

*In the opinion of Orrick, Herrington & Sutcliffe LLP (“Bond Counsel”) based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, the accuracy of certain representations and compliance with certain covenants, interest on the Bonds (as defined below) is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986, except that no opinion is expressed as to the status of interest on any Bond for any period that such Bond is held by a “substantial user” of the facilities financed or refinanced by the Bonds or by a “related person” within the meaning of Section 147(a) of the Internal Revenue Code of 1986. In the further opinion of Bond Counsel, interest on the Bonds is not a specific preference item for purposes of the federal individual and corporate alternative minimum taxes, nor is it included in adjusted current earnings when calculating corporate alternative minimum taxable income. Bond Counsel is also of the opinion that interest on the Bonds is exempt from State of California personal income taxes. Bond Counsel expresses no opinion regarding any other tax consequences related to the ownership or disposition of, or the amount, accrual or receipt of interest on, the Bonds. See “TAX MATTERS” herein.*

**\$7,100,000**

**California Statewide Communities Development Authority  
Variable Rate Demand Multifamily Housing Revenue Bonds  
(Heritage II Apartments Project), 2014 Series G**

**Dated: Date of Delivery**

**Price: 100%**

**CUSIP: 13079P VU4**

**Maturity: May 1, 2054**

The above-captioned bonds (the “Bonds”) are being issued by the California Statewide Communities Development Authority (the “Issuer”) under and pursuant to an Indenture of Trust, dated as of May 1, 2014 (the “Indenture”), by and between the Issuer and Wilmington Trust, National Association, as trustee (the “Trustee”). The Bonds will bear interest at interest rates determined by the Remarketing Agent on or before the date of delivery of the Bonds to and including the following Wednesday, and thereafter will bear interest at Variable Rates of interest in the Weekly Mode until adjusted to Variable Rates of interest in the Daily Mode, until the first Reset Date, if any, or until the Conversion Date, if any, all as described herein. The Bonds are issuable as fully registered bonds without coupons, in the minimum denomination of \$100,000 and any integral multiple of \$5,000 in excess thereof during any Variable Period. When issued, the Bonds will be registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York (“DTC”). The principal of, premium, if any, and interest on the Bonds are payable by the Trustee by wire transfer directly to DTC, which will in turn remit such payments to its participants for subsequent disbursement to the beneficial owners of the Bonds. Interest on the Bonds will be payable on the first Business Day (as defined herein) of each month, commencing July 1, 2014.

The Bonds are being issued to finance the construction and development of a multifamily rental housing development known as the Heritage II Apartments, to be located within the City of Lompoc, California (the “Project”) and owned by Heritage II, L.P., a California limited partnership (the “Developer”). The payment of principal of and interest on the Bonds will be secured solely by a pledge of revenues under the Indenture, including amounts drawn under an irrevocable direct-pay Letter of Credit issued by East West Bank, a California banking corporation (the “Credit Bank”), which expires on May 29, 2017, unless it expires earlier as described herein (see “SOURCES OF PAYMENT FOR THE BONDS—The Letter of Credit” herein and Appendix B hereto), and under an irrevocable Standby Letter of Credit (the “Standby Letter of Credit”) issued by

**FEDERAL HOME LOAN BANK OF SAN FRANCISCO**

The Standby Letter of Credit expires on May 29, 2017, unless it expires earlier as described herein (see “SOURCES OF PAYMENT FOR THE BONDS—The Standby Letter of Credit” herein and Appendix C hereto).

The Bonds are subject to mandatory purchase by the Trustee as described herein under “THE BONDS—Mandatory Purchase” herein. The Letter of Credit or the Standby Letter of Credit will be drawn on to fund the Purchase Price of all Bonds tendered for purchase and not promptly remarketed under the terms of the Indenture.

The Bonds will be subject to redemption prior to their stated maturity dates at the prices, on the terms and upon the occurrence of the events described herein. See “REDEMPTION OF BONDS” herein. In addition, the maturity of the Bonds may be accelerated upon the occurrence of certain events. See “SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE—Defaults and Remedies” herein.

