002, the Bank held conventional fixed rate conforming mortgage loans totaling \$0.3 billion that were purchased from four participating financial institutions (PFIs). At December 31, 2002, all loans were current, and the Bank had an allowance for loan losses of \$0.2 million. No loans were purchased in 2001. As the MPF Program matures, the Bank anticipates that activity in the program may increase substantially.

The Bank analyzes the duration, convexity, and earnings risk of the mortgage loans at the time of purchase and of the outstanding mortgage loan portfolio on a regular basis under various interest rate scenarios. The Bank manages the interest rate and prepayment risk associated with mortgage loans through a combination of debt issuance and derivatives. The Bank issues both callable and non-callable debt to achieve cash flow patterns and liability durations similar to those expected on the mortgage loans.

Options may also be used to hedge prepayment risk on the mortgage loans, many of which are not designated as hedges of specific mortgage loans and, therefore, do not receive fair value or cash flow hedge accounting treatment. The options are marked to market through current earnings. The Bank purchases callable swaps to manage the prepayment risk embedded in the mortgage loans. Although these derivatives are economic hedges against the prepayment risk of the loans, they are not specifically linked to individual loans or liabilities and, therefore, do not receive either fair value or cash flow hedge accounting treatment. The derivatives are marked to market through earnings.

Investments. The Bank invests in both short- and long-term instruments to maintain liquidity and provide additional earnings. The short-term investment portfolio is primarily composed of Federal funds sold, resale agreements, negotiable certificates of deposit (interest-bearing deposits in banks), and commercial paper. In determining the amount of assets to invest in each class of securities, the Bank considers the

yield, liquidity, and credit quality of each instrument. The long-term investment portfolio, which is composed of MBS and, to a lesser degree, other housing-related investments, provides the Bank with higher returns than those available in the short-term money markets. Some of the fixed and adjustable rate MBS in which the Bank invests are guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae and are collateralized by residential mortgages. The Bank also invests in publicly registered, AAA-rated non-agency MBS that are also collateralized by residential mortgages. In addition, the Bank invests in housing finance agency bonds, all of which are AAA-rated indexed floating rate mortgage revenue bonds (federally taxable) that are collateralized by pools of residential mortgages. The fixed rate, long-term investments are subject to prepayment risk, and the adjustable rate long-term investments are subject to interest rate cap risk. The Bank has managed these risks by (1) funding the fixed rate MBS with non-callable and callable debt, and (2) purchasing certain investments that are structured with interest rate exchange agreements, creating synthetic, floating rate assets that may have lifetime interest rate caps but do not have periodic interest rate caps. This structure provides the Bank with a relatively stable income stream over a range of interest rates.

In accordance with the provisions of SFAS 133, interest rate exchange agreements associated with held-to-maturity securities are non-hedge qualifying. The transition provisions of SFAS 133 allowed the Bank to transfer any security classified as held-to-maturity to trading (or "held-at-fair-value"). Therefore, the Bank transferred its portfolio of economically hedged MBS to the held-at-fair-value securities category so that fair value gains or losses on the MBS will partly offset the losses or gains on the associated interest rate exchange agreements. During 2002 and 2001, this designation allowed the Bank to mark certain MBS to fair value (for a \$22.7 million gain and a \$7.7 million gain, respectively) to offset the mark-to-fair value of the associated interest rate exchange agreements (a \$26.2 million loss and a \$6.6 million loss, respectively), for a net loss of \$3.5 million and a net gain of \$1.1 million, respectively.

The Bank's MBS portfolio, including MBS held at fair value, increased 16% in 2002, to \$16.0 billion, or approximately 281% of capital, at December 31, 2002, from \$13.8 billion, or approximately 202% of capital, at December 31, 2001. The Bank took advantage of the surge in MBS supply resulting from the increase in mortgage refinancings to increase its MBS portfolio in 2002. The increase in the MBS portfolio and the decline in member capital resulted in balances slightly below the maximum authorized level of 300% of capital.

The Bank's total non-MBS investment portfolio decreased to \$17.7 billion as of December 31, 2002, from \$18.4 billion as of December 31, 2001. Interest-bearing deposits in banks increased \$0.3 billion, resale agreements increased \$2.3

billion, and housing finance agency bonds increased \$0.3 billion, while Federal funds sold decreased \$2.4 billion and commercial paper decreased \$1.2 billion.

