Federal Home Loan Bank of San Francisco

2003 ANNUAL REPORT

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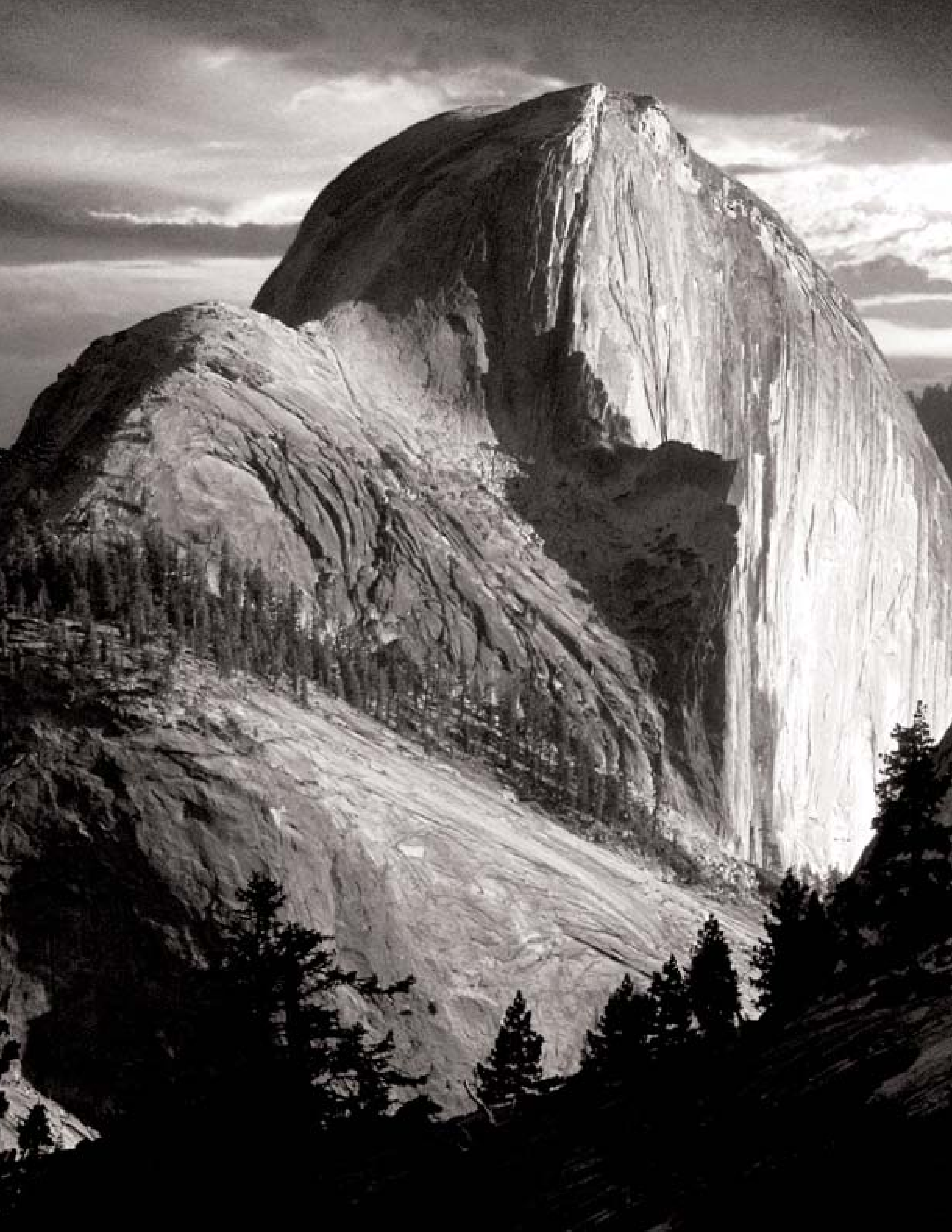
At the Federal Home Loan Bank of San Francisco, we promote housing, homeownership, and community economic development by linking our members to the worldwide capital markets. Prompt, reliable access to low-cost funding enables our members—commercial banks, credit unions, savings institutions, thrift and loans, and insurance companies—to achieve their financial objectives and meet the credit needs of communities throughout Arizona, California, Nevada, and the other regions they serve.



stable funding source

JOHN POLEN
PRESIDENT & CHIEF EXECUTIVE OFFICER
MALAGA BANK, S.S.B.
PALOS VERDES ESTATES, CA

"The Bank is the most dependable, accessible, straightforward source of funds we have. Knowing we can rely on Bank advances gives us an incredible ability to plan, and, if things change, the versatility of Bank borrowings allows us to alter our strategies. It's a phenomenal resource."

THE AAA CREDIT RATING ON FHLBANK SYSTEM DEBT ALLOWS THE BANK TO RAISE FUNDS AT VERY LOW RATES AND PASS ON THOSE RATES TO MEMBERS.

Malaga Bank, S.S.B., incorporates its access to Bank funding into its business plan at the beginning of each year. With a strong emphasis on multifamily lending, chiefly apartment and construction loans, Malaga Bank focuses on building its own portfolio, rather than on originating loans for sale to others. Malaga Bank uses fixed rate advances to match fund its loans and also borrows overnight to manage cash flows. "We can borrow advances for one day, one week, one month, or 30 years," says John Polen. "With the Bank as a funding resource, we can offer any interest rate product our customer needs and readily finance our growth. Reliable access to advances gives us a powerful tool to be competitive in our market."

MARC COOLEY
SENIOR DIRECTOR OF FINANCIAL ANALYSIS
ARIZONA FEDERAL CREDIT UNION
PHOENIX, AZ

"We use Bank advances to fund our structured leverage program, which helps us offset the interest rate risk in our core balance sheet. This program also allows us to put our excess capital to work and generates additional income to support other activities, such as building branches and improving service for our members."

Arizona Federal Credit Union serves all of Maricopa County, the City of Tucson, and specific low-income areas in Arizona. "Our focus is on providing retail consumer products for our members. We're not driven to generate fee income," says Marc Cooley. "The financial prosperity of our members is paramount." Arizona FCU uses term fixed rate advances from the Bank to fund investments in mortgage-backed securities. Because these investments behave differently than the credit union's other assets in different interest rate environments, this strategy helps Arizona FCU manage the interest rate risk of its core lending business.

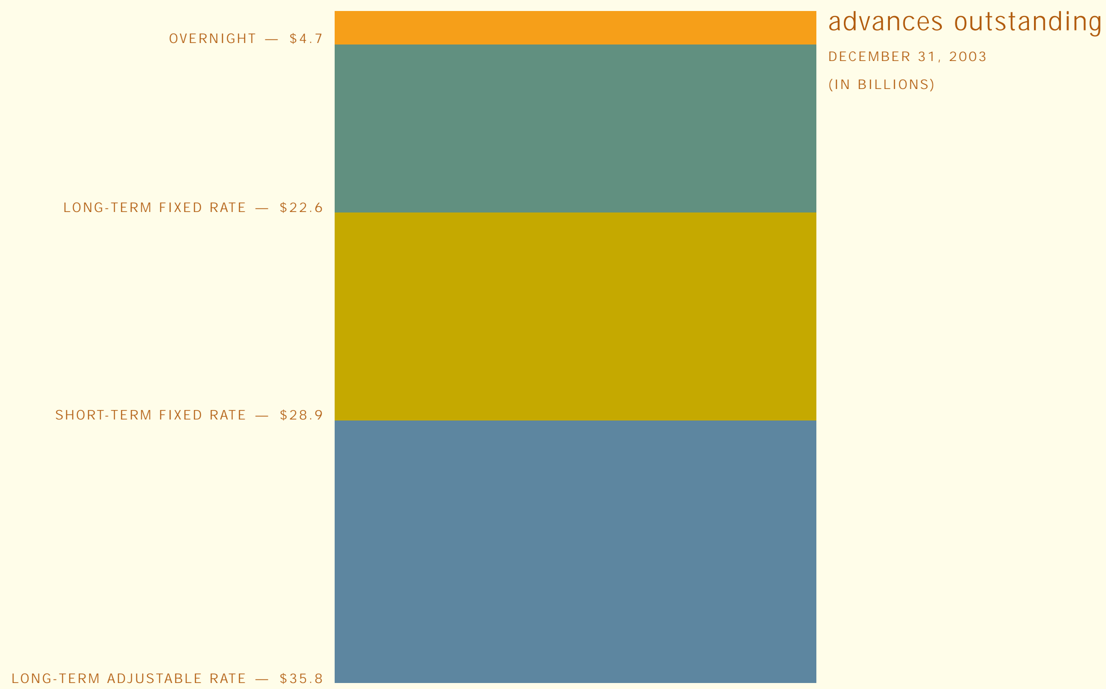
THE BANK'S DIVERSE ARRAY OF CREDIT PRODUCTS CAN BE CUSTOMIZED TO MEET A MEMBER'S FUNDING OR HEDGING REQUIREMENTS IN A VARIETY OF WAYS.

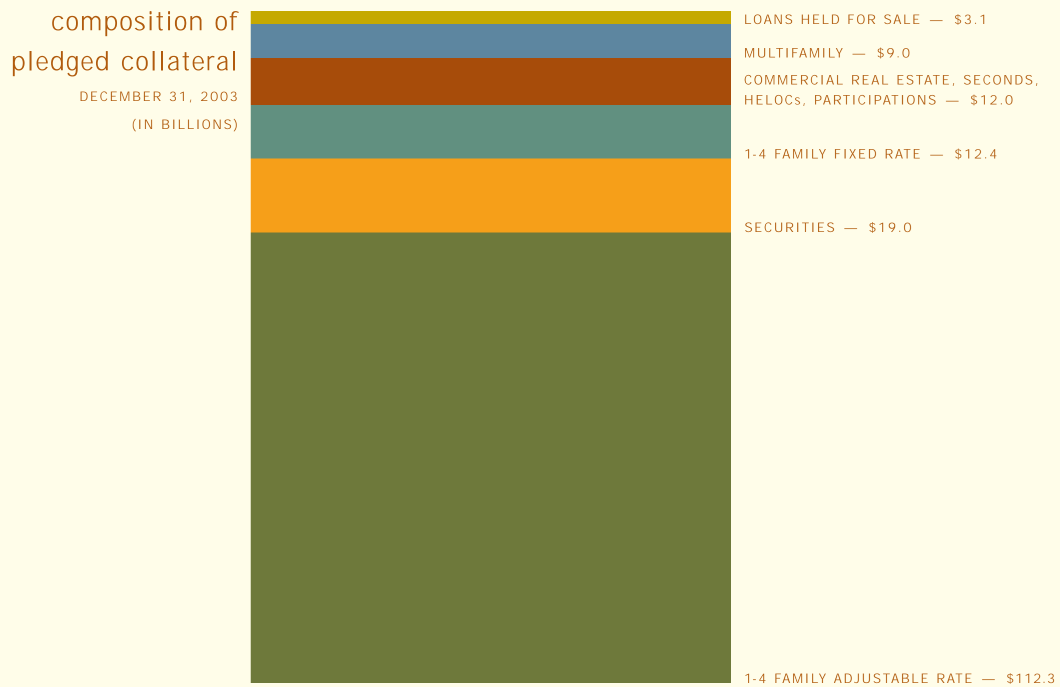
LARRY SORENSEN
EXECUTIVE VICE PRESIDENT
SONOMA NATIONAL BANK
SANTA ROSA, CA

"The Bank plays an integral role in helping us serve the financing needs of Sonoma County residents and businesses. Because we have close ties to our community, we are well positioned to meet local credit needs. Access to the Bank's advance products helps us serve a wide range of borrowers and offer a variety of attractive loan products."

IN 2003, THE BANK AWARDED $47.9 MILLION IN AHP, IDEA, AND WISH GRANTS FOR AFFORDABLE HOUSING AND PROVIDED $957.3 MILLION IN DISCOUNTED CIP AND ACE ADVANCES.

Sonoma National Bank is a traditional community bank emphasizing consumer and business banking, with a portfolio focused on residential and commercial real estate loans. "Bank advances supplement our funding resources and help provide pricing flexibility to be competitive in our market," says Larry Sorensen. "This supports our mission of providing the products and services our community needs." Sonoma National Bank uses adjustable rate, fixed rate, and amortizing advances. It also uses the Community Investment Program and Advances for Community Enterprise to obtain discounted advances for eligible uses, such as small business loans. "We are the quintessential community bank," says Larry Sorenson, "and we will always have a hometown focus. Bank advances enable us to do more for our community."


advances outstanding
DECEMBER 31, 2003
(IN BILLIONS)
OVERNIGHT — $4.7
LONG-TERM FIXED RATE — $22.6
SHORT-TERM FIXED RATE — $28.9
LONG-TERM ADJUSTABLE RATE — $35.8


composition of
pledged collateral
DECEMBER 31, 2003
(IN BILLIONS)
LOANS HELD FOR SALE — $3.1
MULTIFAMILY — $9.0
COMMERCIAL REAL ESTATE, SECONDS,
HELOCs, PARTICIPATIONS — $12.0
1-4 FAMILY FIXED RATE — $12.4
SECURITIES — $19.0
1-4 FAMILY ADJUSTABLE RATE — $112.3

The Bank promotes housing, homeownership, and community economic development by providing a bridge to the capital markets for our members, supplying them with essential liquidity and risk management tools. This bridge is built on a foundation of financial strength. As this report shows, we are dedicated to maintaining that financial strength and preserving and enhancing the value of the Bank to our members and their communities.

To Our Members

What a difference a year makes! In our 2002 annual report we identified several issues and trends that have the potential to alter the mission and structure of the Federal Home Loan Bank System by leading to consolidation. The questions we raised last year—about the growth of the mortgage purchase programs, the possibility of new securitization programs, SEC registration, and the expansion of multidistrict membership in the System—are still valid. These forces are still at work, and they still raise the long-term potential for structural alterations to the System that could change the way the Federal Home Loan Banks fulfill their housing mission. However, they are not the issues occupying center stage right now. Instead, questions of governance and regulatory oversight are in the spotlight.

Last spring an event that most observers would previously have considered extremely unlikely occurred when accounting irregularities were discovered at Freddie Mac. Even before those problems emerged, pressure had been building to reexamine the regulatory structure of both Fannie Mae and Freddie Mac. Freddie Mac's problems increased that pressure.

At the same time, others proposed that the FHLBanks be included in any regulatory restructuring proposal. They believed that if the regulatory structure of Fannie Mae and Freddie Mac was going to be strengthened to improve safety and soundness, the size and importance of the FHLBanks made it imperative that they receive the same treatment—both for enhanced safety and soundness and to prevent any perception in the market that the FHLBanks were less well regulated.

Our Board of Directors considered these ideas and concluded that if world-class regulation was appropriate for the other housing GSEs, it was also appropriate for the FHLBanks.

As ideas of reform developed, as specific proposals emerged, and as op-ed pieces proliferated, it became clear that there were many other objectives being pursued under the rubric of GSE regulatory reform. Observers each seem to see something different as they look at the housing GSEs. Some commentators question the value of the GSEs and whether there truly is any need for the capital market intermediary function. These people assert that the housing market would not be impaired by loss of access to the capital markets at agency rates through the GSEs. They urge privatization or elimination of the GSEs. Others seem to share that objective, but choose to couch their comments in terms of eliminating particular attributes of GSE status. These may include eliminating the relatively small line of credit with the U.S. Treasury that is made available to each GSE, eliminating the statutory exemptions from certain SEC registration requirements, and so forth. Others want to curb GSE activities or advantages in other ways, by restricting new product development, changing capital requirements, etc.

Clearly, any change that has a negative impact on access to the capital markets at agency rates would diminish the role and value of the GSEs and their contribution to housing. More expensive funding in the capital markets would reduce the availability of low-cost mortgage credit, as would any reduction in the amount of funding available.

It is our belief that the FHLBank System deserves a world-class regulator. At the same time, our objective is to maintain the cooperative structure of the System and to achieve our mission in the same way we do today. In other words, it is the regulatory structure that should be reformed, not the mission or structure of the System.

The stakeholders in the System are the ones to whom this issue matters the most. Borrowers from the FHLBanks want ongoing access to the advance programs. Members that originate loans for sale want viable and continually available alternatives to the traditional secondary mortgage market dominated by two giant GSEs. Housing advocates want a robust System so that the Affordable Housing Program and community investment programs will be consistently available through our financial institution members. The FHLBanks and the other GSEs are significant participants in numerous financial markets—their counterparties need, and expect to have, ongoing participation in the markets by the FHLBanks.

As is the case with most policy issues in America, if you choose to, you get to have a role in the decision. We urge you to be part of this process and to examine reform proposals closely as they are defined. You need to decide whether the particular things you find useful about the System will be there after reform, just as they are now.

Fortunately, as we move into these legislative debates, we are operating from a foundation of strength. Our membership base continues to grow, as we welcomed 31 new members in 2003. In addition, members' use of Bank products and services expanded significantly throughout the year. Seventy-nine percent of members actively used our products or services during 2003, up from 73% in 2002.

Advances outstanding grew 14% during the year, but, more importantly, we achieved our objective of being able to deliver solid returns to members in both expanding and contracting environments. We entered the year with an advances balance of $81.2 billion, which declined to $65.5 billion at one point in the third quarter, and then grew substantially through the rest of the year to end 2003 at $92.3 billion. Throughout the year, despite the rapid change in members' demand for advances, we continued to generate returns that were quite stable relative to our dividend benchmark.

The Bank's mission is to provide funding for its members. The need for funding may be driven by many factors, such as member asset growth or shrinkage, or the flow of deposits. Ultimately, the size of our balance sheet is not as important as our successful management of the Bank's balance sheet in a manner that gives us the flexibility to grow and

shrink with member needs while continuing to deliver solid returns. This past year was a perfect example of why this strategy is so critical.

Another change you will notice as you read through this annual report is the growth in mortgage loans acquired through our mortgage purchase program. Mortgage loans on our balance sheet grew from $0.3 billion to $6.4 billion during the year. This program provides members with an attractive alternative to selling loans into the secondary market. It also provides the Bank with a way to diversify our revenue sources while enhancing our dividend, which allows us to continue to offer pricing on advances that is competitive with alternative funding sources for any of our members, along with an attractive dividend.

We recognize that owning long-term fixed rate mortgages also adds considerable interest rate risk to our balance sheet, a point that is regularly mentioned in the financial press. We devote considerable resources and attention to managing this risk. Last year provided a good test for those resources, as longer-term interest rates fluctuated throughout the year and led to rapid swings in prepayment rates on mortgages. In 2003, our funding and hedging strategies proved they were up to the test.

In closing, we thank the Bank's directors for their leadership and guidance. Given the significance of the issues being debated today, we are fortunate to be led by a Board of Directors that understands the dynamics of the System and appreciates the importance of its unique mission and structure. In particular, we thank our outgoing Chairman of the Board, Mary Lee Widener, and Vice Chairman of the Board, D. Tad Lowrey. Ms. Widener served as Chairman for the past ten years, and she did a remarkable job leading us through times of significant change for the Bank and the System. Mr. Lowrey served on the Board as an industry director for eight years, the last two as Vice Chairman, and also contributed greatly to our success. In addition, we would like to welcome Monte L. Miller and John F. Robinson to the Board.

We also thank the members of our Affordable Housing Advisory Council for sharing their insight into the housing and economic development needs of our region in order to make our community investment programs and services more effective. In addition, we thank the Bank's employees, who work on a daily basis to meet the needs of members, achieve the Bank's mission, and preserve the safety and soundness of the Bank.

Above all, we thank you, our members, for your business and for your investment in the Bank. The purpose and structure of the Bank only matter as long as you are in the community, working to provide the credit and other financial products your customers need, contributing to the vitality and prosperity of the regions you serve.

Timothy R. Chrisman
VICE CHAIRMAN OF THE BOARD

Robert N. Barone
CHAIRMAN OF THE BOARD

Dean Schultz
PRESIDENT AND CEO

Financial Highlights

(DOLLARS IN MILLIONS EXCEPT PER SHARE AMOUNTS)	2003	2002	2001	2000	1999
SELECTED ITEMS AT YEAREND					
Total Assets	$132,390	$116,129	$135,384	$140,198	$115,922
Advances	92,330	81,237	102,255	110,032	90,514
Mortgage Loans	6,445	262	—	—	—
Mortgage-Backed Securities	16,317	16,001	13,769	10,763	7,049
Capital	5,846	5,685	6,809	6,292	5,438
ANNUAL OPERATING RESULTS					
Net Interest Income	$ 430	$ 515	$ 563	$ 555	$ 387
Net Income	323	292	425	377	333
Net Income Per Share	6.03	4.84	6.58	6.49	7.01
RATIOS					
Tangible Capital to Assets Ratio	4.42%	4.90%	5.03%	4.49%	4.69%
Net Interest Margin	0.38	0.42	0.41	0.44	0.41
Operating Expenses as a Percent of Average Assets	0.05	0.04	0.04	0.03	0.04
Return on Average Equity	5.90	4.73	6.49	6.37	6.87
Dividend Rate	4.29	5.45	5.99	7.17	5.36
ADJUSTED ANNUAL OPERATING RESULTS*					
Adjusted Net Income	$ 252	$ 324	$ 376	$ 381	$ 289
Adjusted Net Interest Margin**	0.35%	0.41%	0.41%	0.45%	0.42%
Adjusted Return on Average Equity	4.60	5.30	5.75	6.46	5.98
Potential Dividend Yield	4.70	5.37	5.80	6.55	6.10
Dividend Benchmark	2.79	3.36	4.69	6.01	5.36
Spread of Potential Dividend Yield to Dividend Benchmark	1.91	2.01	1.11	0.54	0.74
RECONCILIATION OF NET INCOME TO ADJUSTED NET INCOME					
Net Income	$ 323	$ 292	$ 425	$ 377	$ 333
Net Loss/(Gain) on Held-at-Fair-Value Securities	11	(17)	(6)	—	—
Net (Gain)/Loss on Derivatives and Hedging Activities	(80)	47	(47)	—	—
REFCORP Assessments	—	—	—	—	(49)
Other Adjustments	(2)	2	4	5	5
Adjusted Net Income	$ 252	$ 324	$ 376	$ 382	$ 289

*The Bank calculates adjusted financial performance measures to provide a more meaningful comparison of the Bank's financial results over time. These measures are not intended to be a presentation in accordance with generally accepted accounting principles. Adjusted financial performance measures exclude the effects of any current period fair value changes (net of applicable assessments) made in accordance with Statement of Financial Accounting Standards (SFAS) 133, Accounting for Derivative Instruments and Hedging Activities, and fair value adjustments on held-at-fair value securities reclassified from held-to-maturity securities upon the adoption of SFAS 133 because these effects are generally expected to reverse over time. Adjusted financial performance measures also reflect earnings before advance prepayment fees and certain other 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 items, in accordance with the Bank's retained earnings policy, in order to recognize prepayment fees, debt retirement gains and losses, and other transactions over the periods remaining through the related instruments' original maturity dates. In addition, as a result of the Gramm-Leach-Bliley Act of 1999, 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. These adjusted financial performance measures show the Bank's operating results after subtracting the REFCORP assessment for 1999.

**Includes the interest receipts and payments on non-hedge qualifying derivatives that are economic hedges classified in other income in the Statements of Income.

Our Business

INTRODUCTION

At the Federal Home Loan Bank of San Francisco (Bank), our purpose is to enhance the availability of credit for residential mortgages and targeted community development by providing a readily available, low-cost source of funds for housing and community lenders. We are a wholesale bank—we link our customers to the worldwide capital markets and maintain a ready supply of liquidity so that funds are available when our customers need them. By providing needed liquidity and enhancing competition in the mortgage market, our credit and mortgage purchase programs benefit homebuyers and communities.

We are one of 12 regional Federal Home Loan Banks (FHLBanks) that serve the United States as part of the Federal Home Loan Bank System. Each FHLBank is a separate entity with its own board of directors, management, and employees. We operate under a federal charter and are a government-sponsored enterprise (GSE). We are regulated by the Federal Housing Finance Board (Finance Board), an independent federal agency. We are not a government agency and do not receive financial support from taxpayers. The U.S. government does not guarantee, directly or indirectly, the debt securities or other obligations of the Bank or the FHLBank System.

We have a unique, cooperative ownership structure. To access our products and services, a financial institution must be approved for membership and purchase capital stock in the Bank. The member's stock requirement is generally based on its use of Bank products, subject to a minimum membership requirement that reflects the value of having ready access to the Bank as a reliable source of low-cost funds. Bank stock can be issued, exchanged, redeemed, and repurchased only at its stated par value of $100 per share. It is not publicly traded.

Our members are financial services firms that represent a number of different sectors. As of December 31, 2003, the Bank's membership comprised 233 commercial banks, 71 credit unions, 39 savings institutions, 9 thrift and loan companies, and 1 insurance company. Their principal places of business are located in Arizona, California, or Nevada, the three states that make up the 11th District of the FHLBank System, but many do business in other parts of the country. Members range in size from institutions with less than $10 million in assets to the largest savings institution in the nation with assets of over $200 billion.

Our primary business is making low-cost, collateralized loans, known as "advances," to our members. Advances may be fixed or adjustable rate, with terms ranging from one day to 30 years. We accept a wide range of collateral types, some of which cannot be pledged elsewhere or readily securitized. Members use advances to lower their funding costs, facilitate asset/liability management, manage interest rate risk, reduce on-balance sheet liquidity, offer a wider range of mortgage products to their customers, and improve profitability. Because members retain ownership of the loans they pledge to us, these loans do not have to meet the rigid investment criteria of the secondary market, which allows members greater underwriting flexibility and enables them to serve underserved communities more effectively.

To fund advances, the FHLBanks issue debt (consolidated obligation bonds and discount notes) through the FHLBank System's Office of Finance, which manages the issuance and servicing of consolidated obligations on behalf of the 12 FHLBanks. Because the FHLBanks' consolidated obligations are rated Aaa by Moody's Investors Service and AAA by Standard & Poor's, the FHLBanks are able to raise funds at rates that are close to U.S. Treasury security yields. Our modest administrative costs allow us to pass these low funding rates on to our members.

In addition to advances, we provide members with a competitive alternative to the traditional secondary mortgage market through our mortgage purchase program, the Mortgage Partnership Finance® (MPF®) Program. ("Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.) Members also benefit from our affordable housing and economic development programs, which provide grants and discounted loans that support their involvement in creating affordable housing and revitalizing communities.

OUR BUSINESS MODEL

Our unique purpose and structure have led us to develop a business model that is different from that of a typical financial services firm. Our business model is based on the premise that we maintain a balance between our obligation to provide adequate returns on the private capital provided by our members and our obligation to achieve our public policy mission to promote housing, homeownership, and community development. We achieve this balance by delivering low-cost credit to help members meet the credit needs

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; the Bank's 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. This report, including 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 43.

of their communities while paying members a market-rate dividend. Reflecting our nature as a cooperative, our financial strategies are also designed to enable us to expand and contract our assets, liabilities, and capital in response to changes in membership composition and member credit needs.

The value of membership in the Bank derives primarily from two aspects:

- the relatively low rates at which members can borrow, as a result of our ability to raise funds in the capital markets at a low cost because of our AAA-rating and our status as a GSE, and
- the dividends we pay.

Unlike most financial institutions, our dividends represent a large portion of our earnings. In addition, our earnings are largely the result of earnings on the capital stock issued to our members, while net earnings on member advances, mortgage loans, mortgage-backed securities (MBS), and other investments are generally used to pay our operating expenses and other costs (with additional earnings, if any, also contributing to the dividend).

Here's how it works:

- Each member is required to buy a certain amount of capital stock to join the Bank. Above a certain threshold, this requirement is proportional to the member's use of advances and sales of mortgage loans to the Bank under the MPF Program.
- The Bank invests the proceeds from the sale of capital stock 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 when a member reduces its use of Bank products or withdraws from membership. These investments provide the Bank with a market-rate yield, which may be returned to the members through the dividend.
- The capital is leveraged through the issuance of FHLBank System debt.
- Most of the funds raised through debt issuance are loaned to members as advances at a nominal mark-up over the Bank's cost of debt.
- The remainder of the funds raised through debt issuance is used to maintain the Bank's liquidity and investment portfolios (primarily mortgage-backed securities and mortgage loans) to provide financial flexibility and income.
- The net interest income from advances and the liquidity and investment portfolios is used to pay operating expenses and other costs and to help keep advance prices low while enabling the Bank to pay a market-rate dividend.

Our capital grows when members purchase additional stock to support their advance borrowings and the mortgage loans they have sold to the Bank, when members that are not using Bank products (or are using them to a small degree) experience an increase in their membership stock requirement because of asset growth, and when new members join the Bank.

This business model has worked well by requiring members to provide capital to support their activities with the Bank. Our Board of Directors has adopted a policy that balances the trade-off between credit prices and potential dividends. We target the potential dividend, which moves with interest rates, to approximate the yield on a short-term bond fund and hold credit prices down to provide lower borrowing rates to our members. This policy is intended to provide all members with a market rate of return on their stock and to reward borrowing members by providing low advance rates.

In keeping with this business model, we measure our financial performance by comparing the potential dividend yield on our capital stock to a dividend benchmark. The potential dividend yield is current period earnings (excluding fair value adjustments and other adjustments for nonrecurring items) stated as a percentage of total capital stock. The dividend benchmark reflects our strategy for investing the capital provided by members. It 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 difference between the potential dividend yield and the dividend benchmark represents the incremental 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.

PRODUCTS AND SERVICES

Advances. We offer a wide array of fixed and adjustable rate loans, called advances, with maturities ranging from one day to 30 years. We offer both standard and customized advance structures, including option-embedded advances and amortizing advances.