**THE BONDS ARE LIMITED OBLIGATIONS OF THE ISSUER, PAYABLE SOLELY FROM THE REVENUES AND OTHER FUNDS AND MONEYS PLEDGED AND ASSIGNED UNDER THE INDENTURE. NEITHER THE ISSUER, ANY OF ITS PROGRAM PARTICIPANTS, THE STATE OF CALIFORNIA (THE “STATE”), NOR ANY POLITICAL SUBDIVISION THEREOF (EXCEPT THE ISSUER, TO THE LIMITED EXTENT SET FORTH IN THE INDENTURE) NOR ANY PUBLIC AGENCY SHALL IN ANY EVENT BE LIABLE FOR THE PAYMENT OF THE PRINCIPAL OF, PREMIUM (IF ANY) OR INTEREST ON THE BONDS OR FOR THE PERFORMANCE OF ANY PLEDGE, OBLIGATION OR AGREEMENT OF ANY KIND WHATSOEVER EXCEPT AS SET FORTH IN THE INDENTURE, AND NONE OF THE BONDS OR ANY OF THE ISSUER’S AGREEMENTS OR OBLIGATIONS SHALL BE CONSTRUED TO CONSTITUTE AN INDEBTEDNESS OF OR A PLEDGE OF THE FAITH AND CREDIT OF OR A LOAN OF THE CREDIT OF OR A MORAL OBLIGATION OF ANY OF THE FOREGOING WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION WHATSOEVER. THE ISSUER HAS NO TAXING POWER.**

THIS OFFICIAL STATEMENT IS INTENDED FOR USE WITH RESPECT TO THE BONDS ONLY DURING THE WEEKLY MODE, WHICH IS THE PERIOD BEGINNING ON THE DATE OF ISSUANCE OF THE BONDS AND ENDING ON THE DATE, IF ANY, ON WHICH THE INTEREST RATES ON THE BONDS ARE ADJUSTED TO RESET RATES OR TO VARIABLE RATES IN THE DAILY MODE OR CONVERTED TO FIXED RATES.

*The Bonds are offered when, as and if issued and received by Hutchinson, Shockey, Erley & Co. and Stern Brothers & Co. (together, the “Underwriter”), subject to the approving opinion of Orrick, Herrington & Sutcliffe LLP, San Francisco, California, Bond Counsel to the Issuer, and certain other conditions. Certain legal matters will be passed on for the Credit Bank by its in-house counsel, for the Federal Home Loan Bank of San Francisco by its in-house counsel, for the Developer by its counsel, Chernove & Associates, Inc., Encino, California, for the Trustee by Fox Rothschild LLP, Los Angeles, California, and for the Underwriter by its counsel, Eichner Norris & Neumann PLLC, Washington, D.C. It is expected that the Bonds will be delivered through the facilities of The Depository Trust Company in New York, New York, on or about May 29, 2014.*

**HUTCHINSON, SHOCKEY, ERLEY & CO.**

**STERN BROTHERS & CO.**

Dated: May 28, 2014

No dealer, broker, salesman or other person has been authorized by the Issuer, the Credit Bank, the Standby Credit Bank, the Developer or Hutchinson, Shockey, Erley & Co. and Stern Brothers & Co. (together, the "Underwriter") to give any information or to make any representations other than those contained in this Official Statement in connection with the offering made hereby, and, if given or made, such other information or representations must not be relied upon as having been authorized by any of the foregoing. This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of the Bonds by any person in any jurisdiction in which it is unlawful for such person to make such offer, solicitation or sale.

The Underwriter has reviewed the information in this Official Statement in accordance with, and as a part of, its responsibilities to investors under the federal securities laws as applied to the facts and circumstances of this transaction, but the Underwriter does not guarantee the accuracy or completeness of such information.