Borrowings. The Bank funds its assets through the use of FHLBank consolidated obligation bonds and discount notes, which are the joint and several obligations of the 12 FHLBanks. These instruments financed 92% and 93% of the Bank's average total assets in 2002 and 2001, respectively. Consolidated obligation bonds are long-term, while discount notes are short-term instruments. The Bank uses interest rate exchange agreements to change the effective interest rate terms on many of its consolidated obligation bonds and discount notes to better match the interest rate terms of the Bank's assets.

Consistent with the decline in the Bank's total assets, total consolidated obligations outstanding decreased \$17.7 billion, or 14%, in 2002, to \$108.3 billion at December 31, 2002, from \$126.0 billion at December 31, 2001. Average consolidated obligations in 2002 were \$115.6 billion, 11% below the \$129.2 billion average in 2001, consistent with the trend for average advances noted above. Consolidated obligations outstanding at December 31, 2002 and 2001, included fair value adjustments of \$1.1 billion and \$0.9 billion, respectively.

To meet the specific needs of certain investors, fixed and adjustable rate consolidated obligation bonds may contain embedded call options or other features that result in complex coupon payment terms. When such consolidated obligation bonds are issued, the Bank simultaneously enters into interest rate exchange agreements with features that offset the complex features of the bonds and, in effect, convert the bonds to conventional adjustable rate instruments tied to an index, such as the London Interbank Offered Rate (LIBOR). During 2002 and 2001, the Bank used fixed rate callable bonds that were usually offset with interest rate exchange agreements with a call feature mirroring the option embedded in the callable bond. This combined structure enabled the Bank to meet its funding needs at costs not generally attainable solely through the issuance of non-callable debt. The Bank also uses fixed rate callable bonds to finance fixed rate callable advances and fixed rate MBS.

Capital and Capital Ratios. Each member is required to purchase Bank stock based on the amount of either (i) its residential mortgage loans or (ii) its outstanding Bank advances and mortgage loans sold to and held by the Bank. Average capital during 2002 was \$6.2 billion, a 6% decrease from \$6.5 billion in 2001. This decrease included redemptions of capital stock, which primarily resulted from the Bank's surplus capital stock redemption policy. Surplus capital is defined as any excess stock holdings above 115% of a member's minimum capital stock requirement, generally excluding stock dividends earned and credited for the current year. As advance balances declined in 2002, the minimum capital

stock requirements for many members declined as well. In accordance with this policy, the Bank redeemed \$1,687.7 million and \$363.4 million in surplus capital stock during 2002 and 2001, respectively.

On June 2, 2000, the Finance Board adopted a final rule amending the FHLBanks' leverage limit requirements. Effective July 1, 2000, each FHLBank's leverage limit is based on a ratio of assets to capital, rather than a ratio of liabilities to capital. The final rule generally limits each FHLBank's assets to no more than 21 times capital unless the FHLBank has non-mortgage assets, after deducting deposits and capital, that do not exceed 11% of its assets. In that case, the FHLBank's total assets cannot exceed 25 times its capital. As of December 31, 2002 and 2001, the Bank's total assets to capital and non-mortgage assets to total assets ratios were 20.4x and 9.8%, and 19.9x and 8.1%, respectively. The Bank's advances and mortgage-related assets averaged 17.3 times capital and 18.4 times capital in 2002 and 2001, respectively. In addition, the Bank's non-mortgage investments and other non-interest-bearing, non-mortgage assets averaged 3.0 times capital and 2.9 times capital in 2002 and 2001, respectively. The Bank's average ratio of total assets to capital was 20.3x in 2002 compared to 21.3x in 2001. The 11%-of-assets limit that applies to non-mortgage assets when total assets exceed 21 times capital has not restricted the Bank's ability to maintain the target amount of liquid investments necessary to meet its operating needs and the credit needs of members.

The GLB Act imposes new minimum leverage and risk-based capital requirements on the 12 FHLBanks and requires each FHLBank to implement a new capital structure to replace the current structure. The Bank's capital plan was approved by the Bank's Board of Directors on May 31, 2002, and approved by the Finance Board on June 12, 2002. The plan may be amended by the Bank's Board of Directors with the approval of the Finance Board. The plan provides that it will be implemented by the Bank within the three-year period following Finance Board approval. The Board of Directors will consider implementing the plan in 2003 or early in 2004. Until the Bank fully implements its capital plan, the existing capital requirements will remain in effect. (See "Recent Developments" on page 31.)

Letters of Credit. The Bank issues standby letters of credit on behalf of members to support their obligations to third parties. The contractual amounts of letters of credit are not recorded as assets or liabilities on the balance sheet. The amounts outstanding as of December 31, 2002 and 2001, were \$1.4 billion and \$0.8 billion, respectively. The fees earned by the Bank in connection with letters of credit are recorded as other income when received.

