

To Our Members,

For more than 75 years, the Federal Home Loan Bank System has played a vital role in the American housing market. The importance of our role was magnified in 2007 when the collapse of the subprime mortgage market led to a liquidity crisis that extended well beyond the residential mortgage market.

We were there for our members.

2007 was a tumultuous year for the mortgage and housing markets, for the capital markets, and for many of our members. In August, growing anxiety about the meltdown in the subprime mortgage market led to a liquidity crisis of major proportions. The Federal Home Loan Banks played an essential role throughout the crisis, providing critical funding to members when other financing sources dried up. Collectively, the 12 FHLBanks increased advances to members by \$163 billion in August and September. The Federal Home Loan Bank of San Francisco increased advances to members by \$53 billion during those two months. The liquidity crisis has evolved, but not diminished, since the third quarter, and the effects of that crisis and ongoing concerns about the housing and mortgage markets continue to reverberate throughout the capital markets and the economy.

THE SUBPRIME DEBACLE

Many interrelated factors led to the problems in the subprime mortgage market. The housing boom in recent years prompted many mortgage originators to reach out to borrowers with lower credit scores and to make loans with little or no income documentation. Investors were enamored with the returns and the perceived safety of mortgage investments, and the instruments available to securitize mortgage investments became ever more diverse and complex, providing a constant flow of

funds to mortgage originators. In many instances, subprime borrowers were qualified for adjustable rate mortgages at the initial teaser rates, resulting in mortgages that could easily become unaffordable once interest rates began to reset at fully indexed rates. As long as property values continued to rise, the borrower's ability to repay the mortgage was a secondary consideration. But once home price appreciation slowed down, and in some markets stalled completely or began to reverse, the bottom fell out of the subprime mortgage market.

What caught people unawares, however, was not the subprime meltdown itself, but its effect on other sectors of the capital markets. Before the subprime mortgage market began to implode, very few observers appreciated the linkages from that market to the global financial system. That was the surprise.

Those linkages were obscured by the variety of new investment vehicles that were developed to take advantage of the housing boom and profit from the securitization of home mortgages. The credit risk inherent in subprime lending was rarely retained by the originator of the loans, but was dispersed throughout the marketplace. The rapid development of the market for collateralized debt obligations prompted many investors to invest in

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the cash flows derived from asset-backed securities without fully understanding the risks of the underlying assets. These vehicles were complex and opaque, without the kind of detailed disclosures usually provided for more basic mortgage-backed securities, and the senior portions of these securities were highly rated.

As investors began to recognize the extent of the subprime crisis and its effect on other market sectors, uncertainty became rampant, with adverse consequences for the short-term financing used to fund many collateralized debt obligations. There was a swift flight to quality among asset-backed securities investors and there were dramatic shifts in the value of many portfolios. Uncertainty about the size of the problem and which investment vehicles had significant exposure led to a freeze in the credit markets. Deleveraging became the order of the day. The secondary mortgage market for jumbo loans virtually disappeared. The asset-backed commercial paper market dried up. Leveraged investors were subjected to margin calls that forced sales. As the crisis deepened, the Federal Reserve and foreign central banks pumped liquidity into the markets. On August 9 and 10, 2007, the Federal Reserve provided \$62 billion through open market operations,

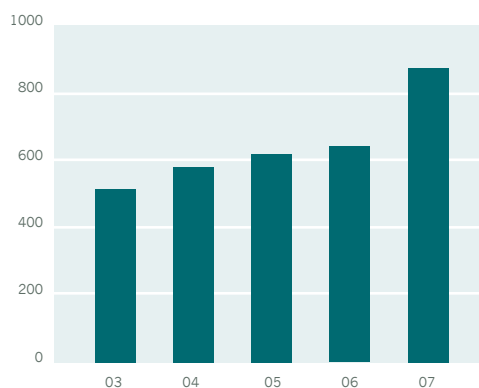
while the European Central Bank provided \$214 billion and other foreign central banks provided \$18 billion.

The FHLBanks also responded immediately and in record volumes, increasing their lending to members by \$110 billion in August and \$53 billion in September. Although the markets were volatile and pricing was a daily challenge, the FHLBanks were successful in raising funds in the capital markets at a reasonable cost and passing that benefit on to members. In an extremely difficult market, the FHLBanks met their members' credit needs, once again demonstrating their ability to fulfill their mission of providing liquidity for housing finance during difficult times. If the FHLBanks had not been able to respond to their members' liquidity needs so effectively, the liquidity crisis would have been much worse.