The information set forth herein has been obtained from the Issuer, the Developer, the Credit Bank and the Standby Credit Bank which are believed to be reliable, but it is not guaranteed as to accuracy or completeness and is not to be construed as a representation by the Underwriter. The information and expressions of opinion herein are subject to change without notice, and neither the delivery of this Official Statement nor any sale made hereunder, under any circumstances, shall create any implication that there has been no change in the affairs of the Credit Bank or any other party described herein subsequent to the date as of which such information is presented.

The Issuer has not provided or approved any information in this Official Statement except the information under the headings "THE ISSUER" and "ABSENCE OF LITIGATION—The Issuer" and takes no responsibility for any other information contained in this Official Statement.

The Developer has not provided or approved any information in this Official Statement except the information under the headings "THE DEVELOPER, THE PROJECT AND THE MANAGER," "ESTIMATED SOURCES AND USES OF FUNDS" and "ABSENCE OF LITIGATION—The Developer" and takes no responsibility for any other information contained in this Official Statement.

THE INFORMATION AND EXPRESSIONS OF OPINION HEREIN ARE SUBJECT TO CHANGE WITHOUT NOTICE AND NEITHER THE DELIVERY OF THIS OFFICIAL STATEMENT NOR ANY SALE HEREUNDER WILL, UNDER ANY CIRCUMSTANCES, CREATE ANY IMPLICATION THAT THERE HAS BEEN NO CHANGE IN THE INFORMATION REFERENCED HEREIN SINCE THE DATE HEREOF.

THESE SECURITIES HAVE NOT BEEN RECOMMENDED BY ANY FEDERAL OR STATE SECURITIES COMMISSION OR REGULATORY AUTHORITY. FURTHERMORE, THE FOREGOING AUTHORITIES HAVE NOT CONFIRMED THE ACCURACY OR DETERMINED THE ADEQUACY OF THIS DOCUMENT. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENCE.

IN CONNECTION WITH THIS OFFERING, THE UNDERWRITER MAY OVERALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE BONDS OFFERED HEREBY AT A LEVEL ABOVE THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

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## **OFFICIAL STATEMENT**

\$7,100,000

California Statewide Communities Development Authority  
Variable Rate Demand Multifamily Housing Revenue Bonds  
(Heritage II Apartments Project), 2014 Series G

### **INTRODUCTION**

The following introductory statement is subject in all respects to more complete information contained elsewhere in this Official Statement. The order and placement of materials in this Official Statement, which includes the cover page and Appendices hereto, are not to be deemed to be a determination of relevance, materiality or relative importance, and this Official Statement, including the cover page and Appendices hereto, must be considered in its entirety. Certain capitalized terms used in this Official Statement are defined herein and in the Appendices hereto. All capitalized terms used in this Official Statement that are not otherwise defined herein shall have the meanings ascribed to them in the Indenture, the Loan Agreement, the Regulatory Agreement, the Credit Agreement, the Intercreditor Agreement, the Letter of Credit and the Standby Letter of Credit (as each such term is hereinafter defined).

This Official Statement, which includes the cover page and Appendices hereto, is furnished in connection with the offering and sale by the California Statewide Communities Development Authority (the “Issuer”) of the above-captioned bonds (the “Bonds”). See “THE BONDS” herein. The Bonds will be issued pursuant to Chapter 5 of Division 7 of Title 1 of the California Government Code and Chapter 7 of Part 5 of Division 31 of the California Health and Safety Code, as amended (the “Act”). The Bonds will be issued pursuant to the terms of an Indenture of Trust, dated as of May 1, 2014 (the “Indenture”), by and between the Issuer and Wilmington Trust, National Association, as trustee (the “Trustee”). See “SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE” herein.