Interest Rate Exchange Agreements. The Bank enters into various types of transactions that involve interest rate exchange agreements (interest rate swap, cap, and floor agreements)

to adjust the interest rate sensitivity of consolidated obligations to more closely approximate the interest rate sensitivity of assets (both advances and investments) or to adjust the interest rate sensitivity of advances or investments to more closely approximate the interest rate sensitivity of liabilities. In addition, the Bank uses interest rate exchange agreements to manage embedded options in assets and liabilities, to hedge the market value of existing assets and liabilities and anticipated transactions, to hedge the prepayment risk of prepayable instruments, and to reduce funding costs. The Bank also provides a variety of products to meet the specific needs of members. Because the financial characteristics of many of these products may not be consistent with the Bank's desired interest rate risk profile, the Bank uses interest rate exchange agreements to modify the financial characteristics of its products to meet the Bank's specific interest rate risk objectives. These instruments are generally negotiated, with terms tailored to meet the specific needs of the Bank and the member. The Bank may also act as an intermediary between members and third parties for interest rate exchange agreement transactions.

Interest income and expense from interest rate exchange agreements used for risk management purposes are recorded with interest on the associated instrument whether or not the transactions qualify for hedge accounting treatment under SFAS 133. Interest income and expense from interest rate exchange agreements in which the Bank acts as an intermediary are recorded as other income.

On January 1, 2001, the Bank adopted SFAS 133, which requires that all derivative instruments be recorded on the balance sheet at their fair value. Changes in the fair value of derivatives are recorded each period in current earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. The gains and losses on derivative instruments that are designated as cash flow hedges are reported in other comprehensive income and will be recognized as earnings in the periods in which earnings are affected by the cash flows of the hedged items. The ineffective portion of all hedges is recognized in current period earnings.

The following table categorizes the notional amounts and estimated fair values of the Bank's interest rate exchange agreements, excluding accrued interest, and related hedged items by product and type of accounting treatment as of December 31, 2002 and 2001. The categories "Fair value" and "Cash flow" represent hedges that qualify for hedge accounting in accordance with SFAS 133. The category "Economic" represents hedge strategies that do not qualify for hedge accounting under the rules of SFAS 133, but are acceptable hedging strategies under the Bank's risk management program.

SUMMARY OF DERIVATIVES AND HEDGED ITEMS

AT DECEMBER 31, 2002

(IN THOUSANDS)	NOTIONAL AMOUNT	ESTIMATED FAIR VALUE GAIN/(LOSS)	HEDGED ITEM FAIR VALUE GAIN/(LOSS)	NET GAIN/(LOSS)
Advances:				
Fair value	\$ 36,119,097	\$ (987,821)	\$ 983,956	\$ (3,865)
Economic	1,225,600	(99)	—	(99)
Total associated with advances	37,344,697	(987,920)	983,956	(3,964)
Held-at-fair-value securities:				
Economic	491,104	(41,798)	37,532	(4,266)
Bonds:				
Fair value	61,154,397	1,090,957	(1,071,502)	19,455
Cash flow	155,000	(1,652)	—	(1,652)
Economic	22,507,900	33,549	(29,924)	3,625
Total associated with bonds	83,817,297	1,122,854	(1,101,426)	21,428
Discount notes:				
Fair value	1,992,000	870	(870)	—
Economic	100,000	(967)	—	(967)
Total associated with discount notes	2,092,000	(97)	(870)	(967)
Intermediated:				
Economic	904,200	291	—	291
Total	\$ 124,649,298	93,330	\$ (80,808)	\$ 12,522
Accrued interest		79,539		
Net Interest Rate Exchange Agreements		\$ 172,869		
Derivative assets		\$ 518,734		
Derivative liabilities		(345,865)		
Net Interest Rate Exchange Agreements		\$ 172,869		

AT DECEMBER 31, 2001

(IN THOUSANDS)	NOTIONAL AMOUNT	ESTIMATED FAIR VALUE GAIN/(LOSS)	HEDGED ITEM FAIR VALUE GAIN/(LOSS)	NET GAIN/(LOSS)
Advances:				
Fair value	\$ 43,532,034	\$ (919,377)	\$ 914,278	\$ (5,099)
Cash flow	27,000	102	—	102
Economic	1,258,100	(435)	—	(435)
Total associated with advances	44,817,134	(919,710)	914,278	(5,432)
Held-at-fair-value securities:				
Economic	513,084	(15,555)	14,787	(768)
Bonds:				
Fair value	69,986,293	937,789	(878,894)	58,895
Cash flow	—	—	—	—
Economic	25,201,900	13,044	(15,151)	(2,107)
Total associated with bonds	95,188,193	950,833	(894,045)	56,788
Discount notes:				
Fair value	3,382,000	3,887	(3,887)	—
Intermediated:				
Economic	820,200	241	—	241
Total	\$ 144,720,611	19,696	\$ 31,133	\$ 50,829
Accrued interest		87,352		
Net Interest Rate Exchange Agreements		\$ 107,048		
Derivative assets		\$ 479,860		
Derivative liabilities		(372,812)		
Net Interest Rate Exchange Agreements		\$ 107,048		