As we write this letter in early 2008, the credit crunch continues and the U.S. economy is still struggling with the fallout from the subprime debacle. Property values are still falling in many markets, foreclosures are still on the rise, and many borrowers are facing large increases in their mortgage payments due to interest rate resets. Misgivings about Alt-A loans, prime jumbo loans,

FHLBank System Yearend Advance Levels

BILLIONS OF DOLLARS



and construction loans also plague the mortgage market. The flight to quality on the part of investors is continuing, many markets are still experiencing a severe lack of liquidity, and there are concerns about the direction of the overall economy, based on these issues and other factors as well. So we are still in the middle of the story.

Nevertheless, we have enough perspective on what happened in the subprime mortgage market to begin to draw some valuable lessons from the experience. In recent years, the markets seemed to operate on the assumption that housing prices would continue to rise indefinitely, a familiar symptom of a “bubble mentality.” When a boom is underway, basic underwriting rules can get rewritten (or disregarded), especially if the underwriter doesn’t have a long-term stake in the loan being made. Another fundamental problem was the moral hazard created by the ability of loan originators and middlemen to pass on the credit risk of subprime mortgages by packaging them into vehicles that obscured the risk of the underlying assets. It appears that investors relied almost exclusively on the ratings assigned by the rating agencies, which provided a false sense of security on these structures. As it turned out, the rating agencies also failed to understand the complex nature and risks of these securities.

A DIFFERENT PERSPECTIVE

There is another way to look at what has taken place over the last few years, and other lessons to be drawn from recent events, including some that are particularly relevant to the FHLBanks and their members.

Critics of the housing GSEs have long argued that they should not exist or should be privatized because they distort the marketplace. They argue that a completely free enterprise system would achieve equally good results for housing. In 2003 and 2004, accounting problems at Freddie Mac and Fannie Mae led them to pull back from the secondary mortgage market significantly. When this happened, the private sector stepped up in a grand experiment that transformed the mortgage marketplace. Wall Street assumed a much larger role in providing funding for mortgages, creating new vehicles to package risk, while Fannie Mae’s and Freddie Mac’s market shares declined. According to the January 4, 2008, issue of “Inside Mortgage Finance,” from 2003 to 2006, Fannie Mae and Freddie Mac’s combined share of the mortgage securitization market fell from 72% to 41%, while the market share of nonagency issuers grew from 20% to 55%.

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In one sense, the critics of the housing GSEs had exactly what they wanted: an expansion of the role of the private market in housing finance, and a diminishment of the role of the housing GSEs. We have lived through this experiment—the rejiggering of the financial markets was something that we experienced—and we see the results. The hypothetical problems supposedly created by the existence of government-sponsored enterprises cannot compare to the current crisis.

In particular, recent events have resoundingly affirmed the value of the FHLBanks. As private funding sources abandoned the housing finance market in the summer of 2007, the FHLBanks stepped in and helped the nation avoid a massive liquidity failure. The argument that the United States would be better off without any government-sponsored enterprises is completely undermined by these events, which demonstrate the vitality and effectiveness of the FHLBanks. Not only have the FHLBanks fulfilled their traditional role as a stable source of low-cost funds for housing lenders in all phases of the housing cycle, but it is also even more evident that they are an integral part of our nation's financial system and a major provider of liquidity in times of stress.

Recent events have also demonstrated the value of the traditional model of portfolio lending. A lender that holds the loans it originates in portfolio,

retaining the credit risk, will underwrite those loans to very high standards, based on its in-depth knowledge of local economic conditions. Because the lender has a long-term stake in the loans it makes, accountability and market discipline are inherent in the process. This benefits the homebuyer, as well, since the lender is motivated to offer loan products that the borrower can reasonably be expected to be able to repay. Portfolio lenders make an ongoing investment in their communities, and the FHLBanks are here to support them in this endeavor.

A MODEL THAT WORKS

One reason the Federal Home Loan Bank of San Francisco was able to respond to the liquidity needs of our members so effectively was that the business model we follow anticipates change. You've heard this before: our business model is explicitly designed to allow us to expand when members need funding and contract when they don't. Our financial strategies provide us with tremendous flexibility. Because our capital stock grows and shrinks in tandem with advance activity, our financial performance can be managed without regard to the size of our advance portfolio. We have stuck to this basic concept over the years because we have seen how well it works. Housing is cyclical, member funding needs change over time, and our goal is to be here for our members in good times and in bad.