All advances must be fully collateralized. To secure advances, members may pledge one- to four-family residential mortgage loans, multifamily mortgage loans, mortgage-backed securities, U.S. government and agency securities, deposits in the Bank, and certain other real estate-related collateral, such as commercial real estate loans. We may also accept secured small business, small farm, and small agribusiness loans as collateral from members that are community financial institutions.

To determine the maximum amount and term of the advances we will lend to a member, we assess the member's creditworthiness and financial condition. We also value the collateral pledged to the Bank and conduct periodic collateral reviews to establish the amount we will lend against each collateral type for each member. We require delivery of all securities collateral, and we may also require delivery of loan collateral under certain conditions (for example, from a newly formed institution or when a member's creditworthiness deteriorates).

As of December 31, 2003, we had $92.3 billion of advances outstanding. The value of all collateral pledged by members as of that date was $167.8 billion. Based on the collateral held as security for advances, our policies and procedures for managing credit risk, and the fact that we have never had a credit loss on an advance, we have not established a loan loss allowance for advances.

Our advance products are designed to help members compete effectively in their markets and meet the credit needs of their communities. For lenders that choose to retain the mortgage loans they originate as assets (portfolio lenders), advances may serve as a funding source for a variety of conforming and nonconforming mortgages. As a result, advances support a variety of housing markets, including those focused on low-and moderate-income households. For members that sell or securitize mortgages and other assets, advances can provide interim funding.

Our credit products also help members with asset-liability management. Members can use a variety of advance types, with different maturities and payment characteristics, to match the characteristics of their assets and reduce their interest rate risk. We offer advances that are callable at the member's option and advances with embedded caps and floors, which can reduce the interest rate risk associated with holding fixed rate mortgage loans and adjustable rate mortgage loans with embedded caps in portfolio.

Standby Letters of Credit. We also provide members with standby letters of credit to support certain obligations of the members to third parties. Members may use standby letters of credit to facilitate residential housing finance and community lending or for liquidity and asset-liability management. Our underwriting and collateral requirements for standby letters of credit are the same as the underwriting and collateral requirements for advances. As of December 31, 2003, we had $1.0 billion in standby letters of credit outstanding.

Mortgage Loans. To provide our members with an alternative to holding conforming fixed rate residential mortgage loans in portfolio or selling them into the secondary market, we began purchasing mortgage loans from members under the MPF Program in 2002. Under the program, we buy qualifying 15-, 20-, and 30-year conventional conforming and government-guaranteed fixed rate mortgage loans on single-family residential properties. We may sell participations in all or a portion of the purchased loans to one or more of the other FHLBanks. We manage the liquidity, interest rate, and prepayment risk of the loans held, while the member manages the origination and servicing activities. We share the credit risk of the loans with the member—we assume the first loss obligation limited by a First Loss Account (FLA), and the member assumes credit losses in excess of the FLA, up to the amount of the credit enhancement obligation specified in the master agreement. The amount of the credit enhancement is calculated so that any credit losses to the Bank (excluding special hazard losses) in excess of the enhancement are limited to those expected from an equivalent investment with a long-term credit rating of AA. The participating member receives a credit enhancement fee from us for managing this portion of the credit risk in the loans.

Affordable Housing Program. Through our Affordable Housing Program (AHP), we provide subsidies to assist in the purchase, construction, or rehabilitation of housing for households earning up to 80% of the median income for the area in which they live. Each year, we set aside approximately 10% of the current year's net income for the AHP, to be awarded in the following year. All subsidies are funded to affordable housing sponsors or developers through our members in the form of direct grants or discounted advances. Since 1990, we have provided nearly $318 million in AHP grants, which have resulted in the creation of approximately 61,000 affordable homes.

Approximately 80% of our annual AHP subsidy is allocated to our competitive AHP, in which applications for specific owner-occupied and rental housing projects are submitted by members and are evaluated and scored by the Bank in a competitive process that occurs twice a year. The remaining 20% is offered to homebuyers through two homeownership set-aside programs, in which members reserve funds to be used as matching grants for eligible homebuyers.

Discounted Credit Programs. We offer two discounted credit programs that may be used in conjunction with advances and standby letters of credit. The Community Investment Program may be used to fund mortgages for low- and moderate-income households, to finance first-time homebuyer programs, to create and maintain affordable housing, and to support other lending activities related to housing for moderate-income families. The Advances for Community Enterprise (ACE) Program may be used to fund projects and activities that create or retain jobs or provide services or other benefits for low- and moderate-income people and communities. ACE funds may be used to support community lending and economic development, including small business, community facilities, and public works projects.

FUNDING SOURCES

Debt Financing. We obtain most of our funds from the sale to the public of the FHLBanks' debt instruments (consolidated obligations), which consist of bonds and discount notes. Consolidated obligations are the joint and several obligations of all the FHLBanks and are sold to the public through the Office of Finance using authorized securities dealers. Although consolidated obligations are backed only by the financial resources of the 12 FHLBanks and are not guaranteed by the U.S. government, the capital markets have traditionally treated the FHLBanks' consolidated obligations as "federal agency" debt, providing the FHLBanks with access to funding at relatively favorable rates. Moody's has rated the consolidated obligations Aaa/P-1, and Standard & Poor's has rated them AAA/A-1+.

Finance Board regulations govern the issuance of debt on behalf of the FHLBanks and related activities. The regulations authorize the FHLBanks to issue consolidated obligations through the Office of Finance under the authority of section 11(a) of the FHLB Act. Through December 31, 2000, the Finance Board issued consolidated obligations on behalf of the FHLBanks through the Office of Finance. All of the FHLBanks are jointly and severally liable for the consolidated obligations.

The Office of Finance has responsibility for facilitating and approving the issuance of the consolidated obligations. It also services all outstanding FHLBank debt, serves as a source of information for the FHLBanks on capital market developments, and prepares the FHLBanks' combined quarterly and annual financial statements. In addition, it administers the Resolution Funding Corporation (REFCORP) and the Financing Corporation (FICO), two corporations established by Congress in the 1980s to provide funding for the resolution and disposition of insolvent savings institutions.

Consolidated Obligation Bonds – Consolidated obligation bonds satisfy term funding requirements and are issued under various programs. Typically, the maturities of these securities range from 1 to 15 years, but the maturities are not subject to any statutory or regulatory limit. The bonds can be fixed or adjustable rate and callable or non-callable. They are issued and distributed daily through negotiated or competitively bid transactions with approved underwriters or selling group members.

Consolidated Obligation Discount Notes – The FHLBanks also sell consolidated obligation discount notes to provide short-term funds for advances to members and for other investments. These securities have maturities up to 360 days and are offered daily through a consolidated obligation discount-note selling group and through other authorized securities dealers. Discount notes are sold at a discount and mature at par.

USE OF INTEREST RATE EXCHANGE AGREEMENTS

We use interest rate exchange agreements (exchange agreements), also known as "derivatives," as part of our interest rate risk management and funding strategies to reduce identified risks inherent in our normal course of business. Exchange agreements include interest rate swaps (including callable swaps and putable swaps), swaptions, interest rate cap and floor agreements, and futures and forward contracts. The Finance Board's regulations, its Financial Management Policy, and the Bank's Risk Management Policy all establish guidelines for our use of exchange agreements. These regulations and policies prohibit trading in exchange agreements for profit and any other speculative use of these instruments. They also limit the amount of credit risk allowable from exchange agreements.

We primarily use exchange agreements to manage our exposure to changes in interest rates. The goal of our interest rate risk management strategy is not to eliminate interest rate risk, but to manage it within appropriate limits. One key way we manage interest rate risk is to acquire and maintain a portfolio of assets and liabilities, which, together with their associated exchange agreements, are conservatively matched with respect to the expected maturities or repricings of the assets and the liabilities. We may also use exchange agreements to adjust the effective maturity, repricing frequency, or option characteristics of financial instruments (like advances and outstanding bonds) to achieve risk management objectives. From time to time, we may also use exchange agreements to act as a counterparty to member institutions for their own risk management activities.

At December 31, 2003, the total notional amount of our outstanding exchange agreements was $126.8 billion. One important point about the risk of exchange agreements is that the contractual or notional amount of an exchange agreement is not a measure of the amount of credit risk from that transaction. The notional amount serves as a basis for calculating periodic interest payments or cash flows.

We are subject to credit risk in all derivatives transactions because of the potential nonperformance by the derivative counterparty. We reduce this credit risk by executing derivatives transactions only with highly rated financial institutions. In addition, the legal agreements governing our derivatives transactions require the credit exposure of all derivative transactions with each counterparty to be netted and require each counterparty to deliver high quality collateral to us once a specified unsecured net exposure is reached. At December 31, 2003, the maximum credit exposure of the Bank was approximately $266 million; after delivery of required collateral the unsecured net credit exposure was approximately $50 million.

The market risk of derivatives can only be measured meaningfully on a portfolio basis, taking into account the entire balance sheet and all derivatives transactions. The market risk of the derivatives and the hedged items is included in the measurement of our duration gap (the difference between the expected weighted average maturities of our assets and liabilities), which was 0.6 months at December 31, 2003. This low interest rate risk profile reflects our conservative asset-liability mix.

CAPITAL

From its enactment in 1932, the FHLB Act provided for a subscription-based capital structure for the FHLBanks. The amount of capital stock that each FHLBank issued was determined by a statutory formula establishing how much FHLBank stock each member was required to purchase. With the enactment of the Gramm-Leach-Bliley Act of 1999 (GLB Act), Congress replaced the statutory subscription-based member stock purchase formula with requirements for total capital, leverage capital, and risk-based capital for the FHLBanks and required the FHLBanks to develop new capital plans to replace the previous statutory structure.

We will implement our new capital plan on April 1, 2004. In general, the capital plan requires each member to own stock in an amount equal to the greater of a membership stock requirement or an activity-based stock requirement. We may adjust these requirements from time to time within limits established in the capital plan.

The new capital plan is similar to the prior capital structure because it bases the stock purchase requirement on the level of activity a member has with the Bank, subject to a minimum membership requirement that reflects the value of having access to the Bank as a reliable funding source.

Bank stock cannot be publicly traded, and it can be issued, exchanged, redeemed, and repurchased only at its stated par value of $100 per share. Under our new capital plan, capital stock may be redeemed upon five years' notice, subject to certain conditions. In addition, the Bank has the discretion to repurchase excess stock from members. Overall, we expect the new plan to result in a similar level of total capital. Ranges we have built into the capital plan will allow us to adjust the stock purchase requirement to meet our regulatory capital requirements, if necessary.

Until we fully implement our capital plan, the current capital rules remain in effect. For more information on capital requirements, see Note 13 in the Notes to the Financial Statements.

COMPETITION

Demand for Bank advances is affected by many factors, including the availability and cost of other sources of funding for members, including retail deposits. We compete with our members' other suppliers of wholesale funding, both secured and unsecured. These suppliers may include securities dealers, commercial banks, and, in certain circumstances, other FHLBanks. (Under the FHLB Act and Finance Board regulations, affiliated institutions may be members of different FHLBanks.)

Members may have access to alternative funding sources through sales of securities under agreements to resell. Larger members may have access to many more funding alternatives, including independent access to the national and global credit markets. The availability of alternative funding sources for members can significantly influence the demand for our advances and can vary as a result of many factors, including, among others, market conditions, members' creditworthiness, and the availability of collateral.

We also compete, primarily with Fannie Mae and Freddie Mac, for the purchase of mortgage loans from members. We compete primarily on the basis of price, products, structures, and services offered.

The FHLBanks also compete with the U.S. Treasury Department, Fannie Mae, Freddie Mac, and other GSEs, as well as corporate, sovereign, and supranational entities, for funds raised through the issuance of unsecured debt in the national and global debt markets. Increases in the supply of competing debt products may, in the absence of increases in demand, result in higher debt costs or lesser amounts of debt issued at the same cost than otherwise would be the case.

ADVANCES CONCENTRATION

For the advances-related business, at December 31, 2003, we had a concentration of advances totaling $62.0 billion outstanding to three members, representing 67% of total advances outstanding. At December 31, 2002, we had a concentration of advances totaling $58.1 billion outstanding to three members, representing 72% of total advances outstanding. Advances held by these three members generated $1.1 billion or 59%, $1.9 billion or 67%, and $4.0 billion or 76% of advances interest income before the impact of interest rate exchange agreements for the years ending December 31, 2003, 2002, and 2001, respectively.

Because of this concentration in advances, we have implemented specific credit and collateral review procedures for these members. In addition, we analyze the implications for our financial management and profitability if we were to lose the advances business of one or more of these customers.

REGULATORY OVERSIGHT, AUDITS, AND EXAMINATIONS

The FHLBanks are supervised and regulated by the Finance Board, which is an independent agency in the executive branch of the U.S. government. The Finance Board ensures that the FHLBanks carry out their housing and community development finance mission, remain adequately capitalized and able to raise funds in the capital markets, and operate in a safe and sound manner. The Finance Board also establishes regulations governing the operations of the FHLBanks.

The Finance Board is supported entirely by assessments from the 12 FHLBanks. To assess the safety and soundness of the Bank, the Finance Board conducts an annual on-site examination of the Bank and off-site reviews of its financial operations. In addition, the Bank is required to submit monthly financial information on the condition and results of operations of the Bank to the Finance Board.

The Bank has an audit committee of the Board of Directors and an internal audit department. An independent public accounting firm audits the Bank's annual financial statements. The independent accountant conducts these audits following Generally Accepted Auditing Standards of the United States of America and Government Auditing Standards issued by the Comptroller General. The Bank, the Finance Board, and Congress all receive the audit reports. The Bank must submit annual management reports to Congress, the President of the United States, the Office of Management and Budget, and the Comptroller General.

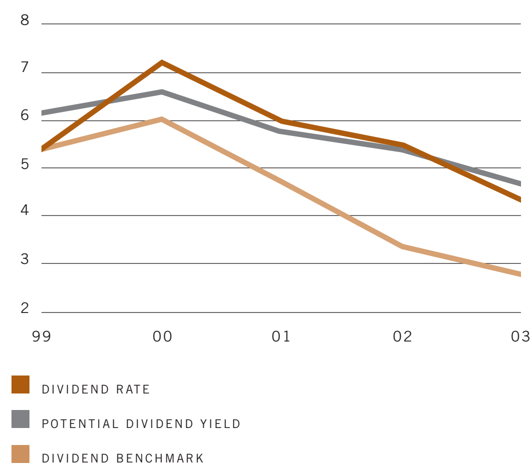
FINANCIAL PERFORMANCE

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. Dividends that may be paid by the Bank are largely the result of the Bank's earnings on invested member capital. Net earnings on member credit, MBS, mortgage loans, and other investments are approximately equivalent to the Bank's operating expenses and assessments, with any excess potentially contributing to dividends.

The Bank's financial strategies are designed to enable the Bank to expand and contract its capital, assets, and liabilities in response to member credit needs and membership composition. The Bank invests member capital in high-quality, short- and intermediate-term financial assets. This strategy reduces the risk of market value loss if investments have to be liquidated for the redemption or repurchase of excess capital stock when a member reduces its use of Bank credit or withdraws from membership.

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 period earnings (excluding fair value adjustments, as explained below, and advances prepayment fees, net of the amortization of current and prior period prepayment fees and other deferred items) 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 difference between the potential dividend yield and the dividend benchmark represents the potential 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.

DIVIDEND RATE, POTENTIAL DIVIDEND YIELD & DIVIDEND BENCHMARK (PERCENT)



The spread between the potential dividend yield and the dividend benchmark (dividend spread) was 191 basis points for 2003 compared to 201 basis points for 2002. The Bank's potential dividend yield was 4.70% for 2003, a decrease of 67 basis points from 5.37% for 2002. The dividend benchmark was 2.79% for 2003, a decrease of 57 basis points from 3.36% for 2002. The decrease in the potential dividend yield in 2003 was primarily due to the decline in market interest rates, as reflected in the dividend benchmark, coupled with lower average capital balances, which reduced the earnings on invested member capital. The decrease in the spread between the potential dividend yield and the dividend benchmark was due to the compression of profit spreads on the Bank's MBS and mortgage loan portfolios. This compression was caused by lower average interest rates during 2003, which led to accelerated principal prepayments and a higher rate of amortization of purchase premiums on mortgage-related assets.

RESULTS OF OPERATIONS

The following table presents average balances and yields of earning asset categories and the sources that fund those earning assets (liabilities and capital). It also presents spreads between yields on total earning assets and the cost of interest-bearing liabilities and spreads between yields on total earning assets and the cost of total funding sources (interest-bearing liabilities plus capital plus other interest-free liabilities that fund earning assets).

The primary source of Bank earnings is net interest income, which is the interest earned on advances, mortgage loans, investments, and invested capital less interest paid on consolidated obligations, deposits, and other borrowings. The net interest spread decreased slightly while the net interest margin decreased 4 basis points during 2003 compared to 2002, reflecting the 57-basis-point drop in the yield on invested capital and the commensurate effect on the net interest income component of the net interest margin. In contrast, the increase in the net interest spread and the net interest margin in 2002 compared to 2001 was primarily due to improved earnings from the Bank's MBS portfolio resulting from higher investment balances and profit spreads.

AVERAGE BALANCE SHEETS

	2003			2002			2001		
(DOLLARS IN MILLIONS)	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	$ 3,681.3	$ 44.0	1.19%	$ 4,405.0	$ 78.3	1.78%	$ 3,636.0	$ 142.4	3.92%
Resale agreements	2,605.6	30.0	1.15	2,731.8	47.9	1.75	1,544.9	63.9	4.14
Federal funds sold	6,808.8	77.9	1.14	6,787.9	119.2	1.76	8,436.0	349.3	4.14
Held-to-maturity securities:									
Other investments	2,212.9	30.2	1.36	3,353.9	64.3	1.92	3,688.0	156.8	4.25
MBS	14,418.5	550.5	3.82	14,394.8	777.1	5.40	11,208.3	684.7	6.11
Held-at-fair-value securities	829.8	31.4	3.79	513.3	10.8	2.10	584.3	27.7	4.74
Mortgage loans	2,971.7	138.5	4.66	31.6	1.6	5.07	—	—	—
Advances[1]	79,419.6	1,128.6	1.42	90,095.3	1,818.9	2.02	107,605.3	4,733.7	4.40
Deposits for mortgage loan program with other FHLBank	10.4	0.1	1.30	3.7	0.1	1.35			
Loans to other FHLBanks	12.3	0.1	1.14	15.2	0.2	1.65	26.8	0.8	2.99
Total interest-earning assets	112,970.9	2,031.3	1.80	122,332.5	2,918.4	2.39	136,729.6	6,159.3	4.50
Other assets[2]	2,596.5	—	—	2,860.2	—	—	2,382.4	—	—
Total Assets	$115,567.4	$2,031.3	1.76%	$125,192.7	$2,918.4	2.33%	$139,112.0	$6,159.3	4.43%
Liabilities and Capital									
Interest-bearing liabilities:									
Consolidated obligations:									
Bonds[1]	$ 89,928.1	$1,391.6	1.55%	$ 99,395.1	$2,082.6	2.10%	$ 94,383.3	$4,065.7	4.31%
Discount notes[1]	17,356.6	206.1	1.19	16,192.3	312.9	1.93	34,783.2	1,513.9	4.35
Deposits	416.6	3.5	0.85	503.3	7.2	1.43	480.2	16.0	3.33
Borrowings from other FHLBanks	0.5	0.0	1.20	3.8	0.1	2.60	2.1	0.1	3.80
Other borrowings	8.9	0.1	1.16	9.2	0.1	1.08	6.1	0.2	3.58
Total interest-bearing liabilities	107,710.7	1,601.3	1.49	116,103.7	2,402.9	2.07	129,654.9	5,595.9	4.32
Other liabilities[2]	2,378.9	—	—	2,914.7	—	—	2,912.1	—	—
Total Liabilities	110,089.6	1,601.3	1.45	119,018.4	2,402.9	2.02	132,567.0	5,595.9	4.22
Capital	5,477.8	—	—	6,174.3	—	—	6,545.0	—	—
Total Liabilities and Capital	$115,567.4	$1,601.3	1.39%	$125,192.7	$2,402.9	1.92%	$139,112.0	$5,595.9	4.02%
Net Interest Income		$ 430.0			$ 515.5			$ 563.4	
Net Interest Spread			0.31%			0.32%			0.19%
Net Interest Margin[3]			0.38%			0.42%			0.41%
Total Average Assets/Capital Ratio	21.1x			20.3x			21.3x		
Interest-Bearing Assets/ Interest-Bearing Liabilities	1.0x			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.

Changes in both volume and interest rates influence changes in net interest income and the net interest margin. The following table details the changes in interest income and interest expense.

CHANGE IN NET INTEREST INCOME: RATE/VOLUME ANALYSIS
2003 COMPARED TO 2002

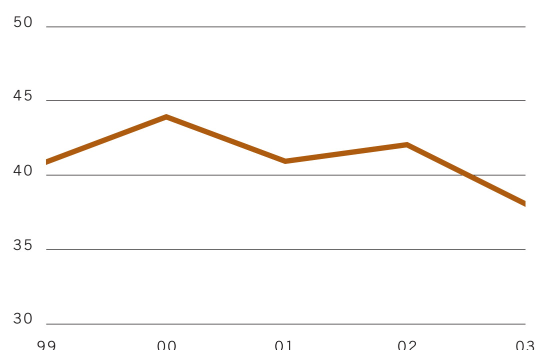
(IN MILLIONS)	(DECREASE)/ INCREASE	ATTRIBUTABLE TO CHANGES IN[1] AVERAGE VOLUME	ATTRIBUTABLE TO CHANGES IN[1] AVERAGE RATE
Interest-earning assets:			
Interest-bearing deposits in banks	$ (34.3)	$ (8.8)	$ (25.5)
Resale agreements	(17.9)	(1.6)	(16.3)
Federal funds sold	(41.3)	0.5	(41.8)
Held-to-maturity securities:			
MBS	(226.7)	1.3	(228.0)
Other securities	(34.1)	(15.8)	(18.3)
Held-at-fair-value securities	20.7	11.7	9.0
Mortgage loans	136.9	137.6	(0.7)
Advances[2]	(690.3)	(155.6)	(534.7)
Loans to other FHLBanks	(0.1)	—	(0.1)
Total interest-earning assets	(887.1)	(30.7)	(856.4)
Interest-bearing liabilities:			
Consolidated obligations:			
Bonds[2]	(691.0)	(150.0)	(541.0)
Discount notes[2]	(106.8)	13.0	(119.8)
Deposits	(3.7)	(0.8)	(2.9)
Borrowings from other FHLBanks	(0.1)	—	(0.1)
Total interest-bearing liabilities	(801.6)	(137.8)	(663.8)
Net interest income before mortgage loan loss provision	$ (85.5)	$ 107.1	$(192.6)

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.

Net Interest Income. Net interest income before mortgage loan loss provision was $430.0 million in 2003, a decrease of $85.5 million, or 17%, from $515.5 million in 2002. The decrease was primarily due to the impact of the lower interest rate environment during 2003, coupled with lower average capital balances, which reduced earnings on invested capital. Lower average interest rates in 2003 also resulted in faster prepayment rates and a higher rate of purchase premium amortization, reducing earnings on the Bank's MBS and mortgage loan portfolios.

To a lesser degree, lower average balances and narrower profit spreads on advances and non-MBS investments contributed to the decline in net interest income. The net interest margin in 2003 decreased 4 basis points to 38 basis points compared to 42 basis points in 2002. The average yield on interest-earning assets in 2003 was 1.80%, compared to 2.39% in 2002, a decrease of 59 basis points. The average cost of interest-bearing liabilities in 2003 was 1.49%, compared to 2.07% in 2002, a decrease of 58 basis points.

As discussed in Note 1 to the Financial Statements on page 54, the Bank reclassified realized gains and losses on stand-alone derivative instruments used in economic hedges from net interest income to other income, increasing net interest income and decreasing other income by $19.6 million in 2002 and $9.1 million in 2001, respectively.



Other Income/(Loss). Other income/(loss) was a net gain of $69.9 million in 2003, an increase of $117.2 million compared to a net loss of $47.3 million in 2002. This increase was primarily due to fair value adjustments associated with derivatives and hedging activities in accordance with Statement of Financial Accounting Standard (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities* on January 1, 2001, and SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* on July 31, 2003 (together referred to as "SFAS 133").

Under SFAS 133, the Bank is required to carry all of its derivative instruments on the balance sheet at fair value. If derivatives meet the hedging criteria (including effectiveness measures) specified in SFAS 133, the underlying hedged instruments may also be carried at fair value, so that some or all of the unrealized gain or loss recognized on the derivative is offset by a corresponding unrealized gain or loss on the underlying hedged instrument. The unrealized gain or loss on the ineffective portion of all hedges is recognized in current period earnings. During 2003, this resulted in a net gain of $65.3 million, an increase of $148.3, compared to a net loss of $83.0 million in 2002.

The majority of the gain in 2003 and loss in 2002 was attributable to changes in the net fair value of the portfolio of callable bonds that have offsetting callable interest rate swaps. The net gain in 2003 reflects the lower net costs of the outstanding callable bonds and swaps compared to the higher net cost of new market-rate callable bond and swap issuances. The net gain also reflects the general rise in interest rates during the second half of 2003, which resulted in the extension of the expected lives of the callable consolidated obligations and callable swaps compared to the lives expected at the time the swapped callable bonds were originally issued. The net loss in 2002 primarily reflected a reversal of the unrealized gains in 2001 on the portfolio of swapped callable bonds. The 2001 gains on the swapped callable bonds were reversed in 2002 as a result of the generally falling interest rate environment during 2002,

which resulted in shorter expected lives compared to the expected lives of the swapped callable bonds at yearend 2001. In addition, prepayment fees increased $6.5 million to $15.5 million in 2003 from $9.0 million in 2002; members prepaid $3.6 billion of advances in 2003, compared to $7.5 billion in 2002. The decline in interest rates during 2003 contributed to the relatively higher prepayment fees collected in 2003.

Because the SFAS 133 cumulative net unrealized gains or losses are primarily a matter of timing, the unrealized gains or losses will reverse over the remaining contractual terms to maturity of the hedged financial instruments and associated interest rate exchange agreements.

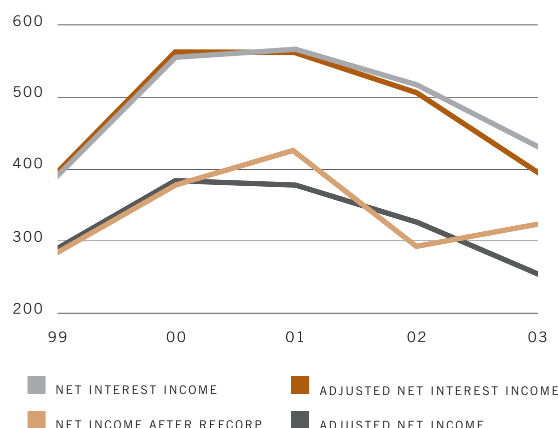
Other income includes the amortization of deferred gains resulting from the 1999 sale of the Bank's office building in San Francisco, which totaled $2.1 million in both 2003 and 2002. The remaining unamortized amount of the deferred gain on the sale of the building at December 31, 2003, was $11.2 million. In addition, fees earned on standby letters of credit were $1.3 million and $1.4 million for the years ended December 31, 2003, and 2002, respectively.

Other Expenses. Other expenses were $60.5 million in 2003, a decrease of $9.9 million, or 14%, from $70.4 million in 2002. The decrease was primarily due to a $9.4 million nonrecurring charge recognized in 2002, which resulted from a final court order confirming an arbitration decision that awarded a member a refund of $7.9 million in prepayment fees paid to the Bank in 1998 plus interest.

Operating expenses were $54.0 million in 2003, essentially flat compared to the prior year.

REFCORP and AHP Assessments. The Bank's REFCORP assessment was $80.8 million in 2003 compared to $73.0 million in 2002, reflecting higher earnings in 2003. Each FHLBank is required to pay 20% of net earnings (after AHP contributions) to REFCORP. The FHLBanks' aggregate payments in 2003 shortened the remaining term of the REFCORP obligation to the third quarter of 2020. The Bank set aside $35.9 million for the AHP in 2003, compared to $32.5 million in 2002, reflecting higher earnings in 2003. Annually, the FHLBanks must set aside for their AHPs, in the aggregate, the greater of $100 million or 10% of the current year's 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 income before AHP and REFCORP to the sum of the net incomes before AHP and REFCORP of the 12 FHLBanks. There was no shortfall for 2003, 2002, or 2001. The Bank's total REFCORP and AHP assessments equaled $116.7 million in 2003, compared with $105.5 million in 2002. The combined assessments in 2003 and 2002 reflect the Bank's effective "tax" rate on pre-assessment income of 27%.

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



Net Income. Net income was $323.0 million in 2003, an increase of $30.8 million, or 11%, from $292.2 million in 2002, and return on equity (ROE) was 5.90% in 2003, an increase of 117 basis points from 4.73% in 2002. These increases were primarily due to the increase in other income resulting from the fair value adjustments associated with SFAS 133, partially offset by the decline in net interest income.

Adjusted Financial Performance. The Bank uses adjusted financial performance measures to provide comparisons of the Bank's performance over time and to provide members with an enhanced understanding of the Bank's economic performance. These measures are not intended to be a presentation in accordance with GAAP. Adjusted financial performance measures exclude the effects of any current period fair value changes (net of applicable assessments) 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 because these effects are generally expected to reverse over the remaining lives of the hedged assets, hedged liabilities, and derivatives. Adjusted financial performance measures also reflect earnings before advance prepayment fees and certain other 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 prepayment fees and other deferred items, in accordance with the Bank's Retained Earnings and Dividend Policy. We make these adjustments in order to recognize prepayment fees, debt retirement gains and losses, and other transactions over the periods remaining through the related instruments' original maturity dates.