The ongoing impact of SFAS 133 on the Bank cannot be predicted, and the Bank's retained earnings in the future may not be sufficient to offset the impact of SFAS 133. As a result, the effects of SFAS 133 may lead to increased volatility in future earnings and dividends.

SEGMENT INFORMATION

Management analyzes financial performance based on the net interest income of two operating segments: Mortgage-Related Business and Advances-Related Business.

The Mortgage-Related Business consists of MBS investments and mortgage loans acquired through the MPF Program and the consolidated obligations specifically identified as funding those assets. Net interest income for this segment is derived primarily from the difference, or spread, between the yield on the MBS securities and mortgage loans and the cost of the consolidated obligations funding those assets, including the cash flows from associated interest rate exchange agreements, less the provision for credit losses on mortgage loans. Net interest income was \$135.3 million in 2002, an increase of \$47.9 million, or 55%, from \$87.4 million in 2001. The increase was primarily due to higher investment balances and higher spreads. Investment balances grew to \$16.2 billion, an increase of \$2.5 billion, or 18%, from \$13.7 billion. This segment represented 27% and 16% of net interest income for 2002 and 2001, respectively.

The Advances-Related Business consists of all other business activities, including advances and investments other than MBS and the consolidated obligations funding those assets, other borrowings, and member capital. Net interest income for this segment, including the cash flows from associated interest rate exchange agreements, was \$360.5 million in 2002, a decrease of \$106.4 million, or 23%, from \$466.9 million in 2001. This decrease was primarily due to the lower interest rate environment in 2002 relative to 2001 and lower member capital, which resulted in lower earnings on member capital, and to a lesser degree, narrower profit spreads on advances and investments. Balances associated with this segment decreased to \$99.9 billion, a decrease of \$21.7 billion, or 18%, from \$121.6 billion. This segment represented 73% and 84% of net interest income for 2002 and 2001, respectively.

RISK MANAGEMENT

Liquidity. The Bank is required to maintain liquidity in accordance with certain regulations, with the Finance Board's Financial Management Policy, and with the Bank's own liquidity policy. The Bank needs liquidity to satisfy member demand for short- and long-term funds, repay maturing consolidated obligations, and meet other obligations. In their asset/liability management planning, members may look to the Bank to provide standby liquidity. The Bank seeks to be in a position to meet its customers' credit and liquidity needs without maintaining excessive holdings of low-yielding liquid investments or being forced to incur unnecessarily high borrowing costs. The Bank's primary sources of liquidity are short-term investments and the issuance of new consolidated obligation

bonds and discount notes. Other short-term borrowings, such as Federal funds purchased, securities sold under agreements to repurchase, and loans from other FHLBanks, also provide liquidity. The Bank maintains contingency liquidity plans designed to enable it to meet its obligations and the liquidity needs of members in the event of operational disruptions at the Bank or the Office of Finance (the FHLBanks' fiscal agent for issuing consolidated obligations) or short-term capital market disruptions.

Interest Rate Risk. The Bank manages the potential effects of interest rate movements on earnings and the market value of equity within prescribed policy limits. The Bank also complies with the duration of equity limits and other limits set forth in the Finance Board's Financial Management Policy.

One measure of interest rate risk is the extent to which the interest rates on the Bank's assets and liabilities reprice at different times. The following table shows the interest rate sensitivity of assets and liabilities by repricing periods. The periodic gaps shown in this table represent the net difference between total asset and liability repricings, including the impact of interest rate exchange agreements, for a specified time period. For example, the periodic gap for the "6 months or less" time period indicates that as of December 31, 2002, there were \$4.3 billion more assets than liabilities repricing during the 6-month period beginning on December 31, 2002. As shown in this table, the Bank's repricing gaps, by design, are concentrated in the "6 months or less" category.