The proceeds of the Bonds will be used to make a loan (the “Loan”) to Heritage II, L.P., a California limited partnership (the “Developer”), to finance the construction and development of a multifamily rental housing development known as the Heritage II Apartments, to be located within the City of Lompoc, California (the “Project”). See “THE DEVELOPER, THE PROJECT AND THE MANAGER” herein. The Loan will be made under and pursuant to a Loan Agreement, dated as of the date of the Indenture (the “Loan Agreement”), by and among the Issuer, the Trustee and the Developer. See “SUMMARY OF CERTAIN PROVISIONS OF THE LOAN AGREEMENT” herein.

To secure the Bonds, the Developer will cause East West Bank, a California banking corporation (the “Credit Bank”), to issue and deliver to the Trustee an irrevocable direct-pay letter of credit (the “Letter of Credit”) (see “SOURCES OF PAYMENT FOR THE BONDS—The Letter of Credit” herein and Appendix B hereto) pursuant to a Reimbursement Agreement, dated as of the date of the Indenture (the “Credit Agreement”) between the Credit Bank and the Developer. See “SUMMARY OF CERTAIN PROVISIONS OF THE CREDIT AGREEMENT” herein. The payment of draws under the Letter of Credit itself will initially be secured by a standby letter of credit (the “Standby Letter of Credit”) (see “SOURCES OF PAYMENT FOR THE BONDS—The Standby Letter of Credit” herein and Appendix C hereto) issued by the Federal Home Loan Bank of San Francisco (the “Standby Credit Bank”). The Trustee will be entitled to draw upon the Letter of Credit or the Standby Letter of Credit up to an amount sufficient to pay (a) principal of or interest on the Bonds on the scheduled dates for payment of such amounts, upon certain redemptions of the Bonds or upon acceleration of the Bonds, and (b) the purchase price of any Bond tendered to and required to be purchased by the Trustee which has not been remarketed by the Remarketing Agent. The Developer will agree in the Credit Agreement to reimburse the Credit

Bank for drawings made under the Letter of Credit, and to make certain other payments to the Credit Bank.

The payment obligations of the Developer under the Loan Agreement will be secured by a Deed of Trust, Security Agreement, Assignment of Leases and Rents and Fixture Filing, dated as of the date of the Indenture (the “First Deed of Trust”), from the Developer for the benefit of the Trustee, as beneficiary. The obligations of the Developer under the Credit Agreement will be secured by a deed of trust subordinate to the First Deed of Trust (the “Credit Bank Deed of Trust”). The Intercreditor Agreement, dated as of the date of the Indenture (the “Intercreditor Agreement”), by and among the Issuer, the Trustee and the Credit Bank, governs the exercise of the rights and remedies by the Trustee and the Credit Bank under the Indenture, the Loan Agreement, the Regulatory Agreement, the First Deed of Trust, the Credit Bank Deed of Trust and certain other documents. See “SUMMARY OF CERTAIN PROVISIONS OF THE INTERCREDITOR AGREEMENT” herein.

The Issuer, the Trustee and the Developer will enter into a Regulatory Agreement and Declaration of Restrictive Covenants, dated as of the date of the Indenture (the “Regulatory Agreement”). The Regulatory Agreement will restrict the operation of the Project, the occupancy of certain units in the Project and the rents chargeable with respect to units in the Project. The restrictions contained in the Regulatory Agreement are imposed by the Code, the Act, the Issuer and CDLAC. See “SUMMARY OF CERTAIN PROVISIONS OF THE REGULATORY AGREEMENT” herein. Occupancy and rents are further restricted in connection with an award of low income housing tax credits with respect to the Project. See “THE DEVELOPER, THE PROJECT AND THE MANAGER—Restrictive Covenants—Tax Credit Regulatory Agreement” herein.

The Regulatory Agreement, the Loan Agreement, the Credit Agreement and certain certificates required by such documents are sometimes referred to herein collectively as the “Loan Documents.”

Pursuant to a Remarketing Agreement, dated as of the date of the Indenture (the “Remarketing Agreement”), between the Developer and Stern Brothers & Co. (the “Remarketing Agent”), the Remarketing Agent has agreed to use its best efforts to remarket Bonds tendered for purchase. The Trustee, in its capacity as tender agent (the “Tender Agent”), will perform certain services in connection with the purchase of tendered Bonds.