In addition to the above, adjusted net interest income includes the net interest payments on stand-alone derivative instruments used in economic hedges that are recorded in "Net gain/(loss) on derivatives and hedging activities" in other income.

Adjusted net income was $251.8 million, a decrease of $72.5 million or 22% from $324.3 million in 2002. Adjusted net interest income was $391.5 million, a decrease of $112.1 million, or 22%, from $503.6 million. Adjusted ROE was 4.60%, a decrease of 70 basis points from 5.30% in 2002. These decreases were primarily due to the decline in market interest rates, which, coupled with lower average capital balances, decreased earnings on invested member capital. Lower average interest rates in 2003 also resulted in faster prepayment rates and a higher rate of purchase premium amortization, reducing earnings on the Bank's MBS and mortgage loan portfolios.

ADJUSTED ANNUAL OPERATING RESULTS AND OTHER NON-GAAP FINANCIAL MEASURES

(DOLLARS IN MILLIONS)	2003	2002	2001
Adjusted net income	$252	$324	$376
Adjusted net interest margin	0.35%	0.41%	0.41%
Adjusted return on average assets	0.22	0.26	0.27
Adjusted return on average equity	4.60	5.30	5.75
Potential dividend yield	4.70	5.37	5.80
Dividend benchmark	2.79	3.36	4.69
Spread of potential dividend yield to dividend benchmark	1.91	2.01	1.11

RECONCILIATION OF NET INTEREST INCOME TO ADJUSTED NET INTEREST INCOME

(IN MILLIONS)	2003	2002	2001
Net interest income	$430	$515	$563
Amortization of deferred advance prepayments fees	8	7	5
Amortization of realized basis adjustments	(2)	1	—
Net interest expense on economic hedges	(44)	(19)	(9)
Adjusted net interest income	$392	$504	$559

RECONCILIATION OF NET INCOME TO ADJUSTED NET INCOME

(IN MILLIONS)	2003	2002	2001
Net income	$323	$292	$425
Net loss/(gain) on held-at-fair-value securities	11	(17)	(6)
Net (gain)/loss on derivatives and hedging activities	(80)	47	(47)
Amortization of realized basis adjustments	2	2	1
Cumulative effect of adopting SFAS 133	—	—	2
Deferred advance prepayment fees, net	(4)	—	1
Adjusted net income	$252	$324	$376

Dividends. The Bank's annual dividend rate was 4.29% for 2003, compared to 5.45% in 2002. The decline in the dividend rate was primarily due to the decline in net interest income. As discussed below, the Bank also retained $22.0 million in 2003 to provide for a build-up of retained earnings, which reduced the annual dividend rate by 41 basis points.

The Bank's Retained Earnings and Dividend Policy establishes the amounts to be retained in restricted retained earnings, subject to the dividend resolution adopted by the Board of Directors for each dividend period. In accordance with this policy, the Bank may be restricted from paying dividends if the Bank is not in compliance with any of its minimum capital requirements or if payment would cause the Bank to fail to meet any of its minimum capital requirements. In addition, the Bank will not pay dividends if any principal or interest due on any consolidated obligations has not been paid in full, or, under certain circumstances, if the Bank fails to satisfy certain liquidity requirements under applicable Finance Board regulations.

In accordance with the Retained Earnings and Dividend Policy, 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 early retirement of consolidated obligations associated with the prepaid advances are similarly treated. Retained earnings restricted in accordance with this provision totaled $10.1 million and $6.6 million at December 31, 2003 and 2002, respectively.

Also in accordance with the Retained Earnings and Dividend Policy, the Bank retains in restricted retained earnings any cumulative net gains in earnings (net of applicable assessments) and any cumulative net gains in other comprehensive income resulting from SFAS 133. Retained earnings restricted in accordance with this provision totaled $86.7 million and $18.8 million at December 31, 2003 and 2002, respectively.

Because the SFAS 133 cumulative net unrealized gains or losses are primarily a matter of timing, the unrealized gains or losses will reverse over the remaining contractual terms to maturity of the hedged financial instruments and associated interest rate exchange agreements. Restricted retained earnings will be adjusted as these cumulative net unrealized gains are reversed, resulting in substantially the same potential 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 a net gain. If the cumulative net effect of SFAS 133 since inception is a net loss, however, the Bank's retained earnings in the future may not be sufficient to offset the full impact of SFAS 133. As a result, the future effects of SFAS 133 may cause the Bank to reduce or temporarily suspend paying dividends.

Effective April 1, 2003, the Board of Directors amended the Retained Earnings and Dividend Policy to provide for an additional build-up of retained earnings totaling $50.0 million (less any cumulative net fair value losses in net income resulting from SFAS 133, with a floor of zero) over seven quarters beginning in the second quarter of 2003. At December 31, 2003, the retained earnings restricted in accordance with this provision totaled $22.0 million. The Finance Board recently provided guidance to the FHLBanks requiring an analysis of the adequacy of their retained earnings and a plan to achieve a target level of retained earnings. Effective January 30, 2004, the Board of Directors further amended this provision of the Retained Earnings and Dividend Policy to provide for a build-up of retained earnings totaling $100.0 million (less any cumulative net fair value losses in net income resulting from SFAS 133, with a floor of zero) by the end of 2006.

The Bank's Board of Directors may declare and pay dividends only from retained earnings or current net earnings. There is no requirement that the Bank declare and pay any dividend. A decision by the Bank's Board of Directors to declare or not declare a dividend is a purely discretionary matter and is subject to the requirements and restrictions of the FHLB Act and applicable Finance Board requirements and guidance.

All dividends except fractional shares were paid in the form of capital stock. The Bank has historically paid dividends, if declared, in stock form and intends to continue this practice.

Comparison of 2002 to 2001. Net income was $292.2 million in 2002, a decrease of $132.4 million, or 31%, from $424.6 million in 2001, and ROE was 4.73% in 2002, a decrease of 176 basis points from 6.49% in 2001. Net interest income was $515.3 million in 2002, a decrease of $48.1 million, or 9%, from $563.4 million in 2001. The decreases were 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, lower average balances and narrower profit spreads on advances. These decreases were partially offset by improved earnings from the Bank's MBS portfolio in 2002 resulting from higher investment balances and profit spreads.

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

(IN MILLIONS)	(DECREASE)/ INCREASE	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)	(33.7)	(196.4)
Held-to-maturity securities:			
MBS	92.4	172.7	(80.3)
Other securities	(92.5)	(8.1)	(84.4)
Held-at-fair-value securities	(16.9)	(1.9)	(15.0)
Mortgage loans	1.6	1.5	0.1
Advances[2]	(2,914.7)	(413.0)	(2,501.7)
Loans to other FHLBanks	(0.6)	(0.1)	(0.5)
Total interest-earning assets	(3,240.9)	(250.0)	(2,990.9)
Interest-bearing liabilities:			
Consolidated obligations:			
Bonds[2]	(1,983.1)	32.4	(2,015.5)
Discount notes[2]	(1,201.0)	(386.6)	(814.4)
Deposits	(8.8)	0.1	(8.9)
Other borrowings	(0.1)	—	(0.1)
Total interest-bearing liabilities	(3,193.0)	(354.1)	(2,838.9)
Net interest income before mortgage loan loss provision	$ (47.9)	$ 104.1	$ (152.0)

[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.

Other (loss)/income was a net loss of $47.3 million in 2002, a decrease of $119.7 million compared to other income of $72.4 million in 2001. This decrease was primarily due to fair value adjustments associated with derivatives and hedging activities in accordance with SFAS 133. These fair value adjustments decreased $138.0 million, from a net gain of $55.0 million in 2001 to a net loss of $83.0 million in 2002. The majority of the loss in 2002 and the gain in 2001 was attributable to changes in the net fair value of the portfolio of callable bonds that have matching callable interest rate swaps. The net loss in 2002 primarily reflected a reversal of the unrealized gains in 2001 on the portfolio of swapped callable bonds. The 2001 gains on the swapped callable bonds were reversed in 2002 as a result of the general falling interest rate environment during 2002, which resulted in shorter expected lives for the callable bonds and swaps when compared to the expected lives of the swapped callable bonds at yearend 2001. 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 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 in 2002 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. The increase in operating expenses was primarily the result of higher compensation and benefits, $33.3 million in 2002 compared to $27.7 million in 2001, reflecting general pay increases and an increase in pension and health care insurance costs.

The Bank's REFCORP assessment was $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. The Bank set aside $32.5 million for the AHP in 2002, compared to $47.2 million in 2001, reflecting 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. The combined assessments reflected the Bank's 2002 and 2001 effective "tax" rate on pre-assessment income of 27%.

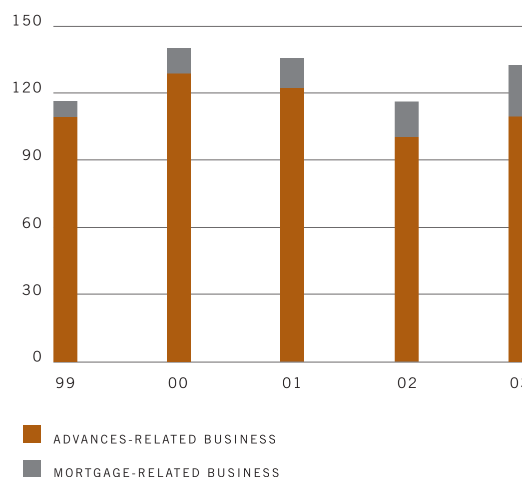
Adjusted net income was $324.3 million, a decrease of $51.6 million or 14%, from $375.9 million in 2001. Adjusted net interest income was $503.6 million, a decrease of $55.9 million or 10% from $559.5 million. Adjusted ROE was 5.30%, a decrease of 45 basis points from 5.75% in 2001, primarily because 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, which resulted from higher investment balances and profit spreads.

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 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.

FINANCIAL CONDITION

Total assets were $132.4 billion at December 31, 2003, an increase of $16.3 billion, or 14%, from $116.1 billion at December 31, 2002. Average total assets were $115.6 billion in 2003, a decrease of $9.6 billion, or 8%, compared to $125.2 billion in 2002.

YEAREND ASSET LEVELS
(BILLIONS OF DOLLARS)



SEGMENT INFORMATION

Management analyzes financial performance based on the net interest income of two operating segments: the advances-related business and the mortgage-related business.

Advances-Related Business. The advances-related business consists of advances to members, related financing and hedging instruments, liquidity and other non-MBS investments (which are associated with the Bank's role as a liquidity provider) and member capital. Net interest income for this segment, including the cash flows from associated interest rate exchange agreements, was $279.5 million in 2003, a decrease of $81.0 million, or 22%, from $360.5 million in 2002. This decrease was primarily due to the lower interest rate environment in 2003 relative to 2002 and lower member capital, which resulted in lower earnings on member capital, and to a lesser degree, lower balances and narrower profit spreads on advances. The balance of total assets associated with this segment increased to $109.6 billion, an increase of $9.7 billion, or 10%, from $99.9 billion. This segment represented 72% and 73% of total Bank net interest income, including the cash flows from associated interest rate exchange agreements, for 2003 and 2002, respectively.

Advances – Advances outstanding increased $11.1 billion, or 14%, in 2003, to $92.3 billion at December 31, 2003, from $81.2 billion at December 31, 2002. Average advances were $79.4 billion in 2003, a decrease of $10.7 billion, or 12%, from $90.1 billion in 2002. Advances outstanding at December 31, 2003 and 2002, included fair value adjustments of $0.4 billion and $1.0 billion, respectively.

The increase in advances outstanding at yearend was primarily the result of a broad-based increase in demand from members of all sizes and charter types, combined with an increase in borrowings by several large members to fund asset growth in the second half of the year. The Bank's largest members accounted for close to one-third of the increase. In total, 156 members increased their advance borrowings during the year, while 65 members decreased their advance borrowings.

The decrease in average advances reflected fluctuations in advance levels throughout the year, influenced by changes in members' balance sheets, particularly those of the largest members. Advance levels declined by $9.4 billion in the first half of the year, as retail deposit growth and mortgage escrows at some member institutions surged ahead of asset growth. Advances then grew by $21.1 billion in the second half of the year, when mortgage originations and the growth of other assets outpaced deposit growth at the Bank's largest members.

The composition of advances shifted during the year, as well. Short-term fixed rate advances grew by $19.4 billion, to $28.9 billion at December 31, 2003, while long-term fixed rate advances decreased by $13.0 billion, to $22.6 billion at December 31, 2003. Short-term adjustable rate advances grew by $1.7 billion, to $4.7 billion at yearend, and long-term adjustable rate advances grew by $3.5 billion, to $35.7 billion at yearend.

Demand for new term advances (advances with terms greater than one day) grew considerably in 2003 relative to the prior year. New term advances totaled $172.3 billion in 2003, compared to $87.5 billion in 2002. The demand for advances with terms of up to one year doubled, from $72.2 billion in 2002 to $146.7 billion in 2003. While demand for new advances with terms greater than one year and up to two years declined by $2.6 billion, or 40%, from $6.6 billion in 2002 to $4.0 billion in 2003, demand for new advances with terms greater than two years grew by $13.0 billion, or 150%, to a total of $21.6 billion in 2003, compared to $8.6 billion in 2002. Most of this growth in demand was in long-term adjustable rate advances.

Non-MBS Investments – The Bank's total non-MBS investment portfolio decreased $1.0 billion in 2003 to $16.7 billion as of December 31, 2003, from $17.7 billion as of December 31, 2002. During 2003, interest-bearing deposits in banks decreased $1.5 billion, Federal funds sold decreased $0.6 billion, and commercial paper decreased $0.3 billion, while resale agreements increased $0.7 billion and housing finance agency bonds increased $0.7 billion. Non-MBS investments other than housing finance agency bonds generally have terms to maturity of three months or less to facilitate the Bank's role as a cost-effective provider of credit and liquidity to members.

Borrowings – Consistent with the increase in advances, total consolidated obligations funding the advances-related business increased $9.6 billion, or 10%, in 2003, to $103.8 billion at December 31, 2003, from $94.2 billion at December 31, 2002.

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 typically enters into interest rate exchange agreements simultaneously 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, primarily the London Interbank Offered Rate (LIBOR). During 2003 and 2002, the Bank used fixed rate callable bonds that were usually offset with interest rate exchange agreements with call features offsetting the call options embedded in the callable bond. This combined financing 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.

The notional amount of interest rate exchange agreements associated with the advances-related business totaled $119.8 billion, of which $46.9 were hedging the advances and $72.9 billion were hedging the consolidated obligations funding the advances.

FHLBank System consolidated obligation discount notes and bonds, along with similar debt securities issued by other GSEs such as Fannie Mae and Freddie Mac, are generally referred to as agency debt. The agency debt market is a large and growing sector of the debt capital markets. The relative cost of FHLBank System consolidated obligation bonds and discount notes compared to market benchmark rates such as LIBOR has risen modestly over the past two years because of several factors. These factors include continued strong growth in the supply of agency debt as a result of the growth of all major GSE debt issuers; the overall decline in short- and intermediate-term rates, which tends to compress the differences between agency debt costs and other market rates; increased issuance of intermediate-term Treasury securities, which tends to push up and also compress the differences between market rates for comparable term securities of other debt issuers, including the GSEs; and increased demand for receive-fixed interest rate swaps by end-users of derivatives, which contributed to compression of the difference between intermediate-term agency debt costs and interest rate swap rates. In addition, beginning in June 2003, the cost of consolidated obligation bonds was further adversely impacted by events that affected all of the housing GSEs: the accounting restatements and related management changes at Freddie Mac, the losses announced by some FHLBanks, and the uncertainty caused by the debate within the federal government regarding the proper oversight and regulatory structure for the housing GSEs.

The sectors of FHLBank System consolidated obligation bonds that experienced the largest increase in relative cost over the past two years were intermediate-term non-callable bonds and intermediate-term callable bonds. In the past two years, the cost of intermediate-term non-callable bonds relative to LIBOR increased 0.05% to 0.10% (5 to 10 basis points), and the cost of intermediate term callable bonds relative to LIBOR increased 0.05% to 0.07% (5 to 7 basis points). The increases in the relative costs of these types of consolidated obligation bonds has resulted in modest compression in the profit spreads earned on intermediate-term advances to members, modest increases in the rates for intermediate-term advances offered to members, and modest compression in the profit spreads earned on investments. At December 31, 2003, the Bank had $26.2 billion of swapped intermediate-term fixed rate non-callable bonds and $27.5 billion of swapped callable bonds that primarily funded advances and non-MBS investments. These swapped non-callable and callable bonds combined represented 58% of the Bank's total consolidated bonds outstanding. The cost of short-term discount notes relative to LIBOR has remained largely unchanged over the past two years; discount notes outstanding at December 31, 2003, were $31.9 billion.

Mortgage-Related Business. The mortgage-related business consists of MBS investments, mortgage loans acquired through the MPF Program, and the consolidated obligations specifically identified as funding those assets and related hedging instruments. 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 $106.7 million in 2003, a decrease of $28.6 million, or 21%, from $135.3 million in 2002. The decrease was primarily due to the impact of the lower interest rate environment during 2003 that reduced earnings on the Bank's MBS and mortgage loan portfolios. Lower interest rates resulted in faster prepayment rates, which reduced the spread between earnings on mortgage assets and the related cost of funds and resulted in a higher rate of amortization of purchase premiums. This segment represented 28% and 27% of total Bank net interest income, including the cash flows from associated interest rate exchange agreements, in 2003 and 2002, respectively.

MPF Program – Under the MPF Program, the Bank buys qualifying 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. The Bank may participate all or a portion of the loans it purchases to one or more of the other FHLBanks.

At December 31, 2003 and 2002, the Bank held conventional fixed rate conforming mortgage loans totaling $6.5 billion and $0.3 billion, respectively, which were purchased from eight and four participating member institutions, respectively. The growth in mortgage loans held was primarily due to purchases from two large sellers. The residential mortgage refinance activity that continued for much of 2003 contributed to the Bank's results for the MPF Program.

No mortgage loans were reported 90 days or more delinquent at December 31, 2003 and 2002; no loans were in foreclosure or classified as nonaccrual or impaired during 2003; and no allowance for loan losses on mortgage loans was deemed necessary by management as of December 31, 2003. Depending on the mortgage market and member demand, management expects to continue to grow the mortgage loan portfolio at a steady pace in 2004 within the Bank's risk management guidelines.

MBS Investments – The Bank's MBS portfolio increased 2% in 2003, to $16.3 billion, or approximately 279% of capital, at December 31, 2003, from $16.0 billion, or approximately 281% of capital, at December 31, 2002. During the year, the Bank purchased $11.1 billion in MBS. However, as a result of declining interest rates during 2003, MBS principal run-off totaled $10.8 billion. The small increases in the MBS portfolio and in member capital resulted in balances that continued to be slightly below the regulatory maximum authorized level of 300% of capital. Management expects to continue to invest at this level in the future subject to the availability of MBS that meet the Bank's credit risk, interest rate risk, and expected profitability parameters.

The fixed rate, long-term MBS investments are subject to prepayment risk, and the adjustable rate long-term MBS 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 MBS 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. These financial strategies provide the Bank with a relatively stable net interest income stream over a range of interest rates.

Total consolidated obligations funding the mortgage-related business increased $6.5 billion, or 40%, in 2003, to $22.8 billion at December 31, 2003, from $16.3 billion at December 31, 2002, paralleling the growth in mortgage loans during 2003.

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 securities classified as held-to-maturity to trading (or "held-at-fair-value"). The Bank transferred its portfolio of economically hedged MBS to the held-at-fair-value securities category on January 1, 2001, so that fair value gains or losses on these MBS will partly offset the losses or gains on the associated interest

rate exchange agreements. During 2003 and 2002, this designation allowed the Bank to mark certain MBS to fair value (for a $15.4 million loss and a $22.7 million gain, respectively) to offset the mark-to-fair value of the associated interest rate exchange agreements (a $14.9 million gain and a $26.2 million loss, respectively), for net losses of $0.5 million and $3.5 million, respectively.

The notional amount of interest rate exchange agreements associated with the mortgage-related business totaled $7.0 billion, of which $0.4 billion were hedging specific MBS classified as held-at-fair-value and $6.6 billion were hedging the consolidated obligations funding the mortgage portfolio.

CAPITAL

Capital and Capital Ratios. Until the Bank implements its new capital plan on April 1, 2004, each member is required to hold 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 2003 was $5.5 billion, an 11% decrease from $6.2 billion in 2002. This decrease is consistent with the decline in average advances outstanding during 2003, primarily because of the Bank's surplus capital stock repurchase 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 during the first three quarters of 2003, the minimum capital stock requirements for many members declined as well. In accordance with this policy, the Bank repurchased $1,502.9 million and $1,687.7 million in surplus capital stock during 2003 and 2002, respectively.

Until an FHLBank implements its new capital plan, Finance Board regulations generally limit 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, 2003 and 2002, the Bank's total assets to capital ratio was 22.6x and 20.4x, respectively, and its non-mortgage assets to total assets ratio was 6.5% and 9.8%, respectively. The Bank's advances and mortgage-related assets combined averaged 18.0 times capital and 17.3 times capital in 2003 and 2002, respectively. The Bank's non-mortgage investments and other non-interest-bearing, non-mortgage assets averaged 3.1 times capital and 3.0 times capital in 2003 and 2002, respectively. The Bank's average ratio of total assets to capital was 21.1x in 2003 compared to 20.3x in 2002. 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 liquidity and 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 Bank's Board of Directors approved amendments to the capital plan on May 30, 2003, and the Finance Board approved the amendments on August 6, 2003. The Bank plans to implement its new capital plan on April 1, 2004. The provisions of the plan are discussed in Note 13 in the Notes to the Financial Statements. Until the Bank fully implements its capital plan, the existing capital requirements will remain in effect.

RISK MANAGEMENT

The Bank's Board of Directors has adopted a Risk Management Policy and a Member Products Policy, which are reviewed regularly and updated at least annually. The Risk Management Policy establishes risk guidelines, limits, and procedures in accordance with Finance Board regulations, the Finance Board's Financial Management Policy, the risk profile established by the Board of Directors, and other applicable guidelines.

The Risk Management Policy addresses the Bank's liquidity, market, credit, business, and operations risks and related requirements and guidelines. Management performs an annual risk assessment that is reviewed by the Board of Directors and updates the Risk Management Policy accordingly, if necessary.

The Bank's Member Products Policy addresses the Bank's management of products offered by the Bank to members and housing associates, including advances, standby letters of credit, acquired member assets, and other products. In terms of risk management, the Member Products Policy addresses the credit risk of secured credit by establishing credit underwriting criteria, appropriate collateralization levels, and collateral valuation methodologies.

BUSINESS RISK

Business risk is defined as the possibility of an adverse impact on the Bank's profitability or financial or business strategies resulting from factors that may occur in both the short and long term. Such factors may include, but are not limited to, continued financial-services industry consolidation; a declining membership base; concentration of borrowing among members; the introduction of new competing products and services; increased inter-FHLBank and non-FHLBank competition; initiatives to weaken the FHLBank System's GSE status; changes in the deposit and mortgage markets for the Bank's members; and other factors that may have a significant direct or indirect impact on the ability of the Bank to achieve its mission and strategic objectives.

The identification of these business risks is an integral part of the Bank's annual planning process, and the Bank's strategic plan identifies initiatives and supporting operating plans to address these risks.

As discussed earlier, the relative cost of the Bank's participation in consolidated obligation bonds and discount notes compared to market benchmark rates such as LIBOR has risen modestly over the past two years. If the relative cost of consolidated obligation bonds and discount notes continues to increase, it could further compress profit spreads on advances and investments, result in increased rates on advances offered to members, reduce the competitiveness of advances as a wholesale funding source for certain members, and lead to reduced demand for advances by some members that have alternative sources of wholesale funding. Some of the factors that may adversely affect the relative cost of FHLBank System consolidated obligations may be cyclical in nature and may reverse at some point in the future, such as the low level of interest rates and the demand for receive-fixed interest rate swaps. Other factors that may affect the relative cost of FHLBank System consolidated obligations may not reverse at some point in the future. These factors may include the growing issuance volume of Treasury securities and the growth rate of the housing GSEs. Still other factors are event-related and may reverse or may reoccur in the future; these factors include operating issues or losses disclosed by individual GSEs and uncertainty regarding the future regulatory structure of the housing GSEs. It is not possible at this time to determine the exact impact on the future relative cost of the Bank's participation in consolidated obligation bonds or discount notes of these factors and any other potential future events.

OPERATIONS RISK

Operations risk is defined as the risk of an unexpected loss to the Bank resulting from human error, fraud, unenforceability of legal contracts, or deficiencies in internal controls or information systems. The Bank's operations risk is controlled through an effective system of internal controls designed to minimize the risk of operational losses. Also, the Bank has established and annually tests its business resumption plan under various disaster scenarios involving offsite recovery and the testing of the Bank's operations and information systems. In addition, an extensive and ongoing internal audit function audits all significant risk areas to assess the effectiveness of the Bank's internal controls.

CONCENTRATION RISK

For the advances-related business, at December 31, 2003, the Bank had a concentration of advances totaling $62.0 billion outstanding to three members, representing 67% of total advances outstanding. 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. Advances held by these three members generated approximately $1.1 billion or 59%, $1.9 billion or 67%, and $4.0 billion or 76% of advance interest income, before the impact of interest rate exchange agreements, for the years ending December 31, 2003, 2002, and 2001, respectively.

Because of this concentration in advances, the Bank has implemented specific credit and collateral review procedures for these members. In addition, the Bank analyzes the implications for our financial management and profitability if we were to lose one or more of these customers.

If these members were to prepay the advances or repay the advances as they came due and no other advances were made to replace them, the Bank's assets would decrease significantly, and income could be adversely affected. The loss of a significant amount of advances could have a material adverse impact on the Bank's dividend until appropriate adjustments were made to the Bank's capital levels and operating expenses. The timing and magnitude of the adjustment period would depend on a number of factors, including: (a) the amount of any decreases in capital; (b) the profitability of any loans that were repaid; (c) the profitability of the Bank's investment portfolio; and (d) the amount of outstanding advances remaining. As discussed in "Our Business Model" on pages 15–16, however, our financial strategies are designed to enable us to shrink and grow in response to changes in membership composition and member credit needs. Under the Bank's new capital plan, Class B stock is redeemable upon five years' notice. The Bank may, however, repurchase excess Class B stock at any time before the five years have expired, at the Bank's discretion.

CONCENTRATION OF ADVANCES

(IN MILLIONS)	ADVANCES OUTSTANDING[1] AS OF DECEMBER 31,		
NAME OF BORROWER	2003	2002	2001
Washington Mutual Bank, FA	$32,439	$32,945	$ 45,647
Citibank (West), FSB[2]	16,039	13,490	—
California Federal Bank, AFSB[2]	—	—	22,323
World Savings Bank, FSB	13,500	11,635	11,038
Subtotal	61,978	58,070	79,008
Other borrowers	29,974	22,183	22,332
Total	$91,952	$80,253	$101,340

1 Member advance amounts and the total advance amounts are at par value, and the total advance amounts will not match amounts shown in the Statements of Condition. The difference between the par and book value amounts primarily relates to basis adjustments arising from hedges of advances under SFAS 133.

2 Citibank (West), FSB, acquired California Federal Bank, AFSB, in November 2002.

LIQUIDITY RISK

Liquidity risk is defined as the risk that the Bank will be unable to meet its obligations as they come due or meet the credit needs of its members and eligible nonmember borrowers in a timely and cost-efficient manner. 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 Risk Management Policy. In their asset/liability management planning, members may look to the Bank to provide standby liquidity. The Bank also needs liquidity to satisfy the repayment of maturing consolidated obligations and other obligations. The Bank seeks to be in a position to meet its customers' credit and liquidity needs and pay its obligations without maintaining excessive holdings of low-yielding liquid investments or being forced to incur unnecessarily high borrowing costs. The Bank maintains short-term, high quality money market investments in amounts that average close to three times the Bank's capital to satisfy these requirements and objectives.

The Bank's primary sources of liquidity are the 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 disruptions of the capital markets.

CREDIT RISK

Credit risk is defined as the risk that the market value, or estimated fair value if market value is not available, of an obligation will decline as a result of deterioration in creditworthiness. The Bank further refines the definition of credit risk as the risk that a secured or unsecured borrower will default and the Bank will suffer a loss due to the inability to fully recover, on a timely basis, amounts owed the Bank.

Advances. 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. These credit and collateral policies balance the Bank's dual goals of meeting members' needs as a reliable source of liquidity and effectively precluding credit loss by adjusting the credit and collateral terms. Eligible collateral includes whole first mortgages on improved residential property, or securities representing a whole interest in such mortgages; securities issued, insured, or guaranteed by the U.S. government or any of its agencies, including without limitation MBS issued or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae; cash or deposits in the Bank; and other real estate-related collateral, such as home equity loans or commercial real estate, acceptable to the Bank. For qualifying community financial institutions, eligible collateral also includes small business, farm, and agribusiness loans, provided that the collateral has a readily ascertainable value and the Bank can perfect a security interest in the property.

The FHLB Act affords any security interest granted to the Bank by any member of the Bank, or any affiliate of any such member, priority over the claims and rights of any party, including any receiver, conservator, trustee, or similar party having rights of a lien creditor, except claims and rights that would be entitled to priority under otherwise applicable law or are held by actual bona fide purchasers for value or by parties that are secured by actual perfected security interests.