INTEREST RATE SENSITIVITY

AS OF DECEMBER 31, 2002 (IN MILLIONS)	INTEREST RATE SENSITIVITY PERIOD			
	6 MONTHS OR LESS	6 MONTHS TO 1 YEAR	1 TO 5 YEARS	OVER 5 YEARS
Assets				
Investments	\$ 17,771	\$ —	\$ —	\$ —
MBS/Mortgage loans	8,523	2,346	4,244	1,150
Advances	56,113	9,528	12,883	2,713
Other assets	858	—	—	—
Total Assets	83,265	11,874	17,127	3,863
Liabilities				
Consolidated obligations:				
Bonds	40,569	18,560	32,122	4,571
Discount notes	11,276	1,171	—	—
Deposits	407	—	—	—
Other borrowings	525	—	—	—
Other liabilities	1,061	—	—	183
Total Liabilities	53,838	19,731	32,122	4,754
Interest rate exchange agreements	(25,102)	9,214	16,227	(339)
Periodic Gap/Invested Capital	\$ 4,325	\$ 1,357	\$ 1,232	\$ (1,230)

The following table shows the estimated percentage change in the market value of equity (the net value of all assets, liabilities, and off-balance sheet items) that would result from a 100-basis-point change in interest rates under different interest rate scenarios. At December 31, 2002, the estimated percentage change in the Bank's market value of equity was

1.9%. If interest rates rose 100 basis points, the Bank's market value of equity would be expected to decline approximately 1.9%, and if interest rates fell 100 basis points, the Bank's market value of equity would be expected to increase approximately 1.9%. If interest rates had been 200 basis points higher at December 31, 2002, a 100-basis-point additional shift in interest rates would be expected to either decrease or increase (depending on the direction of the interest rate movement) the Bank's market value of equity by 2.7%. If interest rates had been 200 basis points lower at December 31, 2002, a 100-basis-point additional shift in interest rates would be expected to alter the Bank's market value of equity by approximately 1.1%.

MARKET VALUE OF EQUITY SENSITIVITY

AS OF DECEMBER 31, 2002

INTEREST RATE SCENARIO	AVERAGE PERCENTAGE CHANGE IN THE MARKET VALUE OF EQUITY PER 100-BASIS-POINT CHANGE IN INTEREST RATES
Actual rates at December 31, 2002	1.9%
Rates start 200 basis points higher	2.7%
Rates start 200 basis points lower	1.1%

The Bank's duration gap, the difference between the duration or market value sensitivity of its assets and liabilities (including the impact of derivatives) was 0.8 months as of December 31, 2002. This low risk profile reflects the Bank's conservative asset-liability mix and its commitment to providing value to its members without subjecting their capital to significant interest rate risk.

The Bank's two business segments have different risk profiles. The Advances-Related Business reflects the Bank's core interest rate risk position from investing 50% of member capital in short-term financial instruments and 50% in a ladder portfolio of financial instruments with maturities of one month to four years. The Mortgage-Related Business segment has a much more complex interest rate risk profile resulting from the prepayment risk of fixed rate MBS investments. These risks are managed primarily by using callable and non-callable bonds. The interest rate risks of both business segments are managed within prescribed policy limits.

Credit Risk. The Bank closely monitors the creditworthiness of the institutions to which it lends funds. The Bank also places great importance on the quality of the assets that are pledged as collateral by its customers. The Bank emphasizes credit monitoring and collateral asset review and valuation to manage the credit risk associated with its lending activities. It also has procedures to assess the mortgage underwriting and documentation standards of its borrowing members. In addition, the Bank has collateral policies and restricted lending procedures in place to manage its exposure to those customers that experience difficulty in meeting their capital requirements or other standards of creditworthiness. The Bank has never experienced any credit losses on credit extended

to any member since its inception. Based on the collateral held as security and prior repayment history, no allowance for losses is deemed necessary by management.

The Bank bases the allowance for credit losses in the Bank's mortgage loan portfolio on management's estimate of credit losses inherent in the portfolio as of the balance sheet date. Actual losses greater than defined levels are offset by the member's credit enhancement up to their respective limits. The Bank performs periodic reviews of its portfolio to identify the losses inherent within the portfolio and to determine the likelihood of collection of the portfolio. The overall allowance is determined by an analysis that includes consideration of various data observations such as past performance, current performance, loan portfolio characteristics, collateral valuations, industry data, and prevailing economic conditions.

The Bank has adopted exposure limits for investments that promote diversification and liquidity. These policies restrict the amounts and terms of the Bank's investment holdings according to the Bank's own capital position as well as the capital and creditworthiness of the counterparty. In addition, the Bank's investments include AAA-rated non-agency MBS; MBS that are guaranteed by government-sponsored enterprises (Fannie Mae, Freddie Mac, and Ginnie Mae); and housing finance agency bonds, which are AAA-rated mortgage revenue bonds (federally taxable) that are collateralized by pools of residential mortgages.