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This essential conservatism also serves us well when it comes to protecting our members' investment in the Bank. Our credit and collateral policies are designed so that all advances are fully secured by high quality, eligible collateral; for that reason, our policies and procedures are rigorous and are subject to change at any time in response to current market conditions. We monitor member creditworthiness and the value of pledged collateral on an ongoing basis. Our investment policies are equally conservative.

As members, you are aware of the recent changes we have made to our collateral policies in response to worsening conditions in the residential real estate markets in our district. In 2007 and early 2008, we took several actions that resulted in reduced borrowing capacities for all collateral types. We have also modified the credit terms for some members in response to weakening credit quality. If the environment continues to deteriorate, we will make additional adjustments to our credit and collateral terms so we can continue to meet the credit needs of our members in a safe and sound manner.

The market rewards our conservatism as well, enabling us to consistently access low-cost funding through the capital markets. Our AAA rating, conservative risk management, and GSE status are

key factors in our ability to keep funding costs low. The flight to quality that began in August 2007 increased the demand for FHLBank System consolidated obligations and lowered our funding costs relative to LIBOR in the second half of the year.

OUR 2007 RESULTS

Our responsiveness to the liquidity crunch is evident in our 2007 operating results. Advances grew to \$251 billion at December 31, 2007, a 37% increase compared to the prior yearend. We were able to meet the liquidity needs of members on a huge scale, when other liquidity sources were unavailable or far more costly. Net income for the year was \$652 million, a 20% increase. We paid our members an annual dividend rate of 5.20%. This rate was lower than the 5.41% annual dividend rate paid for 2006, chiefly because we changed our Retained Earnings and Dividend Policy as of January 1, 2007, to increase the target amount of retained earnings to \$296 million and to increase the percentage of earnings we will retain until the target is reached to 10%.

Membership in the Bank grew from 387 to 405 during the year. At yearend, the Bank's members included 266 commercial banks, 97 credit unions, 28 savings institutions, 11 thrift and loan companies, and 3 insurance companies.

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The Bank’s strong financial performance and increased earnings in 2007 enabled it to set aside \$73 million for the 2008 Affordable Housing Program, a new record. In 2007, we awarded \$65 million in grants through the competitive AHP to 132 projects sponsored by 47 members. The winning initiatives will create over 7,800 affordable rental and ownership units in Arizona, California, Colorado, Florida, Illinois, Minnesota, Montana, Nevada, North Carolina, Texas, and Washington.

Thirty-five Bank members also reserved \$7 million to provide matching grants to low- and moderate-income homebuyers under our two homeownership set-aside programs, the Individual Development and Empowerment Account Program and the Workforce Initiative Subsidy for Homeownership Program. We provided \$417 million in discounted advances under the Community Investment Program and the Advances for Community Enterprise program, and we issued \$130 million in standby letters of credit under the two programs.

LOOKING FORWARD

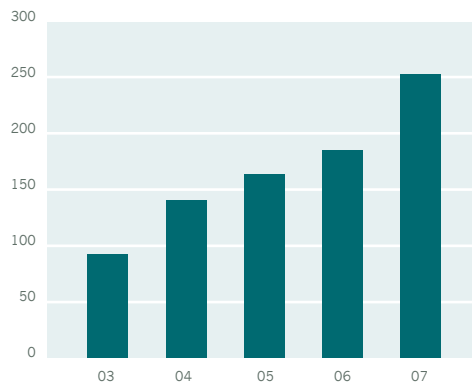
As we head into 2008, we are continuing to monitor market conditions and adjust our policies accordingly. As we said before, we are still in the middle

of this story. As it continues to unfold, we must maintain the balance between meeting the needs of individual members and ensuring the safety and soundness of the Bank as a whole, for the long-term benefit of all our members.

We are also in the process of launching two programs to help low- and moderate-income homeowners at risk of losing their primary residence because of default or delinquency on their mortgage loan—the Homeownership Preservation Subsidy, a matching grant program that provides \$1 for every \$2 contributed by the lender, up to \$25,000 per homeowner, and the Homeownership Preservation Advance, which provides discounted credit that our members can use to refinance or restructure existing mortgage loans.

In closing, we thank our Board of Directors, Affordable Housing Advisory Council, management, and staff for their sustained focus on the fundamentals that make it possible for the Bank to be consistently and reliably responsive to members’ funding needs, even in times of crisis. We also thank our members for allowing us to help them continue to provide the credit that is so essential to the economic health of our communities.

FHLBank San Francisco
 Yearend Advance Levels
 BILLIONS OF DOLLARS





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