The Bank perfects its security interest by completing a UCC-1 filing for each member and will take physical delivery of collateral if the financial condition of a particular member so warrants. The Bank has never experienced a credit loss on an advance. Based on the collateral held as security for advances, management's policies and procedures for managing credit risk, and the Bank's lack of any prior loss experience, the Bank has not established an allowance for losses on advances.

Management determines the borrowing capacity of a member based on the member's credit quality and eligible collateral received in accordance with the Bank's Risk Management Policy and regulatory requirements. Credit quality is determined and periodically assessed using the member's financial information, regulatory examination and enforcement actions, and other public information. The following tables present a summary of the status of members' credit quality and borrowing capacity as of December 31, 2003. As noted below, substantially all borrowing capacity and approved financing availability are with members that have the top three credit quality ratings. Credit quality ratings (CQR) are determined based on results from the Bank's credit model and on other qualitative information, with the assignment of a rating within the range of one to ten, with one being the highest credit rating.

MEMBER FINANCING AVAILABILITY AND BORROWING CAPACITY BY CHARTER TYPE

DECEMBER 31, 2003

(DOLLARS IN MILLIONS)	ALL MEMBERS		MEMBERS WITH CREDIT OUTSTANDING			
					COLLATERAL BORROWING CAPACITY	
CHARTER TYPE	NUMBER	APPROVED FINANCING AVAIL-ABILITY	NUMBER	CREDIT OUT-STANDING*	TOTAL	USED
Savings associations	39	$174,325	36	$77,086	$109,652	70%
Banks	242	62,298	177	15,112	24,690	61
Credit unions	71	12,949	31	1,158	3,133	37
Insurance companies	1	1	—	—	—	—
Total	353	$249,573	244	$93,356	$137,475	68%

MEMBER FINANCING AVAILABILITY AND BORROWING CAPACITY BY CREDIT QUALITY RATING

DECEMBER 31, 2003

(DOLLARS IN MILLIONS)	ALL MEMBERS		MEMBERS WITH CREDIT OUTSTANDING			
					COLLATERAL BORROWING CAPACITY	
MEMBER CQR	NUMBER	APPROVED FINANCING AVAIL-ABILITY	NUMBER	CREDIT OUT-STANDING*	TOTAL	USED
1	94	$ 74,555	74	$28,836	$ 41,506	69%
2	110	152,517	78	59,449	87,975	68
3	62	16,785	43	3,897	6,205	63
4	64	5,124	37	1,060	1,609	66
5	18	353	10	65	110	59
6	4	186	2	49	70	70
7-10	1	53	0	0	0	0
Total	353	$249,573	244	$93,356	$137,475	68%

*Includes letters of credit, the market value of swaps, Federal funds and other investments, and the credit enhancement obligation on MPF loans.

MPF Program. The Bank and the member selling loans to the Bank under the MPF Program share in the credit risk of the loans as specified in the master agreement. These assets may have more credit risk than advances, even though the member provides credit enhancement to protect the Bank to an AA level. The credit risks of MPF loans are managed by structuring potential credit losses into several layers. As is customary for conventional mortgage loans, private mortgage insurance (PMI) is required for MPF loans with a loan-to-value ratio greater than 80%. Losses beyond the borrower's equity and the PMI layer are absorbed first by a First Loss Account established by the Bank. If additional losses beyond this layer are incurred, the member is obligated to cover those losses up to the amount of the member's required credit enhancement. For some MPF products, the member's credit enhancement obligation may be fulfilled through the purchase of supplemental mortgage insurance. For providing this credit enhancement, the member receives monthly credit enhancement fees from the Bank, subject, in some cases, to the performance of the loans. The size of each member's credit enhancement is calculated so that any credit losses in excess of the borrower's equity, any PMI, and the credit enhancement, excluding special hazard losses, are limited to those expected from an equivalent investment with a long-term credit rating of AA.

The Bank provides for a loss allowance, net of credit enhancement, for any impaired loans, and management has policies and procedures in place to appropriately manage the credit risk. The Bank bases the allowance for credit losses for the Bank's mortgage loan portfolio on management's estimate of probable credit losses in the portfolio as of the balance sheet date. The Bank performs periodic reviews of its portfolio to identify the probable losses within the portfolio. The overall allowance is determined by an analysis that includes consideration of observable data such as delinquency statistics, past performance, current performance, loan portfolio characteristics, collateral valuations, industry data, and prevailing economic conditions, taking into account the credit enhancement.

Investments. The Bank has adopted credit 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 GSEs (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 and credit enhanced by bond insurance. The Bank also invests in short-term unsecured Federal funds sold, negotiable certificates of deposits

(interest-bearing deposits in banks), and commercial paper with counterparties with a long-term credit rating of at least A and capital in excess of $250 million. The following tables present the Bank's investment credit exposure at the dates indicated, based on ratings provided by Moody's Investors Service, Standard and Poor's, or Fitch Ratings.

INVESTMENT CREDIT EXPOSURE

DECEMBER 31, 2003

(IN MILLIONS)	CREDIT RATING			
INVESTMENT TYPE	AAA	AA	A	TOTAL
Interest-bearing deposits in banks	$ —	$3,100	$187	$ 3,287
Securities purchased under agreements to resell[1]	5,100	—	—	5,100
Federal funds sold	—	5,167	267	5,434
Held-to-maturity securities:				
Commercial paper	742	300	—	1,042
Housing finance agency bonds	1,328	—	—	1,328
MBS	15,893	—	—	15,893
Total held-to-maturity securities	17,963	300	—	18,263
Held-at-fair-value securities:				
Housing finance agency bonds	493			493
MBS	424	—	—	424
Total held-at-fair-value securities	917	—	—	917
Total investments	$23,980	$8,567	$454	$33,001

DECEMBER 31, 2002

(IN MILLIONS)	CREDIT RATING			
INVESTMENT TYPE	AAA	AA	A	TOTAL
Interest-bearing deposits in banks	$ —	$ 4,356	$478	$ 4,834
Securities purchased under agreements to resell[1]	4,400	—	—	4,400
Federal funds sold	—	6,068	—	6,068
Held-to-maturity securities:				
Commercial paper	998	299	—	1,297
Housing finance agency bonds	1,114	—	—	1,114
MBS	15,468	—	—	15,468
Total held-to-maturity securities	17,580	299	—	17,879
Held-at-fair-value securities:				
MBS	533	—	—	533
Total investments	$22,513	$10,723	$478	$33,714

[1] Classified based on the credit rating of securities held as collateral.

The following tables present the portfolio concentration in the Bank's held-to-maturity securities portfolio of issuers whose aggregate carrying values represented 10% or more of the Bank's capital at the dates indicated.

DECEMBER 31, 2003

(IN MILLIONS)	CARRYING VALUE	ESTIMATED FAIR VALUE
Commercial paper[1]	$ 1,042	$ 1,042
Housing finance agency bonds:		
California Housing Finance Agency	1,328	1,334
MBS:		
U.S. government agency issuers	1,180	1,194
Bank of America Mortgage Securities	1,370	1,373
Countrywide Home Loans	1,034	1,034
CS First Boston Mortgage Securities Corp.	2,107	2,104
Master Adjustable Rate Mortgages Trust	651	643
Sequoia Mortgage Trust	1,154	1,150
Structured Asset Mortgage Investments, Inc.	640	637
Structured Asset Securities Corp.	2,776	2,775
Washington Mutual	1,888	1,879
Other non-agency issuers[1]	3,093	3,101
Total MBS	15,893	15,890
Total held-to-maturity securities	$18,263	$18,266

DECEMBER 31, 2002

(IN MILLIONS)	CARRYING VALUE	ESTIMATED FAIR VALUE
Commercial paper:		
GE Capital International Funding	$ 798	$ 798
Other issuers[1]	499	499
Total commercial paper	1,297	1,297
Housing finance agency bonds:		
California Housing Finance Agency	1,114	1,112
MBS:		
U.S. government agency issuers	1,673	1,714
Bank of America Mortgage Securities	1,805	1,838
Bear Stearns Adjustable Rate Mortgage Trust	608	617
Countrywide Home Loans	870	883
CS First Boston Mortgage Securities Corp.	1,063	1,063
Residential Funding	609	625
Sequoia Mortgage Trust	1,033	1,025
Structured Asset Mortgage Investments, Inc.	724	721
Structured Asset Securities Corp.	1,836	1,850
Washington Mutual	1,791	1,811
Other non-agency issuers[1]	3,456	3,501
Total MBS	15,468	15,648
Total held-to-maturity securities	$17,879	$18,057

[1] Includes issuers of securities that have a carrying value that is less than 10% of total Bank capital.

The following table presents the portfolio concentration in the Bank's held-at-fair-value securities portfolio at the dates indicated.

DECEMBER 31, 2003

(IN MILLIONS)	CARRYING VALUE	ESTIMATED FAIR VALUE
Housing finance agency bonds:		
California Housing Finance Agency	$493	$493
MBS: U.S. government agency issuers	424	424
Total held-at-fair-value securities	$917	$917

DECEMBER 31, 2002

(IN MILLIONS)	CARRYING VALUE	ESTIMATED FAIR VALUE
MBS: U.S. government agency issuers	$533	$533

Derivatives Counterparties. 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 derivatives 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 derivatives counterparties that provide for delivery of collateral at specified levels to limit net credit exposure to 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. The following tables present the Bank's credit exposure to its derivatives counterparties at the dates indicated.

DERIVATIVES COUNTERPARTIES CREDIT EXPOSURE

DECEMBER 31, 2003

(IN MILLIONS) CREDIT RATING	NOTIONAL BALANCE	CREDIT EXPOSURE	EXPOSURE COLLATERALIZED	NET EXPOSURE
AA	$ 71,660	$101	$ 57	$44
A	54,621	155	149	6
Subtotal	126,281	256	206	50
Member institutions[1]	493	10	10	—
Total derivatives	$126,774	$266	$216	$50

DECEMBER 31, 2002

(IN MILLIONS) CREDIT RATING	NOTIONAL BALANCE	CREDIT EXPOSURE	EXPOSURE COLLATERALIZED	NET EXPOSURE
AAA	$ 11	$ —	$ —	$—
AA	76,379	295	228	67
A	47,807	210	190	20
Subtotal	124,197	505	418	87
Member institutions[1]	452	14	14	—
Total derivatives	$124,649	$519	$432	$87

1 Collateral held with respect to interest rate exchange agreements with member institutions represents either collateral physically held by or on behalf of the Bank or collateral assigned to the Bank, as evidenced by a written security agreement, and held by the member institution for the benefit of the Bank.

MARKET RISK

Market risk is defined as the risk to the Bank's net equity value and net interest income (excluding the impact of SFAS 133) as a result of a movement in interest rates, interest rate spreads, market volatility, and other market factors.

The Bank's market risk management objective is to maintain a relatively low exposure of net equity value and future earnings (excluding the impact of SFAS 133) to changes in interest rates. 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. Risk identification and risk measurement are primarily accomplished through (1) market value sensitivity analyses, (2) net interest income sensitivity analyses, and (3) repricing gap analyses. The Risk Management Policy approved by the Board of Directors establishes market risk policy limits and market risk measurement standards at the total Bank level. Additional guidelines approved by the Bank's Asset-Liability Committee (ALCO) apply to the Bank's two business segments. These guidelines provide limits that are monitored at the segment level and are consistent with the total Bank policy limits. Interest rate risk is managed for each business segment on a daily basis, as discussed in "Segment Market Risk." Exceptions to Bank policies or management guidelines are presented to the ALCO or Board of Directors, as appropriate, with a corrective action plan.

Total Bank Market Risk.

Market Value of Equity Sensitivity – Management uses market value of equity sensitivity to measure the Bank's exposure to changes in interest rates. Management maintains its market value of equity sensitivity within the limits specified by the Board of Directors in the Risk Management Policy primarily by managing the interest rate attributes of assets, liabilities, and interest rate exchange agreements. The Bank's market value of equity exposure analysis generally shows that a 100-basis-point increase in interest rates results in a modest decrease in the market value of equity, while a comparable decrease in interest rates shows a modest increase in the market value of equity, but to a lesser degree. This nonlinear change in the sensitivity of the market value of equity to changes in interest rates is generally the result of the impacts of the options embedded in the Bank's assets and liabilities (such as the prepayment option inherent in mortgage assets). The Bank manages the risks associated with these embedded options, but does not completely eliminate these risks.

The Bank's market value of equity sensitivity policy is to limit the adverse impact of an instantaneous parallel shift of a plus or minus 100-basis-point change in interest rates from current rates ("base case") to no worse than –4% of the value of equity. In addition, the policy limits the adverse impact of an instantaneous plus or minus 100-basis-point change in interest rates measured from interest rates that are 200 basis points above or below the base case to no worse than –6% of the value of equity.

At December 31, 2003, the estimated percentage change in the Bank's market value of equity (the net value of all assets, liabilities, and interest rate exchange agreements) was –2.2% if rates increased by 100 basis points, and +1.2% if interest rates decreased by 100 basis points. If interest rates had been 200 basis points higher at December 31, 2003, a 100-basis-point additional increase in interest rates would be expected to decrease the Bank's market value of equity by 3.5%. If interest rates had been 200 basis points lower at December 31, 2003 (interest rates cannot be less than zero), a

100-basis-point additional decline in interest rates would be expected to increase the Bank's market value of equity by 1.0%.

To determine the market value of equity and its sensitivity to interest rates, the Bank uses an external proprietary asset and liability system to calculate market values under alternative interest rate scenarios. The system analyzes all of the Bank's financial instruments including derivatives on a transaction-level basis using sophisticated valuation engines with consistent and appropriate behavioral assumptions, market prices, and current position data. The system also includes a mortgage prepayment model. At least on an annual basis, the Bank reexamines the major assumptions and methodologies used in the model, including discounting curves, spreads for discounting, and prepayment assumptions. The Bank also compares the prepayment assumptions in the proprietary model to other sources, including actual prepayment history.

Net Interest Income Sensitivity – The Bank limits the sensitivity of net interest income through a policy limit on the adverse change in the potential dividend yield. The policy limits the adverse impact of a simulated plus or minus 200-basis-point instantaneous change in interest rates (interest rates cannot be less than zero) on the projected dividend yield, measured over a 12-month forecast period, to –175 basis points (–1.75%). Results of simulations during the year ended December 31, 2003, showed that the adverse change in the potential dividend yield from an instantaneous and parallel plus or minus change of 200 basis points in interest rates was –113 basis points, well within the policy limit of –175 basis points.

Repricing Gap Analysis – Repricing gap analysis shows the interest rate sensitivity of assets, liabilities, and interest rate exchange agreements by term-to-maturity (fixed rate instruments) or repricing interval (adjustable rate instruments). In assigning assets to repricing periods, management considers expected prepayment speeds, amortization of principal, and expected exercise of call options, where applicable, in addition to the contractual maturities of financial instruments. The repricing gap analysis excludes the reinvestment of cash received or paid for maturing instruments. The Bank monitors and reports repricing gap analysis at the total Bank level but does not have a policy limit due to the variability of mortgage cash flows as interest rate levels change. The amounts shown in the following table represent the net difference between total asset and liability repricings, including the impact of interest rate exchange agreements, for a specified time period (the "periodic gap"). For example, the positive periodic gap for the "6 months or less" time period indicates that as of December 31, 2003, there were $3.3 billion more assets than liabilities repricing or maturing during the 6-month period beginning on December 31, 2003. The large positive net periodic gap in the first 6-month period equals approximately 57% of the Bank's total capital, indicating that: (1) the market value risk for a large portion of invested Bank capital, as measured by net periodic gaps, is maintained at a low level, and (2) the income sensitivity for a large portion of invested Bank capital is responsive to changes in short-term interest rates.

REPRICING GAP ANALYSIS

DECEMBER 31, 2003	INTEREST RATE SENSITIVITY PERIOD			
(IN MILLIONS, NET OF INTEREST RATE EXCHANGE AGREEMENTS)	LESS THAN 6 MONTHS	6 MONTHS TO 1 YEAR	1 TO 5 YEARS	OVER 5 YEARS
Advances-related business:				
Assets	$82,984	$13,227	$11,769	$1,647
Liabilities	58,852	6,743	32,981	5,205
Interest rate exchange agreements	(20,838)	(5,847)	23,214	3,471
Periodic gap	3,294	637	2,002	(87)
Mortgage-related business:				
Assets	7,704	1,816	7,086	6,157
Liabilities	8,202	1,169	9,103	4,289
Interest rate exchange agreements	540	—	667	(1,207)
Periodic gap	42	647	(1,350)	661
Total periodic gap	$ 3,336	$ 1,284	$ 652	$ 574

Duration Gap – Duration gap is a measure of market risk published by several large wholesale financial institutions. The duration gap is the difference between the estimated durations (market value sensitivity) of assets and liabilities (including the impact of interest rate exchange agreements) and reflects the extent to which estimated cash flows for assets and liabilities are matched. The Bank monitors and reports duration gap analysis at the total Bank level but does not have a policy limit. The total Bank's duration gap was 0.6 and 0.8 months as of December 31, 2003 and 2002, respectively.

Segment Market Risk. The financial performance and interest rate risks of each business segment are managed within prescribed management guidelines, which, when combined, are consistent with the total Bank policy limits.

Advances-Related Business – Interest rate risk arises from the advances-related business primarily through the investment of the Bank's member-contributed capital. In general, advances create very little interest rate risk for the Bank because most fixed rate advances with maturities greater than 3 months and advances with embedded options are hedged contemporaneously with an interest rate swap. These hedged advances effectively create a pool of variable rate assets, which, in combination with the strategy of raising debt swapped to variable rate liabilities, create an advances portfolio with low interest rate risk.

Non-MBS investments have maturities of less than 3 months or are variable rate investments. These investments are also a good interest rate risk match with the Bank's variable rate funding.

The interest rate risk in the advances-related business is primarily associated with the Bank's strategy for investing the members' contributed capital. The Bank invests approximately 50% of its capital in short-term assets (maturities of three months or less) and approximately 50% of its capital in a laddered portfolio of fixed rate financial instruments with maturities of one month to four years ("targeted gaps"). This investment strategy is intended to mitigate the market value of capital risks associated with potential repurchase of members' surplus capital stock and to take advantage of the higher earnings available from a generally positively sloped yield curve in which intermediate-term investments generally have higher yields than short-term investments. Surplus capital stock primarily results from a decline in a member's advances; capital stock, when repurchased, is required to be repurchased at its statutory purchase price of $100 per share.

On a weekly basis management evaluates the projected impact of expected maturities and scheduled repricings of assets, liabilities, and interest rate exchange agreements on the interest rate risk of the advances-related portfolio. Management regularly compares the targeted repricing and maturity gaps to the actual repricing and maturity gaps to identify rebalancing needs for the targeted gaps. The analyses are prepared under base case and alternate interest rate scenarios to assess the effect of put options and call options embedded in the advances, related financing, and hedges. These analyses also are used to measure and manage potential reinvestment risk (when the remaining term of advances is shorter than the remaining term of the financing) and potential refinancing risk (when the remaining term of advances is longer than the remaining term of the financing). For the advances-related business, actual net asset repricings were 56% in the "less than 6 months" period and 44% for periods of 6 months and more, compared to the targeted amounts of approximately 50% each. Net market value sensitivity analysis and net interest income simulations are also used to identify and measure risk and variances to the target interest rate risk exposure in the advances-related segment.

Mortgage-Related Business – The Bank's mortgage assets include MBS, classified as both held-to-maturity and held-at-fair-value, and mortgage loans purchased under the MPF Program. The Bank is exposed to interest rate risk because the cash flows of the mortgage assets and the liabilities that fund them are not matched through time and across all possible interest rate scenarios because of the uncertainty of mortgage prepayments and the existence of interest rate caps on certain adjustable rate MBS.

The market risk of the mortgage-related business is managed both at the time an individual asset is purchased and on a total portfolio level. At the time of purchase (for all significant mortgage asset acquisitions), the Bank analyzes the earnings sensitivity risk, net market value sensitivity, and prepayment sensitivity of the mortgage assets and anticipated funding and hedging under various interest rate scenarios. At or close to the time of purchase of a mortgage asset, the related funding and hedging transactions are executed.

At least monthly, management reviews the market risk of the entire portfolio of mortgage assets and related funding and hedges. Rebalancing strategies to modify the mortgage portfolio market risks are then considered. At least quarterly, more in-depth analyses are performed, which include the impact of non-parallel shifts in the yield curve and assessments of unanticipated prepayment behavior. Based on these analyses, management may take actions to rebalance the mortgage portfolio's market risk profile. These rebalancing strategies may include the issuance of new funding and hedging transactions or the termination of certain funding and hedging transactions for the mortgage asset portfolio.

The Bank manages the interest rate and prepayment risk associated with mortgage assets through a combination of debt issuance and derivatives. The Bank may issue callable debt and non-callable debt and execute derivative transactions to achieve cash flow patterns and market value sensitivities for the liabilities and derivatives similar to those expected on the mortgage assets. Derivatives may be used as temporary hedges of anticipated debt issuance or as permanent hedges of debt used to finance the mortgage assets. The derivatives used to hedge the interest rate risk of fixed rate mortgage assets may be options to enter into interest rate swaps (swaptions) or callable and non-callable pay-fixed interest rate swaps. Derivatives used to hedge the periodic cap risks of adjustable rate mortgages may be receive-adjustable, pay-adjustable swaps with embedded caps that offset the periodic caps in the mortgage assets. Debt issued to finance mortgage assets may be fixed rate debt, callable fixed rate debt, or adjustable rate debt.

The following tables present results of market value of equity sensitivity and net interest income sensitivity analyses attributable to the mortgage-related business as of December 31, 2003 and 2002.

MARKET VALUE OF EQUITY SENSITIVITY

PERCENTAGE CHANGE IN MARKET VALUE OF BANK EQUITY ATTRIBUTABLE TO THE MORTGAGE-RELATED BUSINESS PER 100-BASIS-POINT CHANGE IN INTEREST RATES:	DECEMBER 31,	
INTEREST RATE SCENARIO	2003	2002
Actual rates at December 31	–1.5%	–1.3%
Rates start 200 basis points higher	–2.4%	–1.9%
Rates start 200 basis points lower	–1.4%	–0.3%

NET INTEREST INCOME SENSITIVITY

POTENTIAL DIVIDEND YIELD CHANGE ATTRIBUTABLE TO THE MORTGAGE-RELATED BUSINESS FOR THE FOLLOWING 12-MONTH PERIOD:	DECEMBER 31,	
	2003	2002
Instantaneous +200-basis-point change	–0.07%	–0.11%
Instantaneous –200-basis-point change	–0.67%	–0.53%

Interest Rate Exchange Agreements. The Bank uses interest rate swaps, options to enter into interest rate swaps (swaptions), interest rate cap and floor agreements, callable and putable interest rate swaps, and futures and forward contracts (collectively, interest rate exchange agreements) to manage its exposure to changes in interest rates. The following list shows the primary ways the Bank uses interest rate exchange agreements. The percentages in parentheses show the proportion of the Bank's total portfolio of interest rate exchange agreements (notional amounts) represented by each use as of December 31, 2003.

- To reduce funding costs by combining a derivative and a consolidated obligation bond. The combined funding structure can be lower in cost than a comparable consolidated obligation bond. (57%)
- To create variable rate assets by executing an interest rate swap that effectively converts fixed rate advances to variable rate advances primarily indexed to LIBOR. (37%)
- To reduce the costs to fund and hedge the potential adverse earnings effects of the possible shortening or extension of the expected lives of mortgage assets caused by changes in interest rates. (5%)

While management uses interest rate exchange agreements to achieve the specific financial objectives described above, certain transactions do not qualify for hedge accounting under the rules of SFAS 133. As a result, changes in the fair value of the interest rate exchange agreement are recorded in current period earnings. Finance Board regulation and the Bank's Risk Management Policy prohibit the speculative use of interest rate exchange agreements, and the Bank does not trade derivatives for profit. It is the Bank's policy to use interest rate exchange agreements only to reduce the market risk exposures inherent in the otherwise unhedged asset and funding positions of the Bank and to achieve other financial objectives of the Bank, such as providing low-cost funding for advances and mortgage assets. The central focus of the financial management practices of the Bank is preserving and enhancing the long-term economic performance of the Bank. Under SFAS 133 it is expected that reported GAAP net income and other comprehensive income will exhibit greater variability than had been the case prior to implementation of SFAS 133.

At December 31, 2003, the Bank had $126.8 billion total notional amount of interest rate exchange agreements outstanding compared with $124.6 billion at December 31, 2002. The notional amount serves as a basis for calculating periodic interest payments or cash flows received and paid.

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, 2003.

FAIR VALUE GAINS/(LOSSES) OF DERIVATIVES, HEDGED ITEMS, AND HELD-AT-FAIR-VALUE SECURITIES

DECEMBER 31, 2003*		CUMULATIVE GAIN/(LOSS)		
(IN MILLIONS)	NOTIONAL AMOUNT	DERIVATIVES	HEDGED INSTRUMENTS	DIFFERENCE
Qualifying for Hedge Accounting:				
Advances	$ 46,748	$(370)	$ 367	$ (3)
Callable bonds	27,050	(97)	187	90
Non-callable consolidated obligations	28,439	363	(354)	9
Mortgage asset funding	1,273	38	(39)	(1)
Subtotal	103,510	(66)	161	95
Not Qualifying for Hedge Accounting:				
Advances	112	—	—	—
Consolidated obligations	16,483	20	(22)	(2)
Intermediated	976	—	—	—
Mortgage assets:				
Mortgage asset funding	5,291	1	—	1
MBS: held-at-fair-value	397	(22)	22	—
MPF firm commitments	5	28	—	28
Subtotal	23,264	27	—	27
Total	$126,774	$ (39)	$ 161	122
Indirect effects				(4)
Fair value gain before assessments				118
Assessments				(31)
Fair value gain after assessments				$ 87
Other comprehensive income/(loss)				$ (12)

*The notional amounts outstanding are as of December 31, 2003, and the cumulative gains and losses are since the adoption of SFAS 133 through the year ended December 31, 2003.

The primary source of SFAS 133-related income volatility arises from hedging the callable consolidated obligation bonds to effectively create floating rate debt with uncertain maturities. Since the implementation of SFAS 133, these transactions have usually resulted in net gains because of the relatively low cost of this swapped debt compared to the estimated cost of comparable new swapped callable consolidated obligations. These net gains can be volatile from period to period as a result of changes in (1) interest rate spreads, (2) the expected life of swapped callable debt due to the absolute level of interest rates, and (3) the volatility of interest rates.

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, other comprehensive income, and dividends. Because the SFAS 133 cumulative net unrealized gains or losses are primarily a matter of timing, the unrealized gains or losses will reverse over the remaining contractual terms to maturity of the hedged financial instruments and associated interest rate exchange agreements.

RECENT DEVELOPMENTS

Proposed Rule on Registration Under the Securities Exchange Act of 1934. On September 17, 2003, the Finance Board published a proposed rule that would require the FHLBanks to voluntarily register a class of securities with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (1934 Act). Comments on the proposed rule were due January 15, 2004. The Bank and other FHLBanks are working with staff of the SEC and the Finance Board to address the implications of voluntary registration. It is uncertain at this time whether the FHLBanks will become subject to financial and operational reporting requirements under the 1934 Act.

Proposed Changes to GSE Regulation. Congressional committees have considered draft legislation to establish a new regulator for the housing GSEs (the FHLBanks, Fannie Mae, and Freddie Mac). The Administration has proposed the creation of a new regulator within the U.S. Department of the Treasury to oversee the housing GSEs. It is uncertain at this time whether there will be final legislation affecting the FHLBanks, the other housing GSEs, or their regulators.

Governance Practices. In early 2004, the Finance Board held two hearings on FHLBank governance to collect information about possible changes to Finance Board regulations or to the FHLB Act to help the boards of directors of the FHLBanks to better identify, measure, monitor, and control the risks on the FHLBanks' balance sheets. In 2003, the Finance Board completed a horizontal review to identify FHLBank board governance practices that contribute to effective governance programs among the FHLBanks. It is uncertain at this time whether there will be changes in the governance requirements and practices of the FHLBanks.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Fair Values. As of December 31, 2003 and 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 Statements 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 various valuation techniques have been used by the Bank for the purpose of determining estimated fair values. Changes in these assumptions, calculations, and techniques 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. Although the Bank uses its best judgment in estimating the fair value of these financial instruments, there are inherent limitations in any estimation technique or valuation methodology. The Bank continually refines its assumptions and valuation techniques and methodologies to better reflect market indications. Therefore, these estimated fair values are not necessarily indicative of the amounts that would be realized in current market transactions.

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.

Provision for Credit Losses.

Advances – Based on the collateral held as security for advances, management's credit analyses, and prior repayment history, no allowance for losses on advances is deemed necessary by management. The Bank is required by Finance Board regulation to obtain sufficient collateral on advances to protect against losses, and to accept only certain collateral on its advances, such as U. S. government or government-agency securities, residential mortgage loans, deposits in the Bank, and other real estate-related assets. At December 31, 2003 and 2002, the Bank had rights to collateral, either loans or securities, on a member-by-member basis, with an estimated fair value in excess of outstanding advances. The Bank's management believes that policies and procedures are in place to effectively manage its credit risk.

Mortgage Loans Acquired Under MPF Program – No loans were reported 90 days or more delinquent at December 31, 2003; no loans were in foreclosure or classified as nonaccrual or impaired during 2003; and no allowance for credit losses on mortgage loans was deemed necessary by management as of December 31, 2003. The Bank bases its allowance on management's estimate of probable credit losses in the mortgage loan portfolio as of the balance sheet date. The overall allowance is determined by an analysis that includes consideration of various observable data, such as delinquency statistics, past performance, current performance, loan portfolio characteristics, collateral valuations, industry data, and prevailing economic conditions, taking into account the credit enhancement provided by the member under the terms of each master commitment.