The Bank has also adopted credit policies and exposure limits for derivatives and off-balance sheet credit exposure. The Bank selects as derivatives counterparties only highly rated non-member swap dealers that meet the Bank's eligibility criteria. In addition, the Bank has entered into master netting arrangements and bilateral security agreements with all active non-member derivative counterparties that provide for delivery of collateral at specified levels to limit net credit exposure from these derivatives. Under these policies and agreements, the amount of unsecured credit exposure to an individual counterparty is the lesser of (1) an amount commensurate with the counterparty's capital and its credit quality, as determined by rating agency credit ratings of the counterparty's debt securities or deposits, or (2) an absolute credit exposure limit.

Concentration Risk. At December 31, 2002, the Bank had a concentration of advances totaling \$58.1 billion outstanding to three members, representing 72% of total advances outstanding (41%, 17%, and 14%, respectively). At December 31, 2001, the Bank had a concentration of advances totaling \$79.0 billion outstanding to three members, representing 78% of total advances outstanding (45%, 22%, and 11%, respectively). Of the total capital stock outstanding at December 31, 2002, three members held 38.5 million shares, representing 69% of total capital stock outstanding (38%, 18%, and 13%, respectively). At December 31, 2001, three members held 50.2 million shares, representing 74% of total capital stock outstanding (41%, 22%, and 11%, respectively). The Bank

manages concentration risk by, among other things, closely monitoring the credit and collateral quality and financial trends of the institutions to which it lends funds, charging market-based prepayment fees on most advances, and monitoring and managing the risks associated with any potential departure of a large member and the resulting capital redemption.

RECENT DEVELOPMENTS

Multiple Federal Home Loan Bank Memberships. In 2001, the Finance Board published a solicitation of comments addressing the issue of multiple memberships in FHLBanks and the implications for the FHLBank System. The solicitation was prompted by the submission of petitions requesting that the Finance Board permit a single depository institution to become a member of two FHLBanks concurrently. In December 2002, the Finance Board adopted a resolution requesting comments from the FHLBanks concerning FHLBank membership and changes in the financial services industry and indicating that the Finance Board will conduct a public process if it determines that regulatory action is appropriate.

Capital Requirements for FHLBanks. The final capital rule published by the Finance Board to implement a new capital structure for the FHLBanks, as required by the GLB Act, established risk-based and leverage capital requirements for the FHLBanks, addressed different classes of stock that an FHLBank may issue and the rights and preferences that may be associated with each class of stock, and required each FHLBank to submit a capital plan to the Finance Board for approval. The Bank's capital plan was approved by the Bank's Board of Directors on May 31, 2002, and was approved by the Finance Board on June 12, 2002. The plan may be amended by the Bank's Board of Directors with the approval of the Finance Board.

The plan provides that it will be implemented by the Bank within the three-year period following Finance Board approval. The Board of Directors will consider implementing the plan in 2003 or early in 2004. Upon implementation, the Bank will exchange current shares for new shares. Any member that does not wish to participate in the exchange must provide the Bank with a written notice of intention to withdraw from membership as provided in the plan.

When an FHLBank's capital plan has been implemented by the FHLBank, the FHLBank will be subject to risk-based capital rules. Under the Bank's capital plan, the Bank will issue only Class B stock, which has a par value of \$100 per share and may be redeemed upon five years' notice, subject to certain conditions. The stock may be issued, exchanged, redeemed, and repurchased only at its stated par value. Only "permanent" capital, defined as retained earnings and Class B stock, can satisfy the risk-based capital requirement. In addition, the GLB Act specifies a 5% minimum leverage capital ratio with a 1.5 weighting factor for permanent capital, and a 4% minimum leverage capital ratio without the 1.5 weighting factor.

The statute and regulations require that the minimum stock requirement for members must be sufficient to enable the Bank to meet its own regulatory requirements for total capital, leverage capital, and risk-based capital. Currently, the new capital plan provides for a minimum stock requirement based on a membership stock requirement and an activity-based stock requirement.

The activity-based stock purchase requirement will apply to all outstanding transactions, including those executed before the plan is implemented that are still outstanding when the plan becomes effective. (This requirement will apply even to members that elect not to continue their membership in the Bank under the new capital plan.) In addition, members that sell loans to the Bank will be required to maintain Bank capital stock in connection with any loans sold to the Bank as long as the Bank retains any interest in the loans, even if the institution ceases to be a member of the Bank.

