To Our Members

2006 presented significant challenges and opportunities for the Federal Home Loan Bank of San Francisco. We are pleased to report that your Bank met the challenges and seized the opportunities to ensure our continued strong financial performance and the accomplishment of our housing finance mission.

In spite of industry consolidation and the advent of new wholesale funding sources for our members, the absolute level of advances increased in 2007, and our credit products continued to be the principal source of wholesale funding for many of our members, often by a wide margin. During the year, members demonstrated the value they place on the Bank's low-cost credit offerings by increasing their advances to a record $183.7 billion. This growth reflected advance demand from a broad cross-section of members, small and large. In all, 162 members increased their advances during the year, and 265 members had credit outstanding at yearend.

Several factors play a critical role in making advances a viable funding option for members. The AAA rating on FHLBank System consolidated obligations, which is based on the System's financial strength and GSE status, enables the FHLBanks to issue low-cost debt in the global capital markets. We lend funds to our members at a very small mark-up, offering all members the same low prices. Members are able to pledge a wide range of collateral as security for advances, including whole loans that they may not be able to pledge elsewhere with the efficiency offered by the Bank. In addition, through our attention to innovation, we offer a variety of products with features that are designed to help members manage interest rate risk and achieve their other financial risk management objectives.

The Bank's growth in recent years has supported this dynamic lending model. As our members have increased their advances, they have also purchased additional capital stock to support those advances and related activities. The expansion of our business has helped us keep advance prices competitive and pay a market-rate dividend to our members, while enhancing our risk management, internal control, and financial reporting infrastructure.

Membership in the Bank also expanded in 2006. Despite continued consolidation activities among financial institutions in our district, total Bank membership rose to 387 by yearend. Our members include 253 commercial banks, 91 credit unions, 28 savings institutions, 12 thrift and loan companies, and 3 insurance companies. Members vary greatly by size, target market, and products and services offered. As a result, they have diverse connections with the customers and communities they serve, meeting the credit needs of people of all income levels, in urban, suburban, and rural areas alike.

These diverse lenders do have one thing in common: many of their portfolios are heavily weighted with residential mortgage loans. As of December 31, 2006, our members held $842 billion in residential mortgage-related assets, and these assets accounted for 42% of their total assets, approximately 50% higher than the percentage of residential mortgage-related assets held by non-member financial institutions in our district.

This direct, long-term investment in their customers and communities allows our members to retain greater flexibility and control over their underwriting decisions, enabling them to take advantage of their credit underwriting expertise to reach out to borrowers who may not meet rigid secondary market guidelines. Members are able to make this investment because they know they can use Bank products and services to meet their liquidity needs and help them control the interest rate risk associated with holding long-term assets on their balance sheets.

Strong financial performance in 2006 enabled the Bank to earn net income of $542 million and to set aside $61 million for the 2007 Affordable Housing Program. During 2006, we helped create over 7,500 affordable rental and ownership units through our competitive AHP by awarding $55 million to 131 projects sponsored by 43 of our members. Under our two homeownership set-aside programs, the Individual Development and Empowerment Account Program and the Workforce Initiative Subsidy for Homeownership Program, 32 members reserved $8.3 million to provide matching grants for low- to moderate-income homebuyers. We also provided $460 million in Community Investment Program and Advances for Community Enterprise advances, and we issued $206 million in standby letters of credit under these programs.

In 2006, we paid our members an annual dividend rate of 5.41%. To assess how well we have met our goal of paying members a market-rate dividend, we compare our dividend rate to a unique benchmark that is consistent with our interest rate risk management and capital management strategies and that also serves as an indicator of the yields available to our members for investments of comparable risk. Our 2006 dividend rate was 1.24% over the dividend benchmark, slightly higher than the 1.22% spread we achieved in 2005.

Our mission accomplishment and financial performance in 2006 once again demonstrated the effectiveness of our business model, as we were able to meet growing member credit needs while paying a market-rate dividend. Even with these successes, however, we face a variety of external risks and forces that could affect our business operations.

For example, the Federal Housing Finance Board's proposed rule on excess stock and retained earnings sparked an intense debate over the appropriate levels that should be held by the FHLBanks. On December 1, 2006, our Board of Directors affirmed a target of $296 million for the buildup of retained earnings (other than SFAS 133 gains) and changed the amount that may be made available for dividends to 90% of net income (excluding the effects of SFAS 133), beginning with the first quarter of 2007, until the new target is reached. This buildup of retained earnings is intended to protect members' paid-in capital from an extremely adverse credit or operations risk event, an extremely adverse SFAS 133 quarterly result, or an extremely low (or negative) level of net income before the effects of SFAS 133 resulting from an adverse interest rate environment. The buildup is in addition to any amounts retained as cumulative net unrealized gains in net income resulting from the application of SFAS 133. Assuming that the Bank's financial performance remains relatively consistent with its recent performance, the Bank would be expected to reach the $296 million target in the second quarter of 2010. In 2007, our Board of Directors intends to continue reviewing the Bank's retained earnings methodology and retained earnings and dividend policy, as well as alternative capital structures. We believe that retained earnings should be set at a level that will help preserve the value of Bank membership and support our mission while appropriately protecting safety and soundness and our members' investment in the Bank.

2007 marks the 75th anniversary of the FHLBank System. While the Federal Home Loan Bank of San Francisco officially came into existence in 1946, our identity, our housing finance mission, and even the fundamentals of our business model date back to the original vision of the designers of the FHLBank System. The purpose of the FHLBanks today is essentially unchanged: to serve the general public by providing liquidity to member financial institutions, enabling them to ensure the flow of credit and other services for housing and community development.

The coming year holds both promise and ongoing challenges for us and for our members, including the possibility of legislation that establishes a new regulatory structure for the GSEs, uncertainty about the economy and particularly the housing market, and the tension between the need to offer creative lending options to address the housing affordability issues that are so prevalent in our district and the need to maintain appropriate credit underwriting standards to protect consumers. Despite these possibilities and challenges, we are confident that our resilient business and lending model will continue to provide value to members, consumers, and communities in the coming year and beyond.

In closing, we would like to thank our Board of Directors, Affordable Housing Advisory Council, management and staff, and, above all, our members for their dedication to meeting the housing needs of families and individuals throughout Arizona, California, Nevada, and the other regions they serve.

James P. Giraldin
VICE CHAIRMAN OF THE BOARD

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CHAIRMAN OF THE BOARD

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PRESIDENT AND CEO