OFF-BALANCE SHEET ARRANGEMENTS AND AGGREGATE CONTRACTUAL OBLIGATIONS

Off-Balance Sheet Arrangements, Guarantees, and Other Commitments. In accordance with Finance Board regulations, the Bank is jointly and severally liable for the System's consolidated obligations issued under Section 11(a) of the FHLBank Act, and in accordance with the FHLBank Act, the Bank is jointly and severally liable for consolidated obligations issued under Section 11(c) of the FHLBank Act. Accordingly, should one or more of the FHLBanks be unable to repay their participation in the consolidated obligations in which they are the primary obligor, 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. The Bank's joint and several contingent liability is a guarantee, as defined by FIN 45, but is excluded from the initial recognition and measurement provisions of FIN 45. Therefore, the valuation of this contingent liability is not recorded on the balance sheet of the Bank. At December 31, 2003, the System had $759.5 billion of consolidated obligations outstanding. For additional information on the Bank's joint and several liability contingent obligation, see Notes 12 and 19 in the Notes to the Financial Statements.

In addition, in the ordinary course of business, the Bank engages in financial transactions that are not recorded on the Bank's balance sheet, in accordance with GAAP, or may be recorded on the Bank's balance sheet in amounts that are different from the full contract or notional amount of the transactions. For example, the Bank routinely enters into commitments to extend credit such as advances and standby letters of credit. While these commitments represent future cash requirements of the Bank, the standby letters of credit usually expire without being drawn upon. Such commitments are subject to the same underwriting and collateral requirements as advances made by the Bank. At December 31, 2003, the Bank had $0.4 billion of advance commitments and $1.0 billion in standby letters of credit outstanding.

The financial statements do not include a liability for future 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, *Accounting for Contingencies*. Accordingly, the REFCORP payments are disclosed as a long-term statutory payment requirement and, for accounting purposes, are treated, accrued, and recognized like an income tax.

Contractual Obligations. In the ordinary course of operations, the Bank enters into certain contractual obligations. Such obligations primarily consist of consolidated obligations for which the Bank is the primary obligor. Other contractual obligations include leases for premises and consolidated obligations that have traded but not yet settled. Further, the Bank enters into purchase commitments for mortgage loans in connection with the Bank's participation in the mortgage purchase program. The table below summarizes the Bank's significant contractual obligations as of December 31, 2003, except for obligations associated with short-term discount notes and pension and retirement benefits. Additional information with respect to the Bank's consolidated obligations is presented in Notes 12 and 19 in the Notes to the Financial Statements. In addition, refer to Note 14 in the Notes to the Financial Statements for a discussion of the Bank's pension and retirement expenses and commitments, and see Note 9 in the Notes to the Financial Statements for a discussion of the Bank's mortgage purchase program.

The Bank enters into derivative financial instruments, which create contractual obligations, as part of the Bank's interest rate risk management. See Note 16 in the Notes to the Financial Statements for additional information regarding derivative financial instruments.

CONTRACTUAL OBLIGATIONS

AS OF DECEMBER 31, 2003	PAYMENTS DUE BY PERIOD				
(IN MILLIONS) CONTRACTUAL OBLIGATIONS	< 1 YEAR	1 TO < 3 YEARS	3 TO < 5 YEARS	≥ 5 YEARS	TOTAL
Long-term debt	$26,177	$38,232	$16,886	$11,297	$92,592
Operating leases	3	7	7	2	19
Mortgage loans	5	—	—	—	5
CO bonds traded not settled	641	—	—	—	641
Total contractual obligations	$26,826	$38,239	$16,893	$11,299	$93,257

Management Report on Responsibility for Financial Reporting

FINANCIAL STATEMENTS

The management of the Federal Home Loan Bank of San Francisco (Bank) prepared the financial statements contained in the Annual Report in accordance with generally accepted accounting principles. Management has primary responsibility for the integrity and objectivity of the financial statements, which include amounts that are based on management's best estimates and judgments. Other information in the Annual Report is consistent with that contained in the financial statements.

The Bank's financial statements have been audited by PricewaterhouseCoopers LLP, independent accountants. Management has made available to PricewaterhouseCoopers LLP all the Bank's financial records and related data, as well as the minutes of the meetings of the Bank's Board of Directors. The report of the independent accountants expresses an opinion as to the fairness of the financial position and results of operations of the Bank based on their audit conducted in accordance with generally accepted auditing standards.

INTERNAL CONTROL SYSTEMS

In meeting its responsibility for the integrity and objectivity of the financial statements, management of the Bank has established and relies upon a system of internal controls designed to provide reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use or disposition, and the prevention and detection of fraudulent financial reporting. The system of internal controls provides for appropriate division of responsibility and is documented by written policies and procedures that are communicated to employees with significant roles in the financial reporting process. Management monitors the system of internal controls for compliance, adequacy, and cost-effectiveness. Management believes that as of December 31, 2003, the Bank's system of internal controls was adequate to accomplish the objectives discussed herein.

The Bank maintains an internal auditing program and the Federal Housing Finance Board performs an examination function that independently assess the effectiveness of the Bank's internal controls and recommend possible improvements thereto. Corrective actions are taken to address control deficiencies and other opportunities for improving the system as they are identified. The Audit Committee of the Board of Directors is composed of independent directors and oversees the Bank's financial reporting and system of internal controls. In addition to meeting regularly with the Bank's management, the Committee met with the Bank's Director of Internal Audit and the independent accountants, without management present, to discuss the results of their audits, their evaluations of the system of internal controls, and the overall quality of the Bank's financial reporting.

There are inherent limitations in the effectiveness of any system of internal controls, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Furthermore, the effectiveness of an internal control system can change with circumstances.

The Bank assesses its internal control system in relation to, among other things, criteria for effective internal control over financial reporting described in "Internal Control-Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its assessment, the Bank believes that, as of December 31, 2003, its system of internal controls over financial reporting met those criteria.

CODE OF CONDUCT

Management also recognizes its responsibility for fostering a strong ethical climate so that the Bank's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in the Bank's code of corporate conduct, which is communicated to employees.

Dean Schultz
President and Chief Executive Officer

Ross Kari
Executive Vice President and Chief Operating Officer

Steven T. Honda
Senior Vice President and Chief Financial Officer

Vera Maytum
Senior Vice President and Controller

February 13, 2004

Audit Committee Report

The Audit Committee of the Board of Directors of the Federal Home Loan Bank of San Francisco (Bank) for 2004 is currently composed of 14 directors, 6 of whom were appointed to the Board by the Federal Housing Finance Board and 8 of whom were elected to the Board by the members of the Bank.

The Audit Committee oversees the Bank's financial reporting process; reviews the programs and policies of the Bank designed to ensure compliance with applicable laws, regulations, and policies and monitors the results of these compliance efforts; and advises and assists the Board in fulfilling its oversight responsibilities relating to risk management, internal controls, the accounting policies and financial reporting and disclosure practices of the Bank, and the audit and examination of the Bank.

The Audit Committee has reviewed and discussed the audited financial statements with management. The Committee has discussed with the independent auditor the matters required to be discussed by Statement on Auditing Standards (SAS) No. 61, *Communications with Audit Committees*, and SAS No. 90, *Audit Committee Communications.* The Committee has also received the written disclosures and the letter from the independent auditor required by Independent Standards Board Standard No. 1, *Independence Discussions with Audit Committees*, and has discussed the auditor's independence with the auditor.

Based on the review and discussions referred to above, the Audit Committee recommends to the Board of Directors that the financial statements be included in the Annual Report.

Frank P. Pekny, Chairman

Kenneth R. Harder, Vice Chairman

Robert N. Barone

Timothy R. Chrisman

Craig G. Blunden

James P. Giraldin

Rick McGill

Monte L. Miller

John F. Robinson

Scott C. Syphax

John T. Wasley

Connie R. Wilhelm

David T. C. Wright

Charlene Gonzales Zettel

February 13, 2004

Report of Independent Accountants

To the Board of Directors and Shareholders of the Federal Home Loan Bank of San Francisco:

In our opinion, the accompanying statements of condition and the related statements of income, capital, and cash flows present fairly, in all material respects, the financial position of the Federal Home Loan Bank of San Francisco (Bank) at December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Bank's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Also, in accordance with those standards and as part of our audit of the Bank's financial statements, we issued a separate report on compliance and on internal control over financial reporting. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2, the FHLBank adopted Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by Statement of Financial Accounting Standards No. 138, on January 1, 2001.

PricewaterhouseCoopers LLP
San Francisco, California

February 13, 2004

Statements of Condition

(IN THOUSANDS – EXCEPT PAR VALUE)	DECEMBER 31, 2003	DECEMBER 31, 2002
ASSETS		
Cash and due from banks	$ 17,579	$ 8,759
Interest-bearing deposits in banks	3,287,000	4,834,000
Deposits for mortgage loan program with other Federal Home Loan Bank	11,611	58,113
Securities purchased under agreements to resell	5,100,000	4,400,000
Federal funds sold	5,434,000	6,068,000
Held-to-maturity securities ($127,375, $250,007, respectively, were pledged as collateral)	18,263,315	17,878,844
Held-at-fair-value securities	917,322	533,090
Advances	92,329,621	81,237,041
Mortgage loans held in portfolio, net of allowance for credit losses on mortgage loans of $0, $180	6,445,192	262,426
Accrued interest receivable	218,123	285,055
Premises and equipment, net	8,388	7,343
Derivative assets	265,677	518,734
Other assets	91,908	38,076
Total Assets	$ 132,389,736	$ 116,129,481
LIABILITIES AND CAPITAL		
Liabilities:		
Deposits:		
Demand and overnight	$ 831,942	$ 352,344
Term	65,450	34,510
Other	90,273	19,785
Total deposits	987,665	406,639
Other borrowings	—	525,000
Consolidated obligations, net:		
Bonds	92,751,350	95,821,797
Discount notes	31,882,203	12,446,816
Total consolidated obligations	124,633,553	108,268,613
Accrued interest payable	527,947	715,620
Affordable Housing Program	134,990	131,706
Payable to REFCORP	16,211	14,012
Derivative liabilities	180,690	345,865
Other liabilities	62,858	37,328
Total Liabilities	126,543,914	110,444,783
Commitments and Contingencies: Note 19		
Capital:		
Capital stock ($100 par value) issued and outstanding: 57,390 shares in 2003 and 55,860 shares in 2002	5,738,966	5,585,988
Retained earnings	118,922	100,978
Accumulated other comprehensive loss:		
Unrecognized net loss related to hedging activities	(12,066)	(2,268)
Total Capital	5,845,822	5,684,698
Total Liabilities and Capital	$ 132,389,736	$ 116,129,481

The accompanying notes are an integral part of these financial statements.

Statements of Income

(IN THOUSANDS)	FOR THE YEARS ENDED DECEMBER 31, 2003	2002	2001
INTEREST INCOME:			
Advances	$ 1,128,638	$ 1,818,901	$ 4,733,629
Interest-bearing deposits in banks	43,971	78,309	142,429
Deposits for mortgage loan program with other Federal Home Loan Bank	136	59	—
Securities purchased under agreements to resell	30,035	47,853	63,861
Federal funds sold	77,895	119,213	349,341
Held-to-maturity securities	580,582	819,607	828,862
Held-at-fair-value securities	31,417	32,654	40,359
Mortgage loans	138,474	1,600	—
Loans to other Federal Home Loan Banks	140	250	843
Total Interest Income	2,031,288	2,918,446	6,159,324
INTEREST EXPENSE:			
Consolidated obligations	1,597,638	2,395,569	5,579,602
Deposits	3,545	7,148	15,994
Borrowings from other Federal Home Loan Banks	6	68	78
Other borrowings	103	133	218
Total Interest Expense	1,601,292	2,402,918	5,595,892
NET INTEREST INCOME BEFORE MORTGAGE LOAN LOSS PROVISION	429,996	515,528	563,432
(Reduction of)/provision for credit losses on mortgage loans	(180)	180	—
NET INTEREST INCOME AFTER MORTGAGE LOAN LOSS PROVISION	430,176	515,348	563,432
OTHER INCOME/(LOSS):			
Prepayment fees	15,486	9,032	5,953
Services to members	893	851	904
Net (loss)/gain on held-at-fair-value securities	(15,403)	22,745	7,653
Net gain/(loss) on derivatives and hedging activities	65,303	(83,029)	54,986
Other, net	3,677	3,137	2,901
Total Other Income/(Loss)	69,956	(47,264)	72,397
OTHER EXPENSE:			
Operating expense	54,001	53,561	48,803
Federal Housing Finance Board	3,742	4,596	4,134
Office of Finance	2,708	2,846	2,526
Arbitration award	—	9,395	—
Total Other Expense	60,451	70,398	55,463
INCOME BEFORE ASSESSMENTS AND CUMULATIVE EFFECT OF ADOPTING SFAS 133	439,681	397,686	580,366
REFCORP assessments	80,758	73,045	106,147
Affordable Housing Program assessments	35,892	32,464	47,177
Total Assessments	116,650	105,509	153,324
INCOME BEFORE CUMULATIVE EFFECT OF ADOPTING SFAS 133	323,031	292,177	427,042
Cumulative effect of adopting SFAS 133	—	—	(2,453)
NET INCOME	$ 323,031	$ 292,177	$ 424,589

The accompanying notes are an integral part of these financial statements.

Statements of Capital Accounts

(IN THOUSANDS)	CAPITAL STOCK		RETAINED EARNINGS			ACCUMULATED OTHER COMPREHENSIVE INCOME/(LOSS)	TOTAL CAPITAL
	SHARES	PAR VALUE	RESTRICTED	UNRESTRICTED	TOTAL		
Balance, December 31, 2000	62,679	$ 6,267,859	$ 24,179	$ 107	$ 24,286	$ —	$6,292,145
Issuance of capital stock	6,655	665,502					665,502
Redemption of capital stock	(5,680)	(567,965)					(567,965)
Comprehensive income:							
Net income				424,589	424,589		424,589
Other comprehensive income:							
Cumulative effect of adopting SFAS 133						(17,065)	(17,065)
Net amounts recognized as earnings						12,217	12,217
Net change in period relating to hedging activities						102	102
Total comprehensive income							419,843
Transfers to restricted retained earnings			38,015	(38,015)	—		—
Dividends on capital stock (5.99%)							
Cash payment				(61)	(61)		(61)
Stock issued	3,865	386,545		(386,545)	(386,545)		—
Balance, December 31, 2001	67,519	6,751,941	62,194	75	62,269	(4,746)	6,809,464
Issuance of capital stock	5,026	502,535					502,535
Redemption of capital stock	(19,219)	(1,921,905)					(1,921,905)
Comprehensive income:							
Net income				292,177	292,177		292,177
Other comprehensive income:							
Net amounts recognized as earnings						4,189	4,189
Net change in period relating to hedging activities						(1,711)	(1,711)
Total comprehensive income							294,655
Transfers from restricted retained earnings			(36,710)	36,710	—		—
Dividends on capital stock (5.50%)							
Cash payment				(51)	(51)		(51)
Stock issued	2,534	253,417		(253,417)	(253,417)		—
Balance, December 31, 2002	55,860	5,585,988	25,484	75,494	100,978	(2,268)	5,684,698
Issuance of capital stock	14,229	1,422,948					1,422,948
Redemption of capital stock	(15,749)	(1,574,970)					(1,574,970)
Comprehensive income:							
Net income				323,031	323,031		323,031
Other comprehensive income:							
Net amounts recognized as earnings						(1,526)	(1,526)
Net change in period relating to hedging activities						(8,272)	(8,272)
Total comprehensive income							313,233
Transfers to restricted retained earnings			93,301	(93,301)	—		—
Dividends on capital stock (4.29%)							
Cash payment				(87)	(87)		(87)
Stock issued	3,050	305,000		(305,000)	(305,000)		—
Balance, December 31, 2003	57,390	$ 5,738,966	$118,785	$ 137	$ 118,922	$(12,066)	$5,845,822

The accompanying notes are an integral part of these financial statements.

Statements of Cash Flows

(IN THOUSANDS)	2003	2002	2001
	FOR THE YEARS ENDED DECEMBER 31,		
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net Income	$ 323,031	$ 292,177	$ 424,589
Cumulative effect of adopting SFAS 133	—	—	2,453
Income before cumulative effect of adopting SFAS 133	323,031	292,177	427,042
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization:			
Net discounts on consolidated obligations and investments	(1,092)	(117,013)	(422,974)
Net premiums on mortgage loans	8,793	128	—
Concessions on consolidated obligations	43,899	45,096	50,326
Bank premises and equipment	2,434	1,694	1,602
Deferred net losses on interest rate exchange agreements	1,529	2,208	9,712
(Reduction of)/provision for credit losses on mortgage loans	(180)	180	—
Increase in Affordable Housing Program (AHP) liability and discount on AHP advances	3,189	4,527	17,260
Increase/(decrease) in REFCORP liability	2,199	(22,863)	11,560
(Gain)/loss due to change in net fair value adjustment on derivative and hedging activities	(228,712)	59,296	(45,527)
Increase in held-at-fair-value securities	(384,233)	(5,219)	(520,737)
Decrease/(increase) in derivative asset accrued interest	18,344	119,925	(231,041)
Increase/(decrease) in derivative liability accrued interest	28,035	(112,676)	143,690
Decrease in accrued interest receivable	66,933	133,551	2,718,170
Decrease in accrued interest payable	(187,673)	(364,507)	(2,808,127)
(Increase)/decrease in other assets	(39,570)	2,923	(2,555)
Increase/(decrease) in other liabilities	25,412	(1,120)	2,287
Total adjustments	(640,693)	(253,870)	(1,076,354)
Net cash (used in)/provided by operating activities	(317,662)	38,307	(649,312)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Net decrease/(increase) in interest-bearing deposits in banks	1,547,000	(347,000)	(1,789,000)
Net decrease/(increase) in Federal funds sold	634,000	2,377,000	(69,000)
Net increase in securities purchased under agreements to resell	(700,000)	(2,250,000)	(1,750,000)
Net decrease in short-term held-to-maturity securities	267,435	934,907	1,593,196
Purchases of long-term held-to-maturity securities	(11,544,881)	(10,286,685)	(7,242,976)
Maturities of long-term held-to-maturity securities	10,883,973	8,067,420	4,771,175
Principal collected on advances	557,274,742	353,940,025	343,437,997
Advances made	(568,983,409)	(332,850,038)	(334,746,482)
Principal collected on mortgage loans	640,465	3,057	—
Purchases of mortgage loans	(6,831,845)	(265,791)	—
Net decrease/(increase) in deposits for mortgage loan program with other Federal Home Loan Bank	46,502	(58,113)	—
Net decrease/(increase) in loans to other Federal Home Loan Banks	—	25,000	(25,000)
Net increase to premises and equipment	(3,479)	(3,508)	(2,805)
Net cash (used in)/provided by investing activities	(16,769,497)	19,286,274	4,177,105

Statements of Cash Flows

(IN THOUSANDS)	FOR THE YEARS ENDED DECEMBER 31, 2003	2002	2001
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase/(decrease) in deposits	581,026	(344,978)	375,204
Net (decrease)/increase in other borrowings	(525,000)	325,000	200,000
Net proceeds from sale of consolidated obligations:			
Bonds	103,600,962	71,761,000	92,897,300
Discount notes	182,665,980	96,800,665	196,443,370
Payments for maturing and retiring consolidated obligations:			
Bonds	(105,854,609)	(80,889,105)	(86,604,445)
Discount notes	(163,220,289)	(105,550,872)	(206,939,393)
Proceeds from issuance of capital stock	1,422,948	502,535	665,502
Payments for redemption of capital stock	(1,574,970)	(1,921,905)	(567,965)
Cash dividends paid	(69)	(51)	(61)
Net cash provided by/(used in) financing activities	17,095,979	(19,317,711)	(3,530,488)
Net increase/(decrease) in cash and cash equivalents	8,820	6,870	(2,695)
Cash and cash equivalents at beginning of year	8,759	1,889	4,584
Cash and cash equivalents at end of period	$ 17,579	$ 8,759	$ 1,889
SUPPLEMENTAL DISCLOSURE:			
Interest paid during the period	$ 2,131,336	$ 3,258,314	$ 7,174,678

The accompanying notes are an integral part of these financial statements.

YEARS ENDED DECEMBER 31, 2003, 2002, AND 2001
(Dollars in thousands)

BACKGROUND INFORMATION

The Federal Home Loan Bank of San Francisco (Bank), a federally chartered corporation exempt from ordinary federal, state, and local taxation except real property taxes, is one of 12 District Federal Home Loan Banks (FHLBanks). The FHLBanks serve the public by enhancing the availability of credit for residential mortgages and targeted community development by providing a readily available, low-cost source of funds to their member institutions. Each FHLBank is operated as a separate entity with its own management, employees, and board of directors. The Bank does not have any special purpose entities or any other type of off-balance sheet conduits. The Bank is a cooperative whose member institutions own the capital stock of the Bank and may receive dividends on their investments. Regulated financial depositories and insurance companies engaged in residential housing finance and community financial institutions are eligible to apply for membership. Community financial institutions are defined for 2003 as FDIC-insured depository institutions with average total assets over the preceding three-year period of $538,000 or less. All members are required to purchase stock in the Bank.

The Federal Housing Finance Board (Finance Board), an independent federal agency in the executive branch of the United States government, supervises and regulates the FHLBanks and the FHLBanks' Office of Finance. The Finance Board ensures that the FHLBanks operate in a financially safe and sound manner, carry out their housing finance mission, remain adequately capitalized, and are able to raise funds in the capital markets. Also, the Finance Board establishes policies and regulations governing the operations of the FHLBanks.

A primary source of funds for the FHLBanks is the proceeds from the sale to the public of the FHLBanks' debt instruments (consolidated obligations), which are the joint and several obligations of all FHLBanks and are sold to the public through the Office of Finance using authorized securities dealers. Other funds are provided by deposits, other borrowings, and the issuance of capital stock to members. The Bank primarily uses these funds to provide advances to members.

In accordance with the Finance Board's regulations, the Bank has established a formal policy governing the compensation and expense reimbursement provided to its directors. Directors are compensated based on the level of responsibility assumed. Fees are paid for attendance at certain meetings. Directors are also reimbursed for reasonable and necessary Bank-related travel, subsistence, and other related expenses under a policy similar to the Bank's travel policy for employees. During 2003, meeting fees totaled $244 and reimbursed travel and related expenses totaled $168.

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates. The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, if applicable, and the reported amounts of income and expenses during the reporting period. Changes in the estimates and assumptions could potentially affect the Bank's financial position and results of operations significantly. In addition, actual results could differ from these estimates.

Investments. Held-to-maturity securities and securities purchased under agreements to resell (resale agreements) are carried at cost, adjusted for the amortization of premiums and the accretion of discounts using methods that approximate the level-yield method. These investments are classified as held-to-maturity securities because management has the positive intent and ability to hold these securities until maturity.

The Bank classifies certain investments as held-at-fair-value securities and carries them at fair value. The Bank records changes in the fair value of these investments through other income. Under Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, the investments would be classified (described) as "trading." Given that Finance Board regulation prohibits the Bank from trading investments, the Bank does not participate in trading activities. Therefore, the Bank classifies the investments as "held-at-fair-value" securities because it believes that description is more appropriate.

The Bank treats resale agreements as collateralized investments.

The Bank regularly evaluates outstanding investments for impairment. If there is an other-than-temporary impairment in the value of an investment, the decline in value is recognized as a loss in other expense.

Advances. The Bank presents advances (loans to members) net of unearned fees and presents advances under the Affordable Housing Program (AHP) net of discounts. Interest on advances is credited to income as earned. Following the requirements of the Federal Home Loan Bank Act of 1932, as amended (FHLB Act), the Bank obtains sufficient collateral for advances to protect the Bank from losses. The FHLB Act limits eligible collateral to secure advances to certain investment securities, residential mortgage loans, cash or deposits with the Bank, and other eligible real estate-related assets. As more fully discussed in Note 7, the Bank may also accept secured small business, small farm, and small agribusiness loans as collateral from members that are community financial institutions (CFIs). The Bank has never experienced any credit losses on advances. Based on the collateral held as security for advances, management's credit analyses, and prior repayment history, no allowance for losses on advances is deemed necessary by management.

Mortgage Loans Held in Portfolio. Under the Mortgage Partnership Finance® (MPF®) Program, the Bank purchases government-insured and conventional conforming fixed rate residential mortgage loans from its participating members. ("Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.) The Bank manages the liquidity, interest rate, and options risk of the loans, while the member retains the marketing and servicing activities. The Bank and the member selling the loans share in the credit risk of the loans, with the Bank assuming the first loss obligation limited by the First Loss Account (FLA), and the member assuming credit losses in excess of the FLA, up to the amount of the credit enhancement obligation as specified in the master agreement. The Bank will incur credit losses when the loss experience exceeds the credit enhancement provided by the member for that master agreement.

The amount of the credit enhancement is calculated so that any credit losses (excluding special hazard losses) in excess of the enhancement are limited to those expected from an equivalent investment with a long-term credit rating of AA. The participating member receives from the Bank a credit enhancement fee for managing this portion of the credit risk in the loans. These fees are paid monthly based on the remaining unpaid principal balance of the mortgage loans. The amount of the member's required credit enhancement obligation may vary depending on which product alternative is selected. The member may obtain supplemental mortgage insurance (SMI) for any portion of its credit enhancement obligation under some product alternatives. The Bank manages credit exposure to SMI carriers in the same way that it manages unsecured credit in its investment portfolio.

The Bank classifies mortgage loans as held for investment and, accordingly, reports them at their principal amount outstanding net of unamortized premiums and discounts. The Bank defers and amortizes premiums and discounts as interest income over the estimated life of the related mortgage loan. Actual prepayment experience and estimates of future principal prepayments are used in calculating the estimated lives of the mortgage loans. The Bank aggregates the mortgage loans by similar characteristics (type, maturity, note rate, and acquisition date) in determining prepayment estimates.

The Bank records credit enhancement fees as a yield adjustment to interest income and records delivery commitment extension fees and pair-off fees in other income.

The Bank places a mortgage loan on nonaccrual status when the collection of the contractual principal or interest from the participating member is reported 90 days or more past due. When a mortgage loan is placed on nonaccrual status, accrued but uncollected interest is reversed against interest income. The Bank records cash payments received on nonaccrual loans as interest income and a reduction of principal.

Allowance for Credit Losses on Mortgage Loans. The Bank bases the allowance for credit losses on mortgage loans on management's estimate of probable credit losses in the Bank's mortgage loan portfolio as of the balance sheet date. Actual losses greater than the levels defined for each participating member for loans purchased from that member are offset by the member's credit enhancement. The Bank performs periodic reviews of its portfolio to identify the losses in 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 observable data, such as delinquency statistics, past performance, current performance, loan portfolio characteristics, collateral valuations, industry data, and prevailing economic conditions, taking into account the credit enhancement. As of December 31, 2003, no loans were classified as either impaired or reported 90 days or more past due. As a result, no allowance for credit losses on mortgage loans was recorded as of December 31, 2003.

Affordable Housing Program. As more fully discussed in Note 8, the FHLB Act requires each FHLBank to establish and fund an AHP. The Bank charges the required funding for the AHP to earnings and establishes a liability. The AHP funds provide subsidies in the form of direct grants and below-market interest rate advances to members to assist in the purchase, construction, or rehabilitation of housing for very low-, low-, and moderate-income households. AHP advances are made at interest rates below the customary interest rate for non-subsidized advances. When an FHLBank makes an AHP advance, the net present value of the difference in the cash flows attributable to the difference between the interest rate of the AHP advance and the FHLBank's related cost of funds for comparable maturity funding is charged against the AHP liability and recorded as a discount on the AHP advance.

Prepayment Fees. The Bank charges its members a prepayment fee when certain advances are paid prior to original maturity. If a member prepays an advance and takes down a second advance within a short period of time after the prepayment of the first advance, the Bank evaluates whether the second advance meets the criteria to qualify as a modification of the first advance or is a new advance. If the second advance qualifies as a modification, the net prepayment fee on the prepaid advance is deferred, recorded in the basis of the advance, and amortized over the life of the modified advance as interest income. If the modified advance is hedged, it is marked to fair value after the amortization of the basis adjustment. This amortization results in offsetting amounts being recorded in net interest income and in "Net realized and unrealized gain/(loss) on derivatives and hedging activities" in other income. If the Bank determines that the second advance is a new advance, the net prepayment fees are recorded in other income.

Other Fees. Other fees for advances are deferred and amortized to interest income using the straight-line method. Issuance fees for letters of credit are recorded as other income when received.

Derivatives. Accounting for derivatives is addressed in SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of Effective Date of FASB Statement No. 133*, and as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (herein referred to as "SFAS 133"). Accordingly, all derivatives are recognized on the balance sheet at fair value and designated as either (1) a hedge of the fair value of (a) a recognized asset or liability or (b) an unrecognized firm commitment (a "fair value" hedge); (2) a hedge of (a) a forecasted transaction or (b) the variability of cash flows that are to be received or paid in connection with a recognized asset or liability (a "cash flow" hedge); (3) a non-SFAS 133-qualifying hedge of an asset or liability (an "economic" hedge) for asset-liability management purposes, or (4) a non-SFAS 133-qualifying hedge of another derivative (an "intermediation" hedge) that is offered as a product to members or used to offset other derivatives with non-member counterparties.