Until the Bank fully implements its new capital plan, the current capital rules remain in effect. Each member is required to hold capital stock in the Bank equal to the greatest of:

- 5% of its total outstanding Bank advances plus 5% of the Bank's interest in the aggregate unpaid principal balance of all loans sold by the member and held by the Bank, or
- 1% of its total unpaid principal balance of residential mortgage loans (usually as of the most recent yearend), or
- \$500.

At the Bank's discretion, capital stock that is greater than a member's minimum requirement may be redeemed or sold to other Bank members at par value.

The GLB Act established voluntary membership for all members. All members may withdraw from membership and redeem their capital stock after giving the required notice. Members that withdraw from membership may not re-apply for membership for five years.

Discussions of Enhanced Financial Disclosures. The FHLBanks, the Finance Board, the Division of Corporation Finance of the Securities and Exchange Commission (SEC), and the U.S. Department of the Treasury are considering the possible expansion of the financial disclosure reporting of the FHLBanks. The Office of Finance prepares the combined financial reports of the FHLBanks, which under current Finance Board regulations generally must be consistent with SEC Regulations S-K and S-X, subject to certain exceptions contained in the Finance Board regulations. Also under current Finance Board regulations, any financial statements contained in an annual or quarterly financial report issued by the FHLBanks must be consistent in both form and content with the combined financial reports prepared by the Office of Finance. Although changes in disclosure requirements for the FHLBanks, if any,

have not yet been determined, possible measures range from an enhanced disclosure regime administered by the Finance Board to registration of securities under the Securities Exchange Act of 1934.

COMPARISON OF 2001 TO 2000

Net income was \$424.6 million in 2001, compared to \$376.6 million in 2000. Net interest income decreased slightly to \$554.3 million in 2001 from \$554.6 million in 2000 as a result of a 3-basis-point decrease in the net interest margin, partially offset by an \$11.0 billion increase in average interest-earning assets outstanding during 2001. The decrease in the net interest margin was primarily due to lower earnings on capital resulting from the significant drop in interest rates during 2001 and, to a lesser degree, narrower profit spreads on advances and investments. The narrower profit spreads were mainly due to the higher cost of discount notes relative to other market interest rates primarily because of an increase in the issuance of similar debt by other federal agencies and the U.S. Department of the Treasury.

Other income increased \$74.8 million to \$81.5 million in 2001 from \$6.7 million in 2000. In 2001, other income consisted primarily of net gains on derivatives and hedging activities of \$64.0 million and net gains on held-at-fair-value securities of \$7.7 million, both results of the adoption of SFAS 133. In addition, prepayment fees increased \$5.6 million in 2001 as members prepaid \$1.9 billion of advances in 2001, compared to \$0.9 billion in 2000.

Other expenses increased to \$55.5 million in 2001 from \$48.7 million in 2000, primarily as a result of a \$6.0 million increase in operating expenses. While operating expenses increased 14% in 2001, average assets increased only 8%, leading to a slight increase in the Bank's ratio of operating expenses to average assets from 3.3 basis points in 2000 to 3.5 basis points in 2001.

The Bank's total REFCORP and AHP assessments equaled \$153.3 million in 2001 and \$136.0 million in 2000. These amounts reflect the Bank's effective "tax" rate on income of 27%. The Bank set aside \$47.2 million for the AHP in 2001, compared to \$41.8 million in 2000. The increase in the AHP assessment reflected higher earnings in 2001.

Adjusted net income decreased 1%, to \$375.9 million in 2001 from \$381.4 million in 2000, reflecting lower earnings in invested member capital resulting from the significant drop in interest rates during 2001.

In 2001, the Bank paid a total of \$386.6 million in dividends, an average annual rate of 5.99%. In 2000, dividends totaled \$416.3 million and the average annual rate was 7.17%. The decline in the dividend rate was primarily attributable to