There follow in this Official Statement brief descriptions of the Bonds, the sources of payment for the Bonds, the Issuer, the Credit Bank, the Standby Credit Bank, the Developer, the Manager and the Project, together with summaries of certain provisions of the Indenture, the Loan Agreement, the Regulatory Agreement, the Credit Agreement, the Intercreditor Agreement, the Letter of Credit, the Standby Letter of Credit and certain other documents. The summaries of certain provisions of the documents described herein do not purport to be complete and are qualified in their entirety by reference to such documents. Copies of such documents are available for inspection by prospective investors at the office of the Trustee which is presently located at Wilmington Trust, National Association, 650 Town Center Drive, Suite 600, Costa Mesa, CA 92626, Attention: Corporate Trust Services.

## **THE BONDS**

### **Description of the Bonds**

The Bonds will be issued in fully registered form and, when issued, will be registered in the name of Cede & Co., as registered owner and nominee of The Depository Trust Company, New York, New York (“DTC”). The Bonds will be held by the Trustee pursuant to DTC’s Fast Automated Securities Transfer (FAST) Program. DTC will act as securities depository for the Bonds. Individual

purchases will be made in book-entry form. Purchasers will not receive certificates representing their interest in the Bonds purchased. So long as Cede & Co. is the registered owner of the Bonds, as nominee of DTC, references herein to the Bondholders or registered owners of the Bonds shall mean Cede & Co., as aforesaid, and shall not mean the beneficial owners of the Bonds.

So long as Cede & Co. is the registered owner of the Bonds, principal, premium, if any, and interest on the Bonds are payable by the Trustee by wire transfer of New York clearing house or equivalent next-day funds, to Cede & Co., as nominee for DTC. DTC will, in turn, remit such amounts to the DTC Participants (as defined herein) for subsequent disbursement to the beneficial owners. See “THE BONDS—Book-Entry Only System” herein.

The Bonds shall be issuable only as fully registered Bonds, without coupons, in Authorized Denominations, and shall be numbered consecutively in the order of their authentication, with any other designation as the Trustee deems appropriate. The Bonds shall be dated the Closing Date, shall mature on the Maturity Date, and shall be subject to redemption prior to maturity as described under the heading “REDEMPTION OF BONDS” herein. The Bonds shall bear interest, payable on each Interest Payment Date, at the initial rate per annum established by the Remarketing Agent on or before the Closing Date to and including the following Wednesday and, thereafter, at a Variable Rate of interest in the Weekly Mode, until adjusted or converted as described under the heading “Adjustment of Interest Rates” below. Interest due on the Bonds shall be calculated based on the Interest Period. Each Bond shall bear interest from the date to which interest has been paid on the Bonds next preceding the date of its authentication, unless it is authenticated as of an Interest Payment Date for which interest has been paid or after the Record Date in respect thereof, in which event it shall bear interest from such Interest Payment Date, or unless it is authenticated on or before the Record Date for the first Interest Payment Date, in which event it shall bear interest from its date.

Both the principal and redemption price, including premium (if any), of the Bonds shall be payable by check in lawful money of the United States of America only upon presentation thereof at the Principal Office of the Trustee. Payment of the interest on any Bond shall be made by check in like lawful money to the person appearing on the Bond registration books of the Trustee as the registered owner thereof on the applicable Record Date, such interest to be paid by check mailed on the Interest Payment Date by first-class mail, postage prepaid, to the registered owner at its address as it appears on such registration books, except that the Trustee will, with respect to Pledged Bonds, and, at the written request of any registered owner of \$1,000,000 or more in aggregate principal amount of Bonds, make payments of interest on such Bonds by wire transfer to the account designated by such owner to the Trustee in writing at least 15 days before the Record Date for such payments, any such designation to remain in effect until withdrawn.