Changes in the fair value of a derivative that is effective as and is designated and qualifies as a fair value hedge, along with changes in the fair value of the hedged asset or liability that are attributable to the hedged risk (including changes that reflect losses or gains on firm commitments), are recorded in current period earnings.

Changes in the fair value of a derivative that is effective as and is designated and qualifies as a cash flow hedge, to the extent that the hedge is effective, are recorded in other comprehensive income, a component of capital, until earnings are affected by the variability of the cash flows of the hedged transaction (i.e., until the periodic recognition of interest on a variable rate asset or liability is recorded in earnings). 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 the variability in the cash flows of the forecasted transaction) is recorded in current period earnings.

Changes in the fair value of a derivative designated as an economic hedge or an intermediation hedge are recorded in current period earnings with no fair value adjustment to an asset or liability. Hedge ineffectiveness and changes in the fair value of economic hedges are recorded in other income as "Net gain/(loss) on derivatives and hedging activities." In addition, the interest income and interest expense associated with economic hedges are recorded in other income as "Net gain/(loss) on derivatives and hedging activities."

The Bank routinely issues debt and makes advances in which derivative instruments are embedded. Upon execution of these transactions, the Bank assesses whether the economic characteristics of the embedded derivative are clearly and closely related to the economic characteristics of the remaining component of the advance or debt (the host contract) and whether a separate, non-embedded instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. When it is determined that (1) the embedded derivative has economic characteristics that are not clearly and closely related to the economic characteristics of the host contract, and (2) a separate, standalone instrument with the same terms would qualify as a derivative instrument, the embedded derivative is separated from the host contract, carried at fair value, and designated as a stand-alone derivative instrument pursuant to an economic hedge. However, if the entire contract (the host contract and the embedded derivative) is to be measured at fair value, with changes in fair value reported in current earnings (such as an investment security classified as "trading" under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*), or if the Bank cannot reliably identify and measure the embedded derivative for purposes of separating that derivative from its host contract, the entire contract is carried on the balance sheet at fair value and no portion of the contract is designated as a hedging instrument.

The Bank documents all relationships between derivative hedging instruments and hedged items, its risk management objectives and strategies for undertaking various hedge transactions, and its method of assessing effectiveness. This process includes linking all derivatives that are designated as fair value or cash flow hedges to (1) assets and liabilities on the balance sheet, (2) firm commitments, or (3) forecasted transactions. The Bank also formally assesses (both at the hedge's inception and at least quarterly on an ongoing basis) whether the derivatives that are used in hedging transactions have been effective in offsetting changes in the fair value or cash flows of hedged items and whether those derivatives may be expected to remain effective in future periods. The Bank typically uses regression analyses or other statistical analyses to assess the effectiveness of its hedges. When it is determined that a derivative has not been or is not expected to be effective as a hedge, the Bank discontinues hedge accounting prospectively.

The Bank discontinues hedge accounting prospectively when (1) it determines that the derivative is no longer effective in offsetting changes in the fair value or cash flows of a hedged item (including hedged items such as firm commitments or forecasted transactions); (2) the derivative and/or the hedged item expires or is sold, terminated, or exercised; (3) it is no longer probable that the forecasted transaction will occur in the originally expected period; (4) a hedged firm commitment no longer meets the definition of a firm commitment; or (5) management determines that designating the derivative as a hedging instrument in accordance with SFAS 133 is no longer appropriate.

When hedge accounting is discontinued because the Bank determines that the derivative no longer qualifies as an effective fair value hedge, the Bank will continue to carry the derivative on the balance sheet at its fair value, cease to adjust the hedged asset or liability for changes in fair value, and begin amortizing the cumulative basis adjustment on the hedged item into earnings over the remaining life of the hedged item using a method that approximates the level yield. When hedge accounting is discontinued because the Bank determines that the derivative no longer qualifies as an effective cash flow hedge of an existing hedged item, the Bank will continue to carry the derivative on the balance sheet at its fair value and will amortize the cumulative other comprehensive income adjustment to earnings when earnings are affected by the original forecasted transaction.

When the Bank discontinues hedge accounting because it is no longer probable that the forecasted transaction will occur in the originally expected period plus the following two months, but it is probable the transaction will still occur in the future, the gain or loss on the derivative remains in accumulated other comprehensive income and is recognized as earnings when the forecasted transaction affects earnings. However, if it is probable that a forecasted transaction will not occur by the end of the originally specified time period or within two months thereafter, the gains and losses that were accumulated in other comprehensive income are recognized immediately in earnings.

When hedge accounting is discontinued because the hedged item no longer meets the definition of a firm commitment, the Bank will continue to carry the derivative on the balance sheet at its fair value, removing from the balance sheet any asset or liability that was recorded to recognize the firm commitment and recording it as a gain or loss in current period earnings.

In all situations in which hedge accounting is discontinued and the derivative remains outstanding, the Bank will carry the derivative at its fair value on the balance sheet, recognizing changes in the fair value of the derivative in current period earnings.

Hedging Activities.
General – The Bank may enter into interest rate swaps (including callable and putable swaps), swaptions, and cap and floor agreements, (collectively, interest rate exchange agreements or derivatives).

Most of the Bank's interest rate exchange agreements are executed in conjunction with the origination of advances and the issuance of consolidated obligation bonds to create variable rate structures. The interest rate exchange agreements are generally executed at the same time as the advances and bonds are transacted and generally have the same maturity dates as the related advances and bonds.

Additional active uses of interest rate exchange agreements include: (1) offsetting interest rate caps embedded in adjustable rate advances made to members, (2) hedging the anticipated issuance of debt, (3) matching against consolidated obligation discount notes or bonds to create the equivalent of callable fixed rate debt, (4) modifying the repricing intervals between variable rate assets and variable rate liabilities, and (5) exactly offsetting other derivatives executed with members (the Bank serves as an intermediary). The Bank's use of interest rate exchange agreements results in one of the following classifications: (1) a fair value or cash flow hedge of an underlying financial instrument, (2) a forecasted transaction, (3) an economic hedge for specific asset and liability management purposes (a non-SFAS 133-qualifying economic hedge), or (4) an intermediary transaction for members.

An economic hedge is defined as an interest rate exchange agreement hedging specific or non-specific underlying assets, liabilities, or firm commitments that does not qualify for hedge accounting treatment under the rules of SFAS 133, but is an acceptable hedging strategy under the Bank's risk management program. These economic hedging strategies also comply with Finance Board regulatory requirements prohibiting speculative hedge transactions. An economic hedge by definition introduces the potential for earnings variability due to the change in fair value recorded on the interest rate exchange agreements that are not offset by corresponding changes in the value of the economically hedged assets, liabilities, or firm commitments.

Consistent with Finance Board regulation, the Bank enters into interest rate exchange agreements only to reduce the interest rate risk exposures inherent in otherwise unhedged assets and funding positions, to achieve the Bank's risk management objectives, and act as an intermediary between our members and counterparties. Bank management uses interest rate exchange agreements when they are deemed to be the most cost-effective alternative to achieve the Bank's financial and risk management objectives. Accordingly, the Bank may enter into interest rate exchange agreements that do not necessarily qualify for hedge accounting under SFAS 133 accounting rules. As a result, the Bank recognizes only the change in fair value of these interest rate exchange agreements in other income as "Net gain/(loss) on derivatives and hedging activities" with no offsetting fair value adjustments for the asset, liability, or firm commitment.

The Bank is subject to credit risk as a result of the risk of nonperformance by counterparties to the derivative agreements. All derivative agreements are subject to master netting arrangements to mitigate the credit risk exposure. The Bank manages counterparty credit risk through credit analyses and collateral requirements and by following the requirements of the Bank's risk management policies and credit guidelines and the Finance Board's Financial Management Policy. Based on the master netting arrangements, its credit analyses, and the collateral requirements in place with each counterparty, management of the Bank does not anticipate any credit losses on its agreements.

Intermediation – As an additional service to its members, the Bank enters into offsetting interest rate exchange agreements, acting as an intermediary between exactly offsetting derivatives transactions with members and other counterparties. This intermediation allows members indirect access to the derivatives market. The offsetting derivatives used in intermediary activities do not receive SFAS 133 hedge accounting treatment and are separately marked to market through earnings. The net result of the accounting for these derivatives does not significantly affect the operating results of the Bank.

Investments – The Bank may invest in U.S. agency securities, mortgage-backed securities (MBS), and the taxable portion of state or local housing finance agency securities. The interest rate and prepayment risk associated with these investment securities is managed through a combination of debt issuance and derivatives. The Bank may manage prepayment and interest rate risk by funding investment securities with consolidated obligations that have call features, or by hedging the prepayment risk with caps or floors, callable swaps, or swaptions. These investment securities may be classified as held-to-maturity or held-at-fair-value.

The Bank may also manage the risk arising from changing market prices or cash flows of investment securities classified as held-at-fair-value by entering into interest rate exchange agreements (economic hedges) that offset the changes in fair value or cash flows of the securities. The market value changes of both the held-at-fair-value securities and the associated interest rate exchange agreements are included in other income in the Statements of Income.

Advances – The Bank offers a wide array of advance structures to meet member's funding needs. These advances can have maturities out to 30 years with variable or fixed rates and may include early termination features or options such as caps or floors. Generally, whenever a member executes a fixed rate advance or a variable rate advance with embedded options, the Bank will simultaneously execute an interest rate exchange agreement with terms that offset the terms and embedded options, if any, in the advance. The combination of the advance and the interest rate exchange agreement effectively creates a simple variable rate asset.

The Bank does not offer certain advance structures that when hedged may lead to significant volatility in income or in other comprehensive income.

Mortgage Loans – The Bank invests in fixed rate mortgage loans. The prepayment options embedded in mortgage loans can result in extensions or contractions in the expected maturities of these investments, depending on changes in estimated prepayment speeds. The Bank manages the interest rate and prepayment risk associated with fixed rate 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 market value sensitivities for liabilities similar to those expected on the mortgage loans. Net income could be reduced if the Bank replaces the mortgages with lower-yielding assets and the Bank's higher funding costs are not reduced accordingly.

The Bank executes callable swaps and purchases swaptions in conjunction with the issuance of certain liabilities to create funding equivalent to fixed rate callable debt. Although these derivatives are economic hedges against the prepayment risk of specific loan pools and are referenced to individual liabilities, they do not receive either fair value or cash flow hedge accounting treatment. The derivatives are marked to market through earnings and provide modest income volatility

Consolidated Obligations – While consolidated obligations are the joint and several obligations of the FHLBanks, FHLBanks individually are counterparties to interest rate exchange agreements associated with specific debt issues.

The Bank issues consolidated obligation bonds with the structures and maturities to meet investor needs. Common structures include fixed rate bonds with or without call options and variable rate bonds with embedded options. Generally, when the Bank issues one of these bond structures, the Bank will simultaneously execute an interest rate exchange agreement with terms that offset the terms and embedded options, if any, of the consolidated obligation bond. This combination of the consolidated obligation bond and the interest rate exchange agreement effectively creates a simple variable rate bond. The cost of this funding combination is lower than what would otherwise be available through the issuance of just a variable rate bond. These transactions generally receive fair value hedge accounting treatment under SFAS 133. Despite the fair value hedge classification, there has been material accounting income volatility from the Bank's portfolio of callable bonds that has been hedged by offsetting callable interest rate swaps to effectively create variable rate bonds. (See Note 2.)

The Bank has not issued consolidated obligation discount notes or bonds denominated in currencies other than U.S dollars.

Firm Commitments – In accordance with SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (herein referred to as "SFAS 149"), which amends and clarifies financial accounting and reporting for derivative instruments and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, mortgage purchase commitments entered into after June 30, 2003, are considered derivatives. Accordingly, the commitment is recorded as a derivative asset or derivative liability at fair value, with changes in fair value recognized in current-period earnings. When the mortgage purchase commitment derivative settles, the current market value of the commitment is included with the basis of the mortgage loan and amortized accordingly.

The Bank may also hedge a firm commitment for a forward starting fixed rate advance through the use of an offsetting forward starting interest rate swap. In this case, the interest rate swap functions as the hedging instrument for both the firm commitment and the subsequent advance. When the commitment is terminated and the advance is made, the current market value associated with the firm commitment is included with the basis of the advance. The basis adjustment is then amortized into interest income over the life of the advance.

Anticipated Debt Issuance – The Bank may enter into interest rate swaps for the anticipated issuance of fixed rate bonds to lock in the cost of funding. These hedges are accounted for as cash flow hedges. The interest rate swap is terminated upon issuance of the fixed rate bond, with the realized gain or loss on the interest rate swap recorded in other comprehensive income. Realized gains and losses reported in accumulated other comprehensive income are recognized as earnings in the periods in which earnings are affected by the cash flows of the fixed rate bonds.

Premises and Equipment. The Bank records premises and equipment at cost less accumulated depreciation and amortization, which totaled approximately $8,388 and $7,343 at December 31, 2003 and 2002, respectively. Depreciation is computed on the straight-line method over the estimated useful lives of assets ranging from 3 to 10 years, and leasehold improvements are amortized on the straight-line method over the estimated useful life of the improvement or the remaining term of the lease, whichever is shorter. Improvements and major renewals are capitalized; ordinary maintenance and repairs are expensed as incurred. Depreciation and amortization expense was $2,434, $1,694, and $1,602 for the years ended December 31, 2003, 2002, and 2001, respectively. The Bank includes gains and losses on disposal of premises and equipment in other income. The net realized gain on disposal of premises and equipment, primarily related to the 1999 sale of the Bank's building, was $2,073, $2,073, and $2,057 in 2003, 2002, and 2001, respectively.

Concessions on Consolidated Obligations. The amounts paid to dealers in connection with the issuance of consolidated obligation bonds are deferred and amortized using a method approximating the level-yield method over the term of the obligations or estimated life of the bonds. The amount of the concession is allocated to the Bank by the Office of Finance based on the percentage of the debt issued for which the Bank is the primary obligor. Unamortized concessions were $38,717 and $24,457 at December 31, 2003 and 2002, respectively, and are included in "Other assets." Amortization of such concessions are included in consolidated obligation interest expense and totaled $9,786, $9,328, and $13,498 in 2003, 2002, and 2001, respectively. Concessions applicable to the issuance of consolidated obligation discount notes are generally charged to interest expense as incurred because of the short-term maturities of these notes.

Discounts and Premiums on Consolidated Obligations. The discounts on consolidated obligation discount notes are amortized to expense using a method approximating the level-yield method over the term to maturity. The discounts and premiums on consolidated obligation bonds are amortized to expense using a method approximating the level-yield method over the term to maturity of the consolidated obligation bonds or estimated life of the bonds.

Resolution Funding Corporation (REFCORP) Assessments. Although the FHLBanks are exempt from ordinary federal, state, and local taxation except real property taxes, they are required to make payments to the REFCORP. Each FHLBank is required to pay 20% of net earnings (after AHP contributions) to REFCORP. The FHLBanks will expense these amounts until the aggregate amounts actually paid by all 12 FHLBanks are equivalent to a $300 million annual annuity whose final maturity date is April 15, 2030, at which point the required payment of each FHLBank to REFCORP will be fully satisfied. The Finance Board in consultation with the Secretary of the Treasury will select the appropriate discounting factors to be used in this annuity calculation. The cumulative amount to be paid to REFCORP by the Bank is not determinable at this time because it depends on the future earnings of the Bank and the other FHLBanks. The FHLBanks' payments through 2003 defease all future benchmark payments after the third quarter of 2020 and $21,456 of the $75,000 benchmark payment for the third quarter of 2020.

Finance Board and Office of Finance Expenses. Each FHLBank is assessed a share of the cost of operating the Finance Board and the Office of Finance, which manages the issuance and servicing of consolidated obligations.

Estimated Fair Values. Many of the Bank's 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 disclosing estimated fair values. 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.

Carrying value is assumed to approximate fair value for financial instruments with three months or less to repricing or maturity. Fair values for certain financial instruments are based on quoted prices, market rates, or replacement rates for similar financial instruments as of the last business day of the year. The estimated fair values of the Bank's financial instruments and related assumptions are detailed in Note 17.

Cash Flows. For purposes of the Statements of Cash Flows, the Bank considers cash on hand and due from banks as cash and cash equivalents.

Reclassifications. Certain amounts in the 2002 and 2001 financial statements have been reclassified to conform to the 2003 presentation.

In particular, for the years ended December 31, 2002 and 2001, the Bank has reclassified realized gains and losses (net interest payments) on stand-alone derivative instruments used in economic hedges. Previously, realized gains and losses on stand-alone derivatives used in economic hedges were classified in "Net Interest Income After Mortgage Loan Loss Provision," while unrealized gains and losses on these derivatives were recorded in "Net gain/(loss) on derivatives and hedging activities" in other income. These amounts have been reclassified and are now both included in "Net gain/(loss) on derivatives and hedging activities" for the years ended December 31, 2002 and 2001. As a result of this reclassification, "Net Interest Income After Mortgage Loan Loss Provision" changed from $495,790 to $515,348 and from $554,307 to $563,432 for the years ended December 31, 2002 and 2001, respectively. In addition, "Net gain/(loss) on derivatives and hedging activities" changed from ($63,582) to ($83,029) and from $63,951 to $54,986 for the years ended December 31, 2002 and 2001, respectively.

NOTE 2 – CHANGE IN ACCOUNTING PRINCIPLE AND RECENTLY ISSUED ACCOUNTING STANDARDS AND INTERPRETATIONS

Adoption of SFAS 145. The Bank adopted SFAS No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections* (herein referred to as "SFAS 145") on June 30, 2002. SFAS 145 rescinds both SFAS 4, *Reporting Gains and Losses from the Extinguishment of Debt*, and the amendment to SFAS 4, SFAS 64, *Extinguishment of Debt Made to Satisfy Sinking-Fund Requirements*, and eliminates the requirement that gains and losses from the extinguishment of debt (except for those considered unusual or infrequent in nature) be aggregated and, if material, classified as an extraordinary item, net of the related income tax effect. In accordance with the transition provisions of SFAS 145, previously reported gains and losses on early retirement of debt have been reclassified into other income under "Other, net." The amounts reclassified were not material.

Adoption of SFAS 149. FASB issued SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (herein referred to as "SFAS 149"), which amends and clarifies financial accounting and reporting for derivative instruments and for hedging activities under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities.* In most cases, SFAS 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003, and, in most cases, all provisions of SFAS 149 should be applied prospectively. The Bank adopted SFAS 149 as of the effective date. Included in "Net gain/(loss) on derivatives and hedging activities" is $29,950 in net gains from the adoption of SFAS 149 for the year ended December 31, 2003.

Adoption of SFAS 150. FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (herein referred to as "SFAS 150") in May 2003. The Bank will adopt SFAS 150 as of January 1, 2005, and is currently in the process of assessing the impact of SFAS 150 on the financial statements.

Adoption of SFAS 132 (revised 2003). FASB issued SFAS No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits* (herein referred to as "SFAS 132 (revised 2003)") in December 2003. The Bank will adopt SFAS 132 (revised 2003) for the year ending December 31, 2004, and is currently in the process of assessing the impact, if any, of SFAS 132 (revised 2003) on its related disclosures.

Adoption of FIN 45. FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an interpretation of FASB Statements No. 5, 57, and 107 and Recission of FASB Interpretation No. 34* (herein referred to as "FIN 45") on November 25, 2002. FIN 45 expands existing disclosure requirements at December 31, 2002, for guarantees and provides initial recognition and measurement provisions to be applied on a prospective basis for guarantees issued or modified after December 31, 2002. The initial recognition and measurement provisions apply to the Bank's letters of credit. The resulting amounts recognized in other liabilities in 2003 were not material. For more information, see Note 19.

Adoption of SFAS 133. The Bank adopted SFAS 133 on January 1, 2001. SFAS 133 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 reported in other comprehensive income are recognized as earnings in the periods in which earnings are affected by the variability of the cash flows of the hedged item. The ineffective portion of all hedges is recognized in current period earnings. Changes in the fair value of a non-SFAS hedge of an asset or liability (economic hedge) for asset/liability management are recorded each period in current earnings.

In accordance with the transition provisions of SFAS 133, the Bank reported the transition adjustment for each derivative designated as a fair value hedge as a cumulative effect adjustment of net income. Concurrently, any fair value gain or loss on the hedged item 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. The transition provisions also provided that at the date of initial implementation, an entity was permitted to transfer any security classified as "held-to-maturity" to "trading" ("held-at-fair-value" securities).

In accordance with the transition provisions of SFAS 133, the Bank recorded the following cumulative effect adjustments to increase or (decrease) earnings as of January 1, 2001:

Net adjustments related to (1) fair value hedges, (2) derivative transactions not designated as hedges under SFAS 133, and (3) derivative transactions not meeting the requirements for fair value or cash flow hedges	$(9,587)
Unrealized net gains on investments transferred from "held-to-maturity" to "held-at-fair-value"	7,134
Total cumulative effect on earnings of adopting SFAS 133	$(2,453)

The Bank also recorded cumulative effect adjustments to increase or (decrease) other comprehensive income as of January 1, 2001, and recorded changes in other comprehensive income for the years ended December 31, 2003, 2002, and 2001, as follows:

Total cumulative effect of adopting SFAS 133 on accumulated other comprehensive income at January 1, 2001, resulting from previously deferred hedging losses	$(17,065)
Net amounts recognized as earnings for the year ended December 31, 2001	12,217
Net change associated with hedging activities for the year ended December 31, 2001	102
Total cumulative effect of adopting SFAS 133 on other comprehensive income at January 1, 2001, less net change during the year ended December 31, 2001, related to hedging activities	(4,746)
Net amounts recognized as earnings for the year ended December 31, 2002	4,189
Net change associated with hedging activities for the year ended December 31, 2002	(1,711)
Accumulated comprehensive income related to hedging activities at December 31, 2002	(2,268)
Net amounts reclassified to earnings for the year ended December 31, 2003	(1,526)
Net change associated with hedging activities for the year ended December 31, 2003	(8,272)
Accumulated comprehensive income related to hedging activities at December 31, 2003	$(12,066)

On January 1, 2001, the Bank transferred held-to-maturity securities with an amortized cost of $664,274 and an estimated fair value of $671,408 into the held-at-fair-value securities category. The unrealized net gain related to the transfer of these held-to-maturity securities into the held-at-fair-value securities category was $7,134 and was shown as an increase to the Bank's results of operations in 2001 as a cumulative effect of adopting SFAS 133. The remaining cumulative effect of adjustments related to fair value hedges and derivative transactions either not designated as hedges under SFAS 133 or not meeting the requirements for fair value or cash flow hedges was shown as a charge to the Bank's results of operations in 2001 as part of the cumulative effect of adopting SFAS 133, decreasing net income by $9,587. These factors combined resulted in a net SFAS 133 transaction loss on January 1, 2001, totaling $2,453. In addition, the Bank recognized a loss of $17,065 in accumulated other comprehensive income as part of the cumulative effect of adopting SFAS 133 at transition, decreasing capital.

As a result of SFAS 133, for the years ended December 31, 2003, 2002, and 2001, the Bank recorded net gains/(losses) on derivatives and hedging activities of $65,303, ($83,029), and $54,986, respectively, in other income. Net (losses)/gains on derivatives and hedging activities for the years ended December 31, 2003, 2002, and 2001, were as follows:

	2003	2002	2001
Gains/(losses) related to fair value hedge ineffectiveness	$ 64,248	$(47,797)	$ 70,400
Gains on firm commitments	29,950	—	—
Losses on economic hedges	(31,501)	(35,987)	(15,414)
Gains related to cash flow hedge ineffectiveness	2,606	755	—
Net gains/(losses) on derivatives and hedging activities	$ 65,303	$(83,029)	$ 54,986

For the years ended December 31, 2003, 2002, and 2001, $778, $540, and $0, respectively, were reclassified into earnings as a result of the discontinuance of cash flow hedges because it became probable that the original forecasted transactions would not occur by the end of the originally specified time period or within a two-month period thereafter. As of December 31, 2003, the deferred net gains/(losses) on derivative instruments accumulated in other comprehensive income expected to be reclassified to earnings during the next 12 months were not material. The maximum length of time over which the Bank is hedging its exposure to the variability in future cash flows for forecasted transactions, excluding those forecasted transactions related to the payment of variable interest on existing financial instruments, is less than three months.

NOTE 3 – CASH AND DUE FROM BANKS

Compensating Balances. The Bank maintains average collected cash balances with commercial banks in consideration for certain services. There are no legal restrictions under these agreements as to the withdrawal of these funds. The average compensating balances for the years ended December 31, 2003 and 2002, were approximately $1,040 and $1,920, respectively.

In addition, the Bank maintained average collected balances with the Federal Reserve Bank of San Francisco as required clearing balances and to facilitate the movement of funds to support the Bank's activities. There are regulations governing the withdrawal of these funds; however, earnings credits on these balances may be used to pay for services received. The average balances for this account for the years ended December 31, 2003 and 2002, were approximately $1,143 and $1,848, respectively.

NOTE 4 – SECURITIES PURCHASED UNDER AGREEMENTS TO RESELL

Securities purchased under agreements to resell (resale agreements) were as follows:

	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
December 31, 2003	$5,100,000	$ —	$ —	$5,100,000
December 31, 2002	$4,400,000	$ —	$ —	$4,400,000

Redemption Terms. The amortized cost and estimated fair value of resale agreements by contractual maturity as of December 31, 2003 and 2002, are shown below.

	2003		2002	
YEAR OF MATURITY	AMORTIZED COST	ESTIMATED FAIR VALUE	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	$5,100,000	$5,100,000	$4,400,000	$4,400,000

The Bank engages in resale agreements with securities dealers, all of which are "primary dealers" as designated by the Federal Reserve Bank of New York. The amounts advanced under these agreements represent short-term loans and are reflected as assets in the Statements of Condition. The collateral from resale agreements, all of which is highly rated, is held by the Bank's safekeeping custodian. If the market value of the underlying securities decreases below the market value required as collateral, the counterparty is required to place additional securities in safekeeping in the name of the Bank. The Bank had rights to securities collateral with an estimated value in excess of the resale agreements outstanding at December 31, 2003 and 2002.

Resale agreements averaged $2,605,623 and $2,731,781 during 2003 and 2002, respectively. The maximum amounts outstanding at any monthend during 2003 and 2002 were $5,100,000 and $4,550,000, respectively.

Interest Rate Payment Terms. The amortized cost of resale agreements, all with fixed rate interest payment terms, were $5,100,000 and $4,400,000 with average yields of 1.05% and 1.33% at December 31, 2003 and 2002, respectively.

NOTE 5 – HELD-TO-MATURITY SECURITIES

Security Types. Held-to-maturity securities were as follows:

DECEMBER 31, 2003	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Commercial paper	$ 1,042,493	$ —	$ —	$ 1,042,493
Housing finance agency bonds	1,327,995	6,111	(647)	1,333,459
Subtotal	2,370,488	6,111	(647)	2,375,952
MBS:				
U.S. government agency-guaranteed	1,179,612	22,305	(7,902)	1,194,015
Non-agency	14,713,215	49,808	(67,359)	14,695,664
Total MBS	15,892,827	72,113	(75,261)	15,889,679
Total	$18,263,315	$78,224	$(75,908)	$18,265,631

DECEMBER 31, 2002	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Commercial paper	$ 1,297,450	$ —	$ —	$ 1,297,450
Housing finance agency bonds	1,113,490	2,380	(4,059)	1,111,811
Subtotal	2,410,940	2,380	(4,059)	2,409,261
MBS:				
U.S. government agency-guaranteed	1,673,436	45,132	(4,845)	1,713,723
Non-agency	13,794,468	159,933	(20,464)	13,933,937
Total MBS	15,467,904	205,065	(25,309)	15,647,660
Total	$17,878,844	$207,445	$(29,368)	$18,056,921

DECEMBER 31, 2001	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE
Commercial paper	$ 2,465,646	$ —	$ —	$ 2,465,646
Housing finance agency bonds	837,080	—	(1,219)	835,861
Subtotal	3,302,726	—	(1,219)	3,301,507
MBS:				
U.S. government agency-guaranteed	3,003,086	35,552	(1,273)	3,037,365
Non-agency	10,238,077	119,124	—	10,357,201
Total MBS	13,241,163	154,676	(1,273)	13,394,566
Total	$16,543,889	$154,676	$(2,492)	$16,696,073

Redemption Terms. The amortized cost and estimated fair value of certain securities by contractual maturity and MBS as of December 31, 2003, 2002, and 2001, are shown below. Expected maturities of certain securities and MBS will differ from contractual maturities because borrowers generally have the right to prepay obligations without prepayment fees.

DECEMBER 31, 2003

YEAR OF MATURITY	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	$ 1,042,493	$ 1,042,493
Housing finance agency bonds (all due after ten years)	1,327,995	1,333,459
Subtotal	2,370,488	2,375,952
MBS:		
U.S. government agency-guaranteed	1,179,612	1,194,015
Non-agency	14,713,215	14,695,664
Total MBS	15,892,827	15,889,679
Total	$18,263,315	$18,265,631

DECEMBER 31, 2002

YEAR OF MATURITY	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	$ 1,297,450	$ 1,297,450
Housing finance agency bonds (all due after ten years)	1,113,490	1,111,811
Subtotal	2,410,940	2,409,261
MBS:		
U.S. government agency-guaranteed	1,673,436	1,713,723
Non-agency	13,794,468	13,933,937
Total MBS	15,467,904	15,647,660
Total	$17,878,844	$18,056,921

DECEMBER 31, 2001

YEAR OF MATURITY	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	$ 2,465,646	$ 2,465,646
Housing finance agency bonds (all due after ten years)	837,080	835,861
Subtotal	3,302,726	3,301,507
MBS:		
U.S. government agency-guaranteed	3,003,086	3,037,365
Non-agency	10,238,077	10,357,201
Total MBS	13,241,163	13,394,566
Total	$16,543,889	$16,696,073

The average yields on held-to-maturity securities due in one year or less were 1.09%, 1.40%, and 2.09%, on those due after 10 years were 1.37%, 1.95%, and 2.64%, on U.S. government agency-guaranteed MBS were 4.16%, 4.63%, and 5.33%, and on non-agency issued MBS were 3.45%, 4.60%, and 5.52% for the years ended December 31, 2003, 2002, and 2001, respectively. The amortized cost of the Bank's MBS classified as held-to-maturity included net premiums of $75,456, net premiums of $30,578, and net discounts of $20,211 at December 31, 2003, 2002, and 2001, respectively.