lower earnings on invested member capital and to supplemental payouts of retained earnings totaling \$36.9 million in 2000. All dividends except fractional shares were paid in the form of capital stock.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Accounting for Derivatives. SFAS 133 requires that all derivatives be recorded on the statement of condition at their fair values. Changes in the fair value of derivatives are recorded each period in current period earnings or other comprehensive income, depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. The gains and losses on derivative instruments that are designated as cash flow hedges and reported in other comprehensive income will be reclassified as earnings in the periods in which earnings are affected by the variability of the cash flows of the hedged item. Any hedge ineffectiveness (which represents the amount by which the change in the fair value of the derivative differs from the change in the fair value of the hedged item or from the variability in the cash flows of the forecasted transaction) is recorded in current period earnings. For a derivative designated as a fair-value hedge, the transition adjustment for the derivative was reported as a cumulative effect adjustment of net income in 2001. Concurrently, any fair value gain or loss on the hedged instrument was recognized as an adjustment of the hedged item's carrying amount, but only to the extent of the offsetting transition adjustment of the derivative, and was also reported as a cumulative effect adjustment of net income in 2001. Changes in the fair value of a non-SFAS 133 hedge of an asset or liability (economic hedge) for asset-liability management are recorded in current period earnings. As discussed in more detail below, the adoption of SFAS 133 has led to volatility in the statement of income because of changes in market prices and interest rates. The transition provisions of SFAS 133 also provide that at the date of initial application an entity may transfer any security classified as "held-to-maturity" to "available-for-sale" or "trading" (herein referred to as held-at-fair-value securities), and any security classified as "available-for-sale" to "trading" (held-at-fair-value securities).

By regulation, derivatives are only permitted to be used by an FHLBank in order to mitigate identifiable risks. All of the Bank's derivatives are positioned to offset some or all of the risk exposure inherent in its member lending, investment, and funding activities. Under SFAS 133, the Bank is required to recognize unrealized losses or gains on derivative positions regardless of whether offsetting gains or losses on the underlying assets or liabilities being hedged are permitted to be recognized in a symmetrical manner. Therefore, the new accounting framework imposed by SFAS 133 introduces the potential for a considerable mismatch between the timing of income and expense recognition from assets or liabilities

and the income effects of hedge instruments positioned to mitigate market risk and cash flow variability. As a result, during periods of significant changes in interest rates, the Bank's reported GAAP earnings may exhibit considerably greater variability than in years prior to 2001. The Bank has generally continued its practice of utilizing the most cost-efficient hedging techniques available, viewing the resulting accounting consequences to be an important but secondary consideration. The Bank anticipates that this approach will result in enhanced long-term performance at the expense of increased variability in earnings as reported under the new requirements of SFAS 133. Given that the Bank manages derivatives with primary emphasis on economic cost-effectiveness as opposed to evenness of accounting results, the adoption of SFAS 133 has led to more volatility in the reported earnings for the Bank because of changes in market prices and interest rates.

Fair Values. At December 31, 2002, certain of the Bank's assets and liabilities, including investments classified as held-at-fair-value securities and all derivatives and associated hedged items accounted for in accordance with SFAS 133, are presented in the statement of condition at fair value. Many of these financial instruments lack an available liquid trading market as characterized by frequent transactions between a willing buyer and willing seller engaging in an exchange transaction. Therefore, significant assumptions and present value calculations have been used by the Bank for the purpose of determining estimated fair values. Changes in these assumptions and calculations could significantly affect the Bank's financial position and results of operations. Thus, the fair values may not represent the actual values of the financial instruments that could have been realized as of yearend or that will be realized in the future. The Bank continually refines its assumptions and present value calculations to better reflect market indications.

Management also estimates the fair value of the collateral that members pledge against advance borrowings to confirm that the Bank has sufficient collateral to protect it from loss. Based on the collateral valuations and the credit evaluation of borrowing members, management has determined that an allowance for advance losses is not warranted.

Carrying value is assumed to approximate fair value for financial instruments with three months or less to repricing or maturity. Fair values are based on quoted prices, market rates, or replacement rates for similar financial instruments as of the last business day of the year.

Consolidated Obligations. The Bank does not recognize a liability for its joint and several obligation related to the other FHLBanks' consolidated obligations. Consolidated obligations are the joint and several obligations of the FHLBanks and

consist of consolidated bonds and discount notes. Accordingly, should one or more of the FHLBanks be unable to repay their participation in the consolidated obligations, each of the other FHLBanks could be called upon to repay all or part of such obligations, as determined or approved by the Finance Board. No liability is recorded for the joint and several obligation related to the other FHLBanks' consolidated obligations under FIN 45 because of the high credit quality of each FHLBank and the remote possibility that an FHLBank would be unable to repay its participation.

REFCORP Payments. The financial statements do not include a liability for statutorily mandated payments from the FHLBanks to REFCORP. No liability is recorded because each FHLBank must pay 20% of net earnings (after its AHP obligation) to REFCORP to support the payment of part of the interest on the bonds issued by REFCORP, and the FHLBanks are unable to estimate their future required payments because the payments are based on future earnings and not estimable under SFAS 5. Accordingly, the REFCORP payments are disclosed as a long-term statutory payment requirement and, for accounting purposes, are treated like an income tax.