## **Holidays**

If the date for making any payment or the last date for performance of any act or the exercising of any right, as provided in the Indenture, is not a Business Day, such payment may be made or act performed or right exercised on the next succeeding Business Day with the same force and effect as if done on the date provided therefor in the Indenture and, in the case of any payment, no interest shall accrue for the period from and after such date.

## **Variable Rate—Weekly Mode**

The Bonds shall initially bear interest at Variable Rates of interest in the Weekly Mode. The Variable Rates of interest borne by the Bonds during each Variable Interest Accrual Period while the Bonds bear interest in the Weekly Mode shall be the Variable Rates determined by the Remarketing

Agent and reported to the Trustee, the Tender Agent, the Developer and the Credit Bank, as provided in the Indenture, no later than the Business Day next succeeding the Variable Interest Computation Date for such Variable Interest Accrual Period. Any Bondholder may obtain information on the Variable Rates by written request to the Trustee. The Bonds shall bear interest during any Variable Period computed on the basis of a 365- or 366-day year, as appropriate, and actual number of days elapsed.

Upon the receipt of written notice from the Remarketing Agent that the first day of a Variable Interest Accrual Period is to change, the Trustee shall provide written notice to the Bondholders of such change.

The Variable Rate determined by the Remarketing Agent on each Variable Interest Computation Date shall be the rate of interest which, if borne by the Bonds would, in its reasonable commercial judgment (having due regard to prevailing financial market conditions) be the interest rate necessary, but which would not exceed the interest rate necessary, to produce as nearly as practicable a par bid (disregarding accrued interest) if such Bonds were sold on the first day of the next Variable Interest Accrual Period; provided, however, that in no event shall any Variable Rate at any time exceed the Maximum Interest Rate. If the Remarketing Agent shall fail or refuse to determine the Variable Rate on any Variable Interest Computation Date, then the existing Variable Rate shall remain in effect for each Variable Interest Accrual Period thereafter until the Remarketing Agent determines the Variable Rate as described above.

The determination of the Variable Rates by the Remarketing Agent shall (in the absence of manifest error) be conclusive and binding on the holders of the Bonds, the Issuer, the Developer, the Credit Bank, the Remarketing Agent, the Tender Agent and the Trustee, and each shall be protected in relying on it.

### **Adjustment of Interest Rates**

The Developer may cause the interest rates on the Bonds to be adjusted to Reset Rates or Variable Rates in the Daily Mode (so long as no Standby Letter of Credit is then in effect) or converted to Fixed Rates. In connection with such any adjustment, the Bonds will be subject to mandatory tender for purchase. See “THE BONDS—Mandatory Purchase” herein.

THIS OFFICIAL STATEMENT IS INTENDED FOR USE WITH RESPECT TO THE BONDS ONLY DURING THE WEEKLY MODE, WHICH IS THE PERIOD BEGINNING ON THE DATE OF ISSUANCE OF THE BONDS AND ENDING ON THE DATE, IF ANY, ON WHICH THE INTEREST RATES ON THE BONDS ARE ADJUSTED TO RESET RATES OR TO VARIABLE RATES IN THE DAILY MODE OR CONVERTED TO FIXED RATES.

### **Purchase of Bonds on Demand**

Any Bond (other than Pledged Bonds), or any portion of the principal amount thereof in Authorized Denominations, shall be purchased, from proceeds of a drawing on the Letter of Credit or the Standby Letter of Credit on any Business Day during a Variable Period at the option of the Owner or Beneficial Owner of the Bond. Such purchase shall be made upon, in the case of a demand purchase while the Bonds bear interest at a Variable Rate in the Weekly Mode, delivery to the Tender Agent, with a copy provided by the Tender Agent to the Trustee and the Remarketing Agent, of a written notice in the form set forth as an exhibit to the Indenture (a “Tender Notice”), which notice shall upon receipt by the Tender Agent be irrevocable, and states (A) the principal amount of such Bond for which payment is demanded, and (B) the date on which such Bond or portion of the principal amount thereof in Authorized Denominations shall be purchased as described under this heading, which date shall be a Business Day