Interest Rate Payment Terms. Interest rate payment terms for held-to-maturity securities at December 31, 2003, 2002, and 2001, are detailed in the following table:

	2003	2002	2001
Amortized cost of held-to-maturity securities other than mortgage-backed securities:			
Fixed rate	$ 1,042,493	$ 1,297,450	$ 2,465,646
Adjustable rate	1,327,995	1,113,490	837,080
Subtotal	2,370,488	2,410,940	3,302,726
Amortized cost of held-to-maturity MBS:			
Passthrough securities:			
Fixed rate	648,545	618,777	984,694
Adjustable rate	274,570	381,733	522,636
Collateralized mortgage obligations:			
Fixed rate	10,498,801	10,196,231	8,505,740
Adjustable rate	4,470,911	4,271,163	3,228,093
Subtotal	15,892,827	15,467,904	13,241,163
Total	$18,263,315	$17,878,844	$16,543,889

The following table summarizes the held-to-maturity securities with unrealized losses as of December 31, 2003. The unrealized losses are aggregated by major security type and length of time that individual securities have been in a continuous unrealized loss position.

	LESS THAN 12 MONTHS		12 MONTHS OR MORE	
	FAIR VALUE	UNREALIZED LOSSES	FAIR VALUE	UNREALIZED LOSSES
Housing finance agency bonds	$1,327,995	$ 647	$ —	$ —
MBS:				
U.S. government agency-guaranteed	400,397	5,627	253,228	2,275
Non-agency	7,427,844	65,605	448,056	1,754
Total MBS	7,828,241	71,232	701,284	4,029
Total	$9,156,236	$71,879	$701,284	$4,029

Based on the credit quality of the issuers and the underlying collateral, management fully expects to receive all scheduled payments of principal and interest in a timely manner. As a result, management does not consider these investments to be impaired.

NOTE 6 – HELD-AT-FAIR-VALUE SECURITIES

	2003	2002	2001
Housing finance agency bonds	$493,283	$ —	$ —
MBS: U.S. government agency-guaranteed	424,039	533,090	527,870
Total	$917,322	$533,090	$527,870

Net (losses)/gains on held-at-fair-value securities during the years ended December 31, 2003, 2002, and 2001, were $(15,403), $22,745, and $7,653, respectively. These amounts represent the changes in the fair value of the securities during the reported periods. The average yields on held-at-fair-value securities were 3.36%, 6.24%, and 6.64% for the years ended December 31, 2003, 2002, and 2001, respectively.

NOTE 7 – ADVANCES

Redemption Terms. At December 31, 2003 and 2002, the Bank had advances outstanding, including AHP advances (see Note 8), at interest rates ranging from 0.75% to 8.75% and 1.01% to 8.75%, respectively, as summarized below. AHP advances had interest rates ranging from 3.30% to 7.00% in 2003 and 2002.

DECEMBER 31, 2003 YEAR OF MATURITY	AMOUNT OUTSTANDING	WEIGHTED AVERAGE INTEREST RATE
Overdrawn demand deposit accounts	$ 1,838	2.94%
2004	53,198,845	1.43
2005	12,369,925	1.88
2006	15,873,964	1.63
2007	3,944,671	2.51
2008	4,552,934	3.16
Thereafter	2,010,038	5.26
Subtotal	91,952,215	1.74%
Discount on AHP advances	(225)	
SFAS 133 valuation adjustments	367,036	
Deferred net loss on terminated interest rate exchange agreements	10,595	
Total	$92,329,621	

DECEMBER 31, 2002 YEAR OF MATURITY	AMOUNT OUTSTANDING	WEIGHTED AVERAGE INTEREST RATE
Overdrawn demand deposit accounts	$ 765	3.16%
2003	49,645,412	2.49
2004	16,749,023	3.10
2005	7,945,379	2.40
2006	1,748,357	3.94
2007	1,005,284	4.38
2008	1,482,748	5.15
Thereafter	1,675,795	5.55
Subtotal	80,252,763	2.77%
Discount on AHP advances	(321)	
SFAS 133 valuation adjustments	983,956	
Deferred net loss on terminated interest rate exchange agreements	643	
Total	$81,237,041	

Many of the Bank's advances are prepayable at the member's option. However, when advances are prepaid, the member is generally charged a prepayment fee that makes the Bank financially indifferent to the prepayment. Some advances may be repaid on pertinent call dates without incurring prepayment fees (callable advances). At December 31, 2003 and 2002, the Bank had callable advances outstanding totaling $473,733 and $1,524,057, respectively.

The following table summarizes advances at December 31, 2003 and 2002, by the earlier of the year of contractual maturity or next call date for callable advances:

EARLIER OF YEAR OF CONTRACTUAL MATURITY OR NEXT CALL DATE	2003	2002
Overdrawn demand deposit accounts	$ 1,838	$ 765
2003	—	49,735,412
2004	53,530,845	16,777,023
2005	12,293,625	7,870,379
2006	15,721,964	1,723,357
2007	3,972,671	987,284
2008	4,541,267	1,482,748
Thereafter	1,890,005	1,675,795
Total par value	$91,952,215	$80,252,763

The Bank also provides below-market fixed rate advances in exchange for the right of the Bank to retain a put option. At the Bank's discretion, on pertinent put dates, the Bank may terminate the advance (Putable Advance/Termination Option) or convert the advance to an Adjustable Rate Credit advance of predetermined index and spread for the remaining term to maturity (Putable Advance/Conversion Option). The Bank's advances at December 31, 2003 and 2002, included $1,754,700 and $1,991,700, respectively, of Putable Advances/Termination Option. There were no Putable Advances/Conversion Option outstanding as of December 31, 2003 and 2002.

The following table summarizes advances to members at December 31, 2003 and 2002, by the earlier of the year of contractual maturity or next put date for putable advances:

EARLIER OF YEAR OF CONTRACTUAL MATURITY OR NEXT PUT DATE	2003	2002
Overdrawn demand deposit accounts	$ 1,838	$ 765
2003	—	51,150,812
2004	54,667,745	16,718,523
2005	12,349,925	7,802,379
2006	15,804,364	1,640,757
2007	3,900,671	961,284
2008	3,712,934	787,748
Thereafter	1,514,738	1,190,495
Total par value	$91,952,215	$80,252,763

Security Terms. The Bank lends to member financial institutions involved in housing finance that have a principal place of business in Arizona, California, or Nevada. The Bank is required by the FHLB Act to obtain sufficient collateral for advances to protect against losses and to accept only certain U.S. government or government agency securities, residential mortgage loans or MBS, cash or deposits in the Bank, and other eligible real estate-related assets as collateral for advances. The Bank may also accept secured small business, small farm, and small agribusiness loans as collateral from members that are CFIs.

The Bank requires each borrowing member to execute a written Advances and Security Agreement, which describes the Bank's credit and collateral terms. The capital stock of the Bank owned by each borrowing member is pledged as additional collateral for the member's indebtedness to the Bank. As more fully discussed in Note 13, until the Bank implements its new capital plan, the FHLB Act requires that aggregate advances from the Bank to a member may not exceed 20 times the amount paid by the member for capital stock of the Bank. At December 31, 2003 and 2002, the Bank had a perfected security interest in collateral pledged by each borrowing member with an estimated value in excess of outstanding advances for that member. Based on the financial condition of the borrowing member, the Bank may either (i) allow the member to physically retain mortgage collateral assigned to the Bank, provided that the member agrees to hold the collateral for the benefit of the Bank, or (ii) require the member to deliver physical possession of the mortgage collateral to the Bank or its

safekeeping agent. All securities collateral is delivered to the Bank's safekeeping agent. All loan collateral pledged by the member is also subject to a UCC-1 filing statement.

Beyond these provisions, Section 10(e) of the FHLB Act affords any security interest granted by a member to the Bank priority over claims or rights of any other party, except claims or rights that (i) would be entitled to priority under otherwise applicable law and (ii) are held by bona fide purchasers for value or secured parties with perfected security interests.

Credit Risk. The Bank's potential credit risk from advances is concentrated in savings institutions. As of December 31, 2003, the Bank had a concentration of advances totaling $61,978,282 outstanding to three members, representing 67% of total outstanding advances (35%, 17%, and 15%, respectively). The interest income from advances to these members amounted to approximately $1,100,124 during 2003. The Bank held collateral with an estimated value in excess of advances to these institutions, and the Bank does not expect to incur any credit losses on these advances.

The Bank has never experienced any credit losses on advances to a member. Management has policies and procedures in place to manage the credit risk of advances. Based on the collateral held as security for advances, management's credit analyses, and prior repayment history, no allowance for losses on advances is deemed necessary by management.

Interest Rate Payment Terms. Interest rate payment terms for advances at December 31, 2003 and 2002, are detailed below:

	2003	2002
Par amount of advances:		
Fixed rate	$51,547,101	$45,081,308
Adjustable rate	40,405,114	35,171,455
Total	$91,952,215	$80,252,763

Prepayment Fees, Net. During 2003, 2002, and 2001, the Bank charged its members prepayment fees when the principal on certain advances was paid prior to original maturity. In addition, some of these advances were associated with interest rate exchange agreements. Upon termination of these advances, prior to January 1, 2001, the associated interest rate exchange agreements were either marked to market and redesignated as hedges of other advances or terminated, and the resulting gains or losses were netted with the prepayment fees on the Statements of Income. Starting January 1, 2001, the resulting gains or losses were recognized in accordance with SFAS 133 (see Note 2). These transactions during the years ended December 31, 2003, 2002, and 2001, are summarized in the following table:

	2003	2002	2001
Prepayment fees received	$ 15,486	$ 9,032	$ 5,953
Advance principal prepaid	$3,649,894	$7,491,982	$1,859,685

NOTE 8 – AFFORDABLE HOUSING PROGRAM

Section 10(j) of the FHLB Act requires each FHLBank to establish an AHP. Each FHLBank provides subsidies in the form of direct grants and below-market interest rate advances to members, which use the funds to assist in the purchase, construction, or rehabilitation of housing for very low-, low-, and moderate-income households. Annually, the FHLBanks must set aside for their AHPs, in the aggregate, the greater of $100 million or 10% of the current year's income before charges for the AHP but after the assessment for REFCORP (see Note 1). 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 income before AHP and REFCORP to the sum of the net incomes before AHP and REFCORP of the 12 FHLBanks. There was no AHP shortfall in 2003, 2002, or 2001. The Bank set aside $35,892, $32,464, and $47,177 during 2003, 2002, and 2001, respectively, for the AHP. These amounts were charged to earnings each year and recognized as a liability. As subsidies are disbursed, the AHP liability is reduced. All subsidies were distributed in the form of direct grants in 2003, 2002, and 2001. The Bank had $11,705 and $12,873 in outstanding AHP advances at December 31, 2003 and 2002, respectively.

NOTE 9 – MORTGAGE LOANS

Under the MPF Program, the Bank purchases qualifying mortgage loans from its participating members. The mortgage loans represent held-for-investment loans under the MPF Program, under which the Bank's members originate, service, and credit-enhance home mortgage loans that are owned by the Bank. The following table presents information as of December 31, 2003 and 2002, on mortgage loans, all of which are conventional, conforming fixed rate loans on single-family properties:

	2003	2002
Fixed rate medium-term mortgage loans	$2,297,236	$180,064
Fixed rate long-term mortgage loans	4,196,294	77,640
Unamortized net (discounts)/premiums	(48,338)	4,902
Total mortgage loans	$6,445,192	$262,606

Medium-term loans have contractual terms of 15 years or less, and long-term loans have contractual terms of more than 15 years.

The allowance for credit losses on these loans was as follows:

	2003	2002
Balance, beginning of the period	$ 180	$ —
Chargeoffs	—	—
Recoveries	—	—
(Reduction of)/provision for credit losses	(180)	180
Balance, end of the period	$ —	$180

Mortgage loans are considered impaired when a loan is reported 90 days or more past due or, based on current information and events, it is probable that the Bank will be unable to collect all principal and interest amounts due according to the contractual terms of the mortgage loan agreements. At

December 31, 2003 and 2002, the Bank did not have any loans classified as nonaccrual or impaired, and no allowance for credit losses on mortgage loans was deemed necessary by management as of December 31, 2003.

NOTE 10 – DEPOSITS

The Bank maintains demand deposit accounts that are directly related to the extension of credit to members and offers short-term deposit programs to members and qualifying non-members.

Interest Rate Payment Terms. Interest rate payment terms for deposits at December 31, 2003 and 2002, are detailed in the following table:

	2003	2002
Deposits:		
Fixed rate	$ 65,450	$ 34,510
Adjustable rate	922,215	372,129
Total	$987,665	$406,639

NOTE 11 – BORROWINGS

At times the Bank enters into sales of securities under agreements to repurchase (repurchase agreements) with securities dealers, all of which are "primary dealers" as designated by the Federal Reserve Bank of New York. The amounts received under these agreements represent short-term borrowings and are reflected as liabilities in the Statements of Condition. The securities sold under agreements to repurchase are delivered to the purchasing primary dealers or their custodians. Should the market value of the underlying securities decrease below the market value required by the repurchase agreements, the Bank is required to deliver additional securities to the dealers. There were no repurchase agreements outstanding during 2003 or 2002.

The Bank had other borrowings due to commercial banks at December 31, 2002, of $525,000, bearing interest at the overnight Federal funds rate, and none were outstanding as of December 31, 2003.

NOTE 12 – CONSOLIDATED OBLIGATIONS

As more fully discussed in Note 19, consolidated obligations are the joint and several obligations of the FHLBanks and consist of consolidated obligation bonds and discount notes. Consolidated obligations are jointly issued by the FHLBanks through the Office of Finance, which serves as their agent. Consolidated obligation bonds are issued primarily to raise intermediate- and long-term funds for the FHLBanks. Usually the maturity of consolidated obligation bonds ranges from one year to fifteen years, but the maturity is not subject to any statutory or regulatory limits. Consolidated obligation discount notes are primarily used to raise short-term funds. These notes are issued at less than their face amount and redeemed at par when they mature.

The par amount of the outstanding consolidated obligations of all 12 FHLBanks, including consolidated obligations issued by other FHLBanks, was approximately $759,509,748 and $680,695,058 at December 31, 2003 and 2002, respectively. Regulations require the FHLBanks to maintain, for the benefit of investors in consolidated obligations, in the aggregate, unpledged qualifying assets in an amount equal to the consolidated obligations outstanding. Qualifying assets are defined as cash; secured advances; assets with an assessment or credit rating at least equivalent to the current assessment or credit rating of the consolidated obligations; obligations, participations, mortgages, or other securities of or issued by the United States or an agency of the United States; and such securities as fiduciary and trust funds may invest in under the laws of the state in which the FHLBank is located.

As more fully discussed in Note 13, until the Bank implements its capital plan, each FHLBank's assets are generally limited to no more than 21 times its capital unless an FHLBank has non-mortgage assets, after deducting deposits and capital, that do not exceed 11% of its assets. In that case, an FHLBank's total assets cannot exceed 25 times its capital. At December 31, 2003 and 2002, the Bank's total assets to capital and non-mortgage assets to total assets ratios were 22.6x and 6.52% and 20.4x and 9.8%, respectively.

To provide the holders of consolidated obligations issued prior to January 29, 1993 (prior bondholders), protection equivalent to that provided under the FHLBanks' previous leverage limit of 12 times the FHLBanks' aggregate capital stock, prior bondholders have a claim on a certain amount of the qualifying assets (Special Asset Account or SAA) if the FHLBanks' aggregate capital stock is less than 8.33% of consolidated obligations outstanding. At December 31, 2003 and 2002, the FHLBanks' capital stock was 5.0% and 5.2% of the par value of consolidated obligations outstanding, and the minimum SAA balance was approximately $23,989 and $24,004, respectively. The Bank's share of this SAA balance was approximately $3,370 and $3,975 at December 31, 2003 and 2002, respectively. In addition, each FHLBank is required to transfer qualifying assets in the amount of its allocated share of the FHLBanks' SAA to a trust for the benefit of the prior bondholders if its individual capital-to-assets ratio falls below 2.0%.

General Terms. Consolidated obligations are generally issued with either fixed rate payment terms or adjustable rate payment terms, which use a variety of indices for interest rate resets, including the London Interbank Offered Rate (LIBOR), Federal funds, U.S. Treasury Bill, Constant Maturity Treasury (CMT), Prime Rate, and others. In addition, to meet the specific needs of certain investors, fixed rate and adjustable rate consolidated obligation bonds may also contain certain embedded features, which may result in call options and complex coupon payment terms. Generally, when such consolidated obligations bonds are issued, the Bank simultaneously enters into interest rate exchange agreements containing offsetting features to convert the terms of the bond, in effect, to the terms of a simple adjustable rate bond (tied to an index, such as those detailed above).

Consolidated obligations, in addition to having fixed rate or simple adjustable rate coupon payment terms, may also include "callable bonds," which the Bank may redeem in whole or in part at its discretion on predetermined call dates according to the terms of the bond offerings; "step-up callable bonds," which generally pay interest at increasing fixed rates for specified intervals over the life of the bond and can be called at the Bank's option on the step-up dates; "conversion bonds," which have coupon rates that convert from fixed to adjustable or from adjustable to fixed; "comparative index bonds," which have coupon rates that are determined by the difference between two or more market indices; "zero-coupon callable bonds," which are long-term discounted instruments that earn a fixed yield to maturity or to the optional principal redemption date, and for which all principal and interest are paid at maturity or at the optional principal redemption date, if exercised prior to maturity; "inverse floating bonds," which have coupons that increase as an index declines and decrease as an index rises; and "index amortizing notes," which repay principal according to predetermined amortization schedules that are linked to the level of a certain index. As of December 31, 2003, the Bank's index amortizing notes had fixed rate coupon payment terms. Usually, as market interest rates fall, the maturity of the index amortizing notes contracts.

Redemption Terms. The following is a summary of the Bank's participation in consolidated obligation bonds:

DECEMBER 31, 2003 YEAR OF MATURITY	AMOUNT OUTSTANDING	WEIGHTED AVERAGE INTEREST RATE
2004	$26,177,410	2.70%
2005	23,716,380	1.91
2006	14,515,500	2.91
2007	6,692,250	3.43
2008	10,194,210	3.37
Thereafter	11,281,775	4.57
Index amortizing notes	15,000	4.61
Total par value	92,592,525	2.88%
Bond premiums	74,270	
Bond discounts	(144,030)	
SFAS 133 valuation adjustments	228,585	
Total	$92,751,350	

DECEMBER 31, 2002 YEAR OF MATURITY	AMOUNT OUTSTANDING	WEIGHTED AVERAGE INTEREST RATE
2003	$50,179,130	2.51%
2004	18,295,000	3.76
2005	9,493,400	3.79
2006	6,147,500	4.58
2007	5,050,750	4.08
2008	1,433,000	4.99
Thereafter	4,050,030	5.39
Index amortizing notes	76,805	5.05
Total par value	94,725,615	3.26%
Bond premiums	66,732	
Bond discounts	(71,976)	
SFAS 133 valuation adjustments	1,101,426	
Total	$95,821,797	

The Bank's participation in consolidated obligation bonds outstanding at December 31, 2003 and 2002, includes callable bonds of $35,370,560 and $36,271,005, respectively. Contemporaneous with such callable bond issuance, the Bank usually enters into an interest rate swap (in which the Bank pays a variable rate and receives a fixed rate) with a call feature that mirrors the option embedded in the bond (a sold callable swap). The combined sold callable swap and callable bond enable the Bank to meet its funding needs at costs not otherwise directly attainable solely through the issuance of non-callable debt, while converting the Bank's own payment to an adjustable rate. The Bank also uses fixed rate callable bonds to finance fixed rate callable advances (see Note 7), fixed rate MBS, and fixed rate mortgage loans.

The Bank's participation in consolidated obligation bonds was as follows:

	2003	2002
Par amount of consolidated obligation bonds:		
Non-callable	$57,221,965	$58,454,610
Callable	35,370,560	36,271,005
Total par value	$92,592,525	$94,725,615

The following is a summary of the Bank's participation in consolidated obligation bonds outstanding at December 31, 2003 and 2002, by the earlier of the year of contractual maturity or next call date:

EARLIER OF YEAR OF CONTRACTUAL MATURITY OR NEXT CALL DATE	2003	2002
2003	$ —	$70,761,135
2004	56,716,570	15,662,700
2005	21,094,380	4,806,400
2006	8,412,500	2,105,500
2007	922,750	424,750
2008	4,030,000	493,000
Thereafter	1,401,325	395,325
Index amortizing notes	15,000	76,805
Total	$92,592,525	$94,725,615

Interest Rate Payment Terms. Interest rate payment terms for consolidated obligations at December 31, 2003 and 2002, are detailed in the following table:

	2003	2002
Par amount of consolidated obligations:		
Bonds:		
Fixed rate	$ 61,576,315	$ 66,205,205
Adjustable rate	23,429,000	23,766,000
Step-up	5,044,260	3,227,000
Fixed rate that converts to adjustable rate	324,750	261,900
Adjustable rate that converts to fixed rate	862,000	580,000
Comparative index	807,700	478,705
Zero-coupon	175,000	105,000
Inverse floaters	358,500	25,000
Index amortizing notes	15,000	76,805
Total bonds, par	92,592,525	94,725,615
Discount notes, par	31,931,984	12,483,980
Total consolidated obligations, par	$124,524,509	$107,209,595

The Bank's participation in consolidated obligation discount notes, all of which are due within one year, were as follows:

	2003		2002	
	AMOUNT OUTSTANDING	WEIGHTED AVERAGE INTEREST RATE	AMOUNT OUTSTANDING	WEIGHTED AVERAGE INTEREST RATE
Par value	$31,931,984	1.05%	$12,483,980	1.53%
Discounts	(49,615)		(38,034)	
SFAS 133 valuation adjustments	(166)		870	
Total	$31,882,203		$12,446,816	

Section 11(i) of the FHLB Act authorizes the Secretary of the Treasury, at his discretion, to purchase certain obligations issued by the FHLBanks aggregating not more than $4.0 billion; terms, conditions, and interest rates are to be determined by the Secretary of the Treasury. There were no such purchases by the U.S. Treasury during the two-year period ended December 31, 2003.

NOTE 13 – CAPITAL

Capital Requirements. The Gramm-Leach-Bliley Act (GLB Act) required a number of changes in the capital structure of the FHLBanks. On January 30, 2001, the Finance Board published a final capital rule requiring 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 Bank's Board of Directors approved amendments to the capital plan on May 30, 2003, and the Finance Board approved the amendments on August 6, 2003.

The Bank is scheduled to implement the capital plan on April 1, 2004. To implement the capital plan, the Bank will exchange its current capital stock for new Class B stock. Under the capital plan, the Bank will issue only Class B stock, with a par value of $100 per share, which may be redeemed (subject to certain conditions) upon five years' notice. The stock may be issued, exchanged, redeemed, and repurchased only at its stated par value. The Bank may only redeem or repurchase capital stock from a member if, following the repurchase or redemption, the member will continue to meet its minimum stock requirement and the Bank will continue to meet its regulatory requirements for total capital, leverage capital, and risk-based capital.

Members that opted not to participate in the capital plan implementation were required to provide written notice of intention to withdraw from membership on or before January 1, 2004. The Bank received opt-out notices from four members, which had capital stock with a total par value of $15,587 at December 31, 2003. All other members will participate in the exchange, and outstanding shares of existing capital stock will automatically be exchanged for Class B stock redeemable only upon five years' notice to the Bank.

Once the Bank's capital plan is implemented, the Bank will be subject to risk-based capital requirements, which must be met with permanent capital (defined as retained earnings and Class B stock). In addition, the Bank will be subject to a 5% minimum leverage capital ratio with a 1.5 weighting factor for permanent capital, and a 4% minimum total capital ratio calculated without reference to the 1.5 weighting factor. The FHLB Act and Finance Board regulations require that the minimum stock requirement for members must be sufficient to enable the Bank to meet its regulatory requirements for total capital, leverage capital, and risk-based capital.

In general, the capital plan requires each member to own stock in an amount equal to the greater of its membership stock requirement or its activity-based stock requirement. The Bank may adjust these requirements from time to time within limits established in the capital plan.

A member's initial membership stock requirement will be 1.0% of its membership asset value. The membership stock requirement for a member is initially capped at $25.0 million. The Bank may adjust the membership stock requirement within a range of 0.5% to 1.5% of a member's membership asset value and may adjust the cap within an authorized range of $10 million to $50 million. A member's membership asset value is determined by multiplying the amount of the member's membership assets by the applicable membership asset factors. Membership assets are those assets (other than Bank capital stock) of a type that could qualify as collateral to secure a member's indebtedness to the Bank under applicable law, whether or not the assets are pledged to the Bank or accepted by the Bank as eligible collateral. The membership asset factors were based on the typical borrowing capacity percentages generally assigned by the Bank to the same types of assets when pledged to the Bank (although the factors may differ from the actual borrowing capacities, if any, assigned to particular assets pledged by a specific member at any point in time).

A member's initial activity-based stock requirement will be the sum of 4.7% of the member's outstanding advances plus 5.0% of any portion of any mortgage loan sold by the member and owned by the Bank. The Bank may adjust the activity-based stock requirement within a range of 4.4% to 5.0% of the member's outstanding advances and a range of 5.0% to 5.7% of any portion of any mortgage loan sold by the member and owned by the Bank.

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

- 5% of the member's total outstanding Bank advances plus 5% of the Bank's interest in the aggregate unpaid principal balance of all loans sold by the member to the Bank, or
- 1% of the member's 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 repurchased or transferred to other Bank members at par value.

The GLB Act established voluntary membership for all members. Any member may withdraw from membership and have its capital stock redeemed after giving the required notice. Members that withdraw from membership may not re-apply for membership for five years, in accordance with Finance Board rules.

Retained Earnings and Dividend Policy. The Bank has a Retained Earnings and Dividend Policy that establishes amounts to be retained in restricted retained earnings, subject to the dividend resolution adopted by the Board of Directors for each dividend period. In accordance with this policy, 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 early retirement of consolidated obligations associated with the prepaid advances are similarly treated. Retained earnings restricted in accordance with this provision totaled $10,090 and $6,604 at December 31, 2003 and 2002, respectively.

In accordance with the Retained Earnings and Dividend Policy, the Bank also retains in restricted retained earnings any cumulative net gains in earnings (net of applicable assessments) and any cumulative net gains in other comprehensive income resulting from SFAS 133. Retained earnings restricted in accordance with this provision totaled $86,695 and $18,785 at December 31, 2003 and 2002, respectively. (The Bank's retained earnings in the future may not be sufficient to offset the full impact of SFAS 133. As a result, the effect of SFAS 133 may lead to increased volatility in future earnings and dividends.)

Effective April 1, 2003, the Board of Directors amended the Retained Earnings and Dividend Policy to provide for a build-up of retained earnings totaling $50,000 (less any cumulative net fair value losses in net income resulting from SFAS 133, with a floor of zero) over seven quarters beginning in the second quarter of 2003. At December 31, 2003, the retained earnings restricted in accordance with this provision totaled $22,000. The Finance Board recently provided guidance to the FHLBanks requiring an analysis of the adequacy of their retained earnings and a plan to achieve a target level of retained earnings. Effective January 30, 2004, the Board of Directors further amended the Retained Earnings and Dividend Policy to provide for a build-up of retained earnings totaling $100,000 (less any cumulative net fair value losses in net income resulting from SFAS 133, with a floor of zero) by the end of 2006.

The Bank's Board of Directors may declare and pay dividends only from retained earnings or current net earnings. There is no requirement that the Bank declare and pay any dividend. A decision by the Bank's Board of Directors to declare or not declare a dividend is a purely discretionary matter and is subject to the requirements and restrictions of the FHLB Act and applicable Finance Board requirements and guidance. The Bank has historically paid dividends on its stock in stock form and anticipates that any dividends will continue to be paid in stock form.

Surplus Capital Stock Repurchase Policy. The Bank's surplus capital stock repurchase policy allows the Bank to reduce its capital stock base if advances and mortgage loan balances decline. A member's surplus capital stock is defined as any excess stock holdings above 115% of the member's capital stock requirement, excluding stock dividends earned and credited for the current year. In accordance with this policy, the Bank repurchased $1,502,893 and $1,687,674 in surplus capital stock in 2003 and 2002, respectively. In January 2004, the Bank repurchased $47,078 of surplus capital stock that was subject to repurchase as of December 31, 2003.

Concentration. As of December 31, 2003, the Bank had a concentration of capital stock totaling 35,907 shares outstanding to three members, representing 63% of total capital stock outstanding (35%, 15%, and 13%, respectively).

NOTE 14 – EMPLOYEE RETIREMENT PLANS

The Bank provides retirement benefits through a Bank-sponsored Cash Balance Plan, a defined benefit plan. The Cash Balance Plan covers all employees who have completed at least six months of Bank service. Under the plan, each eligible Bank employee accrues benefits annually equal to 6% of the employee's annual pay, plus 6% interest on the benefits accrued to the employee through the prior yearend. The Cash Balance Plan is funded through a trust established by the Bank. The projected benefit obligation and the accrued benefit cost of the Cash Balance Plan were $7,870 and ($400), respectively, at December 31, 2003, and $5,695 and $1,140, respectively, at December 31, 2002. The periodic pension cost for the years ended December 31, 2003 and 2002, totaled $1,405 and $1,061, respectively.

The following tables summarize the changes in the projected benefit obligation, the plan assets, and funded status of the defined benefit cash balance plan for the years ended December 31, 2003, 2002, and 2001.

	2003	2002	2001
Change in benefit obligation:			
Benefit obligation, beginning of year	$ 5,695	$ 4,466	$ 4,044
Service cost	1,058	850	696
Interest cost	435	322	253
Actuarial loss/(gain)	763	129	(390)
Benefits paid	(81)	(72)	(137)
Benefit obligation, end of year	$ 7,870	$ 5,695	$ 4,466
Change in plan assets:			
Fair value of plan assets, beginning of year	$ 2,536	$ 1,927	$ 1,070
Actual return on plan assets	745	(371)	(46)
Employer contributions	1,272	1,052	1,040
Benefits paid	(81)	(72)	(137)
Fair value of plan assets, end of year	$ 4,472	$ 2,536	$ 1,927
Funded status	$(3,398)	$(3,159)	$(2,539)
Unrecognized net actuarial loss	1,857	1,836	1,407
Unrecognized prior service cost	268	183	—
Contributions after measurement date	1,673	—	—
Accrued benefit cost	$ 400	$(1,140)	$(1,132)

The following table summarizes the assumptions used in computing the projected benefit obligation and net pension expense for the years ending December 31, 2003, 2002, and 2001.

	2003	2002	2001
Discount rate in determining expense	7.00%	7.00%	7.00%
Discount rate in determining benefit obligations at yearend	7.00	7.00	7.00
Rate of increase in future compensation levels for determining expense	5.00	5.00	5.00
Rate of increase in future compensation levels for determining benefit obligations at yearend	5.00	5.00	5.00
Expected return on plan assets	8.00	8.00	8.00

The net periodic pension cost for the years ended December 31, 2003, 2002, and 2001 are as follows:

	2003	2002	2001
Service cost	$1,059	$ 850	$ 696
Interest cost	435	322	253
Expected return on assets	(253)	(209)	(106)
Amortization and deferral	164	98	—
Net periodic pension cost	$1,405	$1,061	$ 843

Prior to January 1, 2002, the Bank participated in the Financial Institutions Thrift Plan, a defined contribution savings plan. Contributions to this plan consisted of elective participant contributions and a Bank matching contribution of up to 6% of those participant contributions (based on compensation). The Bank contributed approximately $634 to the plan in 2001. Effective January 1, 2002, the Bank withdrew its participation in the Financial Institutions Thrift Plan and implemented a successor defined contribution savings plan, the Federal Home Loan Bank of San Francisco Savings Plan. Contributions to the successor plan also consist of elective participant contributions and a Bank matching contribution of up to 6% of those participant contributions (based on compensation). The Bank contributed approximately $877 and $990 in 2003 and 2002, respectively.

The Bank also provides the Benefit Equalization Plan (BEP). The BEP is a non-qualified retirement plan restoring those benefits offered under the qualified plans that have been limited by laws governing such plans. The Bank's projected benefit obligation and accrued benefit cost for this plan was $1,186 and $1,388, respectively, at December 31, 2003, and $1,408 and $1,224, respectively, at December 31, 2002.

Effective January 1, 2003, the Bank provides a Supplemental Executive Retirement Plan (SERP) for the Bank's executive management. The SERP is a non-qualified retirement benefit plan that will provide a service-linked supplemental cash balance contribution to SERP participants that is in addition to the contributions made to the qualified Cash Balance Plan. The Bank's projected benefit obligation was $361 at December 31, 2003.

In addition, the Bank maintains a deferred compensation plan that is available to all officers and directors. The plan liability consists of the accumulated compensation deferrals and accrued earnings on the deferrals. The Bank's obligation for this plan at December 31, 2003 and 2002 was $14,026 and $9,825, respectively.

NOTE 15 – SEGMENT INFORMATION

Management analyzes financial performance based on the net interest income of two operating segments, advances-related business and mortgage-related business, based on the Bank's method of internal reporting. The advances-related business consists of advances and other credit products provided to members, related financing and hedging instruments, liquidity and other non-MBS investments associated with the Bank's role as a liquidity provider, and member capital. Net interest income for this segment is derived primarily from the difference, or spread, between the yield on all business activities in this segment and the cost of funding those activities, including earnings on invested member capital and the cash flows from associated interest rate exchange agreements. The mortgage-related business consists of MBS investments, mortgage loans acquired through

the MPF Program, the consolidated obligations specifically identified as funding those assets, and related hedging instruments. 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.

The following table sets forth the Bank's financial performance by operating segment for the years ended December 31, 2003, 2002, and 2001. Interest income and interest expense associated with economic hedges are recorded in other income as "Net gain/(loss) on derivatives and hedging activities."

NET INTEREST INCOME

	ADVANCES-RELATED BUSINESS	MORTGAGE-RELATED BUSINESS	SUBTOTAL	INTEREST INCOME/ EXPENSE ON ECONOMIC HEDGES	NET INTEREST INCOME
2003	$279,540	$106,657	$386,197	$43,979	$430,176
2002	$360,451	$135,339	$495,790	$19,558	$515,348
2001	$466,880	$ 87,427	$554,307	$ 9,125	$563,432

TOTAL ASSETS	ADVANCES-RELATED BUSINESS	MORTGAGE-RELATED BUSINESS	TOTAL ASSETS
2003	$109,627,678	$22,762,058	$132,389,736
2002	$ 99,903,593	$16,225,888	$116,129,481
2001	$121,629,626	$13,754,246	$135,383,872

NOTE 16 – INTEREST RATE EXCHANGE AGREEMENTS

The contractual or notional amounts of interest rate exchange agreements reflect the extent of the Bank's involvement in particular classes of financial instruments. At December 31, 2003 and 2002, the Bank had $126,774 and $124,649, respectively, in notional amounts outstanding. The notional amount does not represent the exposure to credit loss. The Bank is subject to credit risk relating to the nonperformance by a counterparty to a non-exchange-traded interest rate exchange agreement. The amount potentially subject to credit loss is the estimated cost of replacing the favorable interest rate exchange agreement if the counterparty defaults; this amount is substantially less than the notional amount. However, based on management's credit analyses of Bank counterparties and on the Bank's bilateral netting arrangements and collateral requirements, no allowance for losses is deemed necessary by management.

Maximum credit risk is defined as the estimated cost of replacing all interest rate exchange agreements the Bank has transacted with counterparties where the Bank is in a net favorable position (i.e., has a net unrealized gain) if the counterparties all defaulted and the related collateral proved to be of no value to the Bank. At December 31, 2003 and 2002, the Bank's maximum credit risk, as defined above, was estimated at $265,677 and $518,734, respectively, including $92,773 and $111,117 of net accrued interest receivable, respectively. Accrued interest receivables and payables and the legal right to offset assets and liabilities by counterparty (under which amounts recognized for individual transactions may be offset against amounts recognized for other transactions with the same counterparty) are considered in determining the maximum credit risk. The Bank held investment grade securities with a fair value of $215,485 and $428,300 as collateral from counterparties as of December 31, 2003 and 2002, respectively. This collateral has not been sold or repledged. A significant number of the Bank's interest rate exchange agreements are transacted with financial institutions such as major banks and broker-dealers. Some of these banks and dealers or their affiliates buy, sell, and distribute consolidated obligations. Assets pledged as collateral by the Bank to these counterparties are more fully discussed in Note 19.

Intermediation. Interest rate exchange agreements in which the Bank is an intermediary may arise when the Bank enters into offsetting interest rate exchange agreements with members and other counterparties to meet the needs of members or when the Bank enters into interest rate exchange agreements to offset the economic effect of other interest rate exchange agreements that are no longer designated to advances, investments, or consolidated obligations. The notional principal of the interest rate exchange agreements in which the Bank was an intermediary at December 31, 2003 and 2002, was $975,800 and $904,200, respectively.

NOTE 17 – ESTIMATED FAIR VALUES

The following estimated fair value amounts have been determined by the Bank using available market information and the Bank's best judgment of appropriate valuation methods. These estimates are based on pertinent information available to the Bank as of December 31, 2003 and 2002. Although the Bank uses its best judgment in estimating the fair value of these financial instruments, there are inherent limitations in any estimation technique or valuation methodology. For example, because an active secondary market does not exist for a portion of the Bank's financial instruments, in certain cases, fair values are not subject to precise quantification or verification and may change as economic and market factors and evaluation of those factors change. Therefore, these estimated fair values are not necessarily indicative of the amounts that would be realized in current market transactions. The fair value summary tables do not represent an estimate of the overall market value of the Bank as a going concern, which would take into account future business opportunities.

Cash and Due from Banks. The recorded carrying value approximates the estimated fair value.

Interest-Bearing Deposits in Banks, Deposits for Mortgage Loan Programs, Securities Purchased Under Agreements to Resell, and Federal Funds Sold. The estimated fair values of these instruments have been determined based on quoted prices or by calculating the present value of expected cash flows for instruments with more than three months to maturity or repricing excluding accrued interest. The discount rates used in these calculations are the replacement rates for securities with similar terms. For instruments with three months or less to maturity or repricing, the recorded carrying value approximates the estimated fair value.

Held-to-Maturity and Held-at-Fair-Value Securities. The estimated fair value of these instruments with more than three months to maturity or repricing, including MBS, has been determined based on quoted prices, by calculating the present value of expected cash flows as of the last business day of the year excluding accrued interest, or by using industry standard analytical models and certain actual and estimated market information. The discount rates used in these calculations are the replacement rates for securities with similar terms. Estimates developed using these methods require judgments regarding significant matters such as the appropriate discount rates and prepayment assumptions. Changes in these judgments often have a material effect on the fair value estimates. For instruments with three months or less to maturity or repricing, the recorded carrying value approximates the estimated fair value.

Advances and Loans to Other Federal Home Loan Banks. The estimated fair value of these instruments with more than three months to maturity or repricing has been determined by calculating the present value of expected cash flows from these instruments and reducing this amount for accrued interest receivable. The discount rates used in these calculations are the replacement rates for advances with similar terms. Pursuant to the Finance Board's advances regulation, advances with a maturity or repricing period greater than six months generally require a prepayment fee sufficient to make the Bank financially indifferent to the borrower's decision to prepay the advances. Therefore, the estimated fair value of advances does not include the value of any potential prepayment fee. For instruments with three months or less to maturity or repricing, the recorded carrying value approximates the estimated fair value.

Mortgage Loans, Net of Allowance for Credit Losses for Mortgage Loans. The estimated fair values for mortgage loans have been determined based on quoted prices of similar mortgage loans available in the market. These prices, however, can change rapidly based on market conditions and are highly dependent on the prepayment assumptions that are used.

Accrued Interest Receivable and Payable and Other Assets and Liabilities. The recorded carrying value approximates the estimated fair value.

Derivative Assets and Liabilities. The Bank bases the estimated fair value of interest rate exchange agreements on the estimated costs of instruments with similar terms or available market prices, including accrued interest receivable and payable. However, active markets do not exist for many types of financial instruments. Consequently, fair values for these instruments are estimated using techniques such as discounted cash flow analysis, option pricing models, and comparisons to similar instruments. Estimates developed using these methods are subjective and require judgments regarding significant matters such as the amount and timing of future cash flows, the volatility of interest rates, and the selection of discount rates that appropriately reflect market and credit risks. Changes in these judgments often have a material effect on the fair value estimates. Since these estimates are made as of a specific point in time, they are susceptible to material near-term changes. The fair values are netted by counterparty where such legal right exists. If these netted amounts are positive, they are classified as an asset and, if negative, a liability.

Deposits and Other Borrowings. For deposits and other borrowings with more than three months to maturity or repricing, the estimated fair value has been determined by calculating the present value of expected future cash flows from the deposits and other borrowings excluding accrued interest. The discount rates used in these calculations are the cost of deposits with similar terms. For deposits and other borrowings with three months or less to maturity or repricing, the recorded carrying value approximates the estimated fair value.

Consolidated Obligations. The estimated fair value has been determined based on the estimated cost of raising comparable term debt and, where applicable, option pricing models. The estimated cost of issuing debt is determined daily based on the primary market for debt of the FHLBank System and other government-sponsored enterprises and other indications from securities dealers; the estimated cost of issuing debt includes non-interest selling costs. Estimates of the fair value of callable consolidated obligations that are developed using these methods require judgments regarding significant matters such as the volatility of market rates for agency debt. Changes in these judgments often have a material effect on the fair value estimates. Since these estimates are made as of a specific point in time, they are susceptible to material near-term changes.

Commitments. The estimated fair value of the Bank's commitments to extend credit, including letters of credit, was immaterial at December 31, 2003 and 2002.

The estimated fair values of the Bank's financial instruments at December 31, 2003 and 2002, were as follows:

FAIR VALUE OF FINANCIAL INSTRUMENTS – 2003	CARRYING VALUE	NET UNREALIZED GAINS/(LOSSES)	ESTIMATED FAIR VALUE
ASSETS			
Cash and due from banks	$ 17,579	$ —	$ 17,579
Deposits for mortgage loan program	11,611	—	11,611
Interest-bearing deposits in banks	3,287,000	—	3,287,000
Securities purchased under agreements to resell	5,100,000	—	5,100,000
Federal funds sold	5,434,000	—	5,434,000
Held-to-maturity securities	18,263,315	2,316	18,265,631
Held-at-fair-value securities	917,322	—	917,322
Advances	92,329,621	113,294	92,442,915
Mortgage loans, net of allowance for credit losses on mortgage loans	6,445,192	(131,725)	6,313,467
Accrued interest receivable	218,123	—	218,123
Derivative assets	265,677	—	265,677
Other assets	100,296	(38,718)	61,578
Total	$132,389,736	$ (54,833)	$132,334,903
LIABILITIES			
Deposits	$ 987,665	$ —	$ 987,665
Consolidated obligations:			
Bonds	92,751,350	44,683	92,706,667
Discount notes	31,882,203	(298)	31,882,501
Accrued interest payable	527,947	—	527,947
Derivative liabilities	180,690	—	180,690
Other liabilities	214,059	—	214,059
Total	$126,543,914	$ 44,385	$126,499,529

FAIR VALUE OF FINANCIAL INSTRUMENTS – 2002	CARRYING VALUE	NET UNREALIZED GAINS/(LOSSES)	ESTIMATED FAIR VALUE
ASSETS			
Cash and due from banks	$ 8,759	$ —	$ 8,759
Deposits for mortgage loan program	58,113	—	58,113
Interest-bearing deposits in banks	4,834,000	—	4,834,000
Securities purchased under agreements to resell	4,400,000	—	4,400,000
Federal funds sold	6,068,000	—	6,068,000
Held-to-maturity securities	17,878,844	178,077	18,056,921
Held-at-fair-value securities	533,090	—	533,090
Advances	81,237,041	226,992	81,464,033
Mortgage loans, net of allowance for credit losses on mortgage loans	262,426	1,406	263,832
Accrued interest receivable	285,055	—	285,055
Derivative assets	518,734	—	518,734
Other assets	45,419	(24,457)	20,962
Total	$116,129,481	$ 382,018	$116,511,499
LIABILITIES			
Deposits	$ 406,639	$ (2)	$ 406,641
Other borrowings	525,000	—	525,000
Consolidated obligations:			
Bonds	95,821,797	(270,774)	96,092,571
Discount notes	12,446,816	(3,042)	12,449,858
Accrued interest payable	715,620	—	715,620
Derivative liabilities	345,865	—	345,865
Other liabilities	183,046	—	183,046
Total	$110,444,783	$(273,818)	$110,718,601

NOTE 18 – ARBITRATION AWARD

In August 2002, the Bank received notice of a final court order confirming an arbitration decision awarding a member a refund of $7,879 in prepayment fees paid to the Bank in 1998. The final award, with interest, was $9,395, and this amount was included in other expense in 2002.

NOTE 19 – COMMITMENTS AND CONTINGENCIES

As indicated in Note 12, all FHLBanks have joint and several liability for FHLBank consolidated obligations. Accordingly, if any FHLBank were unable to repay its participation in the consolidated obligations, the other FHLBanks could be required to repay all or a portion of that FHLBank's participation, as determined by the Finance Board. The Bank has never been required to repay any consolidated obligation on behalf of another FHLBank. In addition, at this time Bank management is not aware that any FHLBank is likely to be unable to repay its participation in the consolidated obligations. Accordingly, the Bank has not recognized a liability for its joint and several obligation related to other FHLBanks' participations in the consolidated obligations.

The Finance Board's joint and several liability regulation provides a general framework for addressing the possibility that an FHLBank may be unable to repay its participation in the consolidated obligations for which it is the primary obligor. In accordance with the Finance Board regulation, the President of each FHLBank is required to provide a quarterly certification that, among other things, the FHLBank will remain capable of making full and timely payment of all its current obligations, including direct obligations.

Further, the regulation requires that an FHLBank must provide written notice to the Finance Board if at any time the FHLBank is unable to provide the quarterly certification; projects that it will be unable to timely and fully meet all of its current obligations, including direct obligations, during the quarter; or negotiates or enters into an agreement with another FHLBank for financial assistance to meet its obligations. If an FHLBank gives any one of these notices (other than in a case of a temporary interruption in the FHLBank's debt servicing operations resulting from an external event such as a natural disaster or a power failure), it must promptly file a consolidated obligations payment plan for Finance Board approval specifying the measures the non-complying FHLBank will undertake to make full and timely payments of all of its current obligations.

Notwithstanding any other provisions in the regulation, the Finance Board in its discretion may at any time order any FHLBank to make any principal or interest payment due on any consolidated obligation. To the extent an FHLBank makes any payment on any consolidated obligation on behalf of another FHLBank, the paying FHLBank is entitled to reimbursement from the non-complying FHLBank, which will have a corresponding obligation to reimburse the FHLBank for the payment and associated costs, including interest.

The Finance Board may allocate the outstanding liability of an FHLBank for consolidated obligations among the other FHLBanks on a pro rata basis in proportion to each FHLBank's participation in all consolidated obligations outstanding or on any other basis determined by the Finance Board.

Commitments that legally bind and obligate the Bank for additional advances totaled approximately $419,286 and $29,483 at December 31, 2003 and 2002, respectively. Commitments are generally for periods up to 12 months. Standby letters of credit are generally issued for a fee on behalf of members to support their obligations to third parties. If the Bank is required to make payment for a beneficiary's drawing, the amount is charged to the member's demand deposit account with the Bank or converted into a collateralized advance to the member. Outstanding standby letters of credit were approximately $1,015,009 and $1,391,652 at December 31, 2003 and 2002, respectively, and had original terms of 84 days to 10 years, with a final expiration in 2013. Unearned fees for transactions prior to 2003 as well as the value of the guarantees related to standby letters of credit entered into after 2002 are recorded in other liabilities and amounted to $1,881 at December 31, 2003. Based on management's credit analyses and collateral requirements, no allowance for losses is deemed necessary by management on these advance commitments and letters of credit. Advances funded under these advance commitments and letters of credit are fully collateralized at the time of issuance in a manner consistent with advances to members (see Note 7). The estimated fair value of commitments and letters of credit was immaterial as of December 31, 2003 and 2002.

Commitments that unconditionally obligate the Bank to purchase mortgage loans totaled $4,628 and $15,426 at December 31, 2003 and 2002, respectively. Commitments are generally for periods not to exceed 45 days. In accordance with SFAS 149, commitments entered after June 30, 2003, were recorded as derivatives at their fair value.

The Bank executes interest rate exchange agreements with major banks and broker-dealers that have long-term credit ratings of single-A or better from both Standard & Poor's and Moody's Investors Service. The Bank enters into bilateral security agreements with all counterparties. As of December 31, 2003 and 2002, the Bank had pledged as collateral securities with a fair value of $133,755 and $261,442, respectively, to broker-dealers that have a net credit risk exposure to the Bank related to interest rate exchange agreements.

The Bank charged operating expenses for net rental costs of approximately $3,434, $3,360, and $3,382 for the years ending December 31, 2003, 2002, and 2001, respectively. Future minimum rentals at December 31, 2003, were as follows:

YEAR	PREMISES	EQUIPMENT	TOTAL
2004	$ 3,117	$226	$ 3,343
2005	3,218	228	3,446
2006	3,242	23	3,265
2007	3,476	21	3,497
2008	3,469	2	3,471
Thereafter	1,628	—	1,628
Total	$18,150	$500	$18,650

Lease agreements for Bank premises generally provide for increases in the basic rentals resulting from increases in property taxes and maintenance expenses. Such increases are not expected to have a material effect on the Bank's financial condition or results of operations.

The Bank is subject to various pending legal proceedings arising in the normal course of business. After consultation with legal counsel, management does not anticipate that the ultimate liability, if any, arising out of these matters will have a material effect on the Bank's financial condition or results of operations.

The Bank executed orders to issue $1,001,618 of consolidated obligations and entered into $843,700 of notional amount of interest rate exchange agreements that had traded but not yet settled at December 31, 2003.

Other commitments and contingencies are discussed in Notes 1, 7, 8, 12, 13, 14, and 16.

NOTE 20 – OTHER

Other income consisted of the following:

	FOR THE YEARS ENDED DECEMBER 31,		
	2003	2002	2001
Fees earned on letters of credit	$1,255	$1,424	$1,398
Amortization of gain from sale of building	2,073	2,073	2,057
Gain/(loss) on early extinguishment of debt	(100)	(394)	(556)
Other	449	34	2
Total	$3,677	$3,137	$2,901

The table below discloses the largest categories included in operating expense. Professional and contract services expense includes the Bank's independent accountants, attorneys, and other consultants used for special projects.

Operating expenses consisted of the following:

	FOR THE YEARS ENDED DECEMBER 31,		
	2003	2002	2001
Compensation and benefits	$34,987	$33,318	$27,748
Professional and contract services	9,192	10,319	12,001
Travel	1,277	1,241	1,064
Occupancy	3,936	3,820	3,566
Equipment	2,783	2,452	2,523
Other	1,826	2,411	1,901
Total operating expense	$54,001	$53,561	$48,803

Board of Directors' Audit Committee Charter

I. PURPOSE

The purpose of the Audit Committee is to assist the Board of Directors in fulfilling the Board's oversight responsibilities for: (1) the integrity of the Bank's financial reporting; (2) the maintenance of effective administrative, risk management, operating, and accounting internal control systems; (3) compliance with legal and regulatory requirements; (4) the qualifications, independence and performance of the external auditors; (5) the performance of the Bank's internal audit function; and (6) the Bank's compliance with internal policies and procedures.

II. MEMBERSHIP

The Committee will be composed of at least five members of the Board, who must all meet the independence requirement in Section 917.7(c) of the regulations of the Federal Housing Finance Board. Committee members and the Committee chair will be designated by the Board, as follows:

- The Committee will include a balance of (i) representatives of community financial institutions and other Bank members; and (ii) elected and appointed Directors.
- The terms of the Committee members will be appropriately staggered to provide for continuity of service.
- At least one member of the Committee will have extensive accounting or related financial management experience.

III. POWERS AND RESPONSIBILITIES

The Committee will:

1. In conjunction with the Board:
    - Review, assess the adequacy of, and amend the Committee charter (as needed) on an annual basis or more often, as appropriate
    - Readopt and reapprove the Committee charter at least every three years

2. Direct senior management to maintain the reliability and integrity of the accounting policies and financial reporting and disclosure practices of the Bank.

3. Review the basis for the Bank's financial statements and the external auditor's opinion rendered with respect to the financial statements (including the nature and extent of any significant changes in accounting principles or the application in the financial statements) and ensure that policies are in place that are reasonably designed to achieve disclosure and transparency regarding the Bank's true financial performance and governance practices.

4. Review significant accounting and reporting issues and understand their impact on the financial statements.

5. Review analysis prepared by management and/or the external auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analysis of the effects of alternative generally accepted accounting principle methods.

6. Oversee the internal audit function by:
    - Selecting, evaluating and, where appropriate, replacing the Director of Audit, who may be removed only with the approval of the Committee
    - Assessing the performance and determining the compensation of the Director of Audit
    - Requiring that the Director of Audit report directly to the Committee on substantive matters and be ultimately accountable to the Committee and the Board
    - Reviewing and approving the internal audit department charter
    - Reviewing budget and staffing needs for the Bank's internal audit department and making appropriate budget and staff recommendations to the Board for approval
    - Reviewing and approving the internal audit plan and revisions, as needed
    - Reviewing the scope of audit services required, significant accounting policies, significant risks and exposures, audit activities and audit findings
    - Reviewing internal audit department compliance with the Institute of Internal Auditors Standards for the Professional Practice of Internal Auditing
    - Meeting in executive session with the Director of Audit on a regular basis to discuss any matters that the Committee or Director of Audit believes should be discussed in confidence
    - Reviewing and confirming the qualifications and independence of the Audit Department staff annually

7. Oversee the external audit function by:
    - Approving the external auditor's annual engagement letter, including compensation (if applicable)
    - Reviewing the performance of the external auditor
    - Making recommendations to the Board regarding the appointment, renewal or termination of the external auditor
    - Reviewing and confirming the qualifications and independence of the external auditor
    - Preapproving non-audit services performed by the external auditor in accordance with a preapproval policy and procedure established by the Committee
    - Requiring the rotation of the lead audit partner and concurring partner every five years and other "significant" partners every seven years
    - Meeting in executive session with the external auditor on a regular basis to discuss any matters that the Committee or external auditor believes should be discussed in confidence

8. Provide an independent, direct channel of communication between the Board and the internal and external auditors.

9. Conduct or authorize investigations into any matters within the Committee's scope of responsibilities.

10. Ensure that senior management has established and is maintaining an adequate internal control system within the Bank by:
    - Reviewing the Bank's internal control system and the resolution of identified material weaknesses and reportable conditions in the internal control system, including the prevention or detection of management override or compromise of the internal control system
    - Reviewing the programs and policies of the Bank designed to ensure compliance with applicable laws, regulations and policies and monitoring the results of these compliance efforts
11. Review the policies and procedures established by senior management to assess and monitor implementation of the Bank's strategic business plan and the operating goals and objectives contained in the plan.
12. Review with senior management and the external auditor at the completion of the annual audit:
    - The Bank's annual financial statements, Management's Discussion and Analysis and related notes
    - The external auditor's audit of the financial statements and audit report
    - All critical accounting policies and practices
    - All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the Bank's accounting firm
    - Other material written communications between the auditor and management of the Bank, such as any management letter, reports on observations and recommendations on internal controls, engagement letter, independence letter or schedule of unadjusted differences
    - Any significant changes required in the external auditor's audit plan
    - Any serious difficulties or disputes between the external auditor and management encountered during the course of the audit
13. Review with senior management and the Director of Audit:
    - Significant audit findings and recommendations and management's responses
    - Management's implementation of significant audit recommendations
    - Difficulties encountered in the course of any internal audit, including restrictions on the scope of the auditors' work or access to required information
    - Legal and regulatory matters that may have a material effect on the financial statements of the Bank, compliance with the Bank's policies and programs, and reports received from regulators
14. Assist the Board in reviewing senior management's risk assessments and addressing risk management and controls, as needed.
15. Provide an "Audit Committee Report" to be included with each Bank Annual Report that states the following:
    - The Committee has reviewed and discussed the audited financial statements with management
    - The Committee has discussed with the external auditors the matters required to be discussed by SAS No. 61 and SAS No. 90, as modified or supplemented, on Audit Committee Communications
    - The Committee has received the written disclosures and the letter from the independent auditors required by ISB Standard No. 1, as modified or supplemented, and has discussed with the auditors the auditor's independence
    - Based on the review and discussions above, the Committee has recommended to the Board that the financial statements be included in the Bank Annual Report
16. Review and discuss with the Chief Executive Officer, Chief Operating Officer and any other officer responsible for the evaluation of internal controls over financial reporting any significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting that are reasonably likely to adversely affect the Bank's ability to record, process, summarize and report financial information; and any fraud, whether or not material, that involves management or other employees who have a significant role in the Bank's internal controls over financial reporting.
17. Establish procedures for:
    - Receiving, retaining and treating complaints received by the Bank relating to accounting, internal accounting controls or audit matters; and
    - The anonymous, confidential submission by employees of the Bank of concerns regarding questionable accounting or auditing matters

In carrying out its responsibilities, the Committee may rely on the assistance, advice and recommendations of Bank management and other advisors, as needed, and may refer specific matters to other committees of the Board. The Committee may, at its sole discretion and without consultation with management or the Board, obtain separate legal counsel or other outside professional services to enable it to fulfill the responsibilities and perform the functions set forth in this charter. The Board will approve appropriate funding, as determined by the Committee, for the compensation of independent advisors to the Committee and the compensation of the external auditor for issuing audit reports.

The Committee will report its activities and recommendations to the Board through the Committee chair.

IV. MEETINGS

The Committee will meet at least four times per year, and more frequently as needed, as determined by the Board, the Committee chair, the Bank President, or the Director of Audit.

2004 Affordable Housing Advisory Council

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Las Vegas, Nevada

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James Zabel

DESIGN: ARGUS, LLC _ SAN FRANCISCO, CA _ ARGUSSF.COM

Federal Home Loan Bank of San Francisco
600 California Street
San Francisco, California 94108
415.616.1000
www.fhlbsf.com