not prior to the seventh day next succeeding the date of the receipt of the Tender Notice by the Tender Agent, and in the case of Bonds tendered during a Reset Period or on a Conversion Date, shall be the day following the last day of such Reset Period or the Conversion Date. In all cases (other than as described in the preceding sentence), such Bond (with an appropriate transfer of registration form executed in blank and in form satisfactory to the Tender Agent) shall be delivered to the Tender Agent at or prior to 11:00 a.m., New York City time, on the Demand Date. While a depository is appointed pursuant to the Indenture and a “book-entry-only” system is in effect with respect to the Bonds, delivery of Bonds for purchase on the Demand Date may be effected in the manner set forth by such depository.

Immediately upon receipt of a Tender Notice described in (i) and (ii) above, the Tender Agent shall give telephonic or facsimile transmission notice to the Trustee of the principal amount of Bonds to be purchased pursuant to such Tender Notice. The Trustee shall, on receipt of any Tender Notice described above, draw on the Letter of Credit immediately in an amount equal to the principal amount of the Bonds to be purchased plus accrued interest thereon.

Payment of the Purchase Price of any Bond shall be made by wire transfer (if requested in writing by the registered owner of \$1,000,000 or more in aggregate principal amount of Bonds) or as designated in the Tender Notice with respect to such Bond, but only upon delivery and surrender of such Bond to the Tender Agent on the Demand Date.

Anything in the Indenture to the contrary notwithstanding, no Bonds shall be purchased as described under this heading or remarketed if an Event of Default under the Indenture, other than an Event of Default described in paragraph (d) under the heading “SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE—Defaults and Remedies” herein, shall have occurred and be continuing and notice of the redemption described in paragraph (c) under the heading “REDEMPTION OF BONDS—Terms of Redemption” herein shall have been given to Bondholders; and no Bonds shall be purchased as described under this heading or remarketed pursuant to the Indenture after the Conversion Date; nor shall any Bond be purchased as described under this heading if such Bond is known by the Trustee to be registered in the name of the Issuer, the Developer or any partner or guarantor of the Developer.

### **Mandatory Purchase**

The Trustee shall notify the registered owners of the Bonds of a mandatory tender and purchase of the Bonds at the Purchase Price, payable from the proceeds of a drawing on the Letter of Credit or the Standby Letter of Credit, (A) on any Reset Date (which includes any date upon which the Bonds begin to bear interest at a Reset Rate for the succeeding Reset Period, at a Variable Rate following a Reset Period or in a Variable Rate of a different mode) or the Conversion Date; (B) on any date on which a substitute Letter of Credit or substitute Standby Letter of Credit is to be exchanged for the then effective Letter of Credit or Standby Letter of Credit, respectively, pursuant to the terms of the Loan Agreement; (C) on any date on which a Substitute Credit Facility is being provided pursuant to the Loan Agreement; (D) on the last Business Day that is not less than five days before the date of the expiration of the Standby Letter of Credit, unless the Trustee receives, on a Business Day that is not less than 15 days before such date of expiration, a commitment for the renewal or extension of or replacement for such Standby Letter of Credit meeting the requirements of the Loan Agreement; or (E) on the first Business Day that is at least five days after the occurrence of a Determination of Taxability (each a “Mandatory Tender Date”), by first-class mail, postage prepaid, not less than 10 days prior to the Mandatory Tender Date as further described below. Any Bond not tendered for purchase on or before the Mandatory Tender Date shall be deemed to have been tendered for purchase on such Mandatory Tender Date for all purposes of the Indenture.



On the tenth day before each Mandatory Tender Date, the Trustee shall notify the Tender Agent by telephone, promptly confirmed in writing, with a copy to the Remarketing Agent, that all of the Bonds are deemed tendered for purchase on the Mandatory Tender Date and such notice from the Trustee shall be treated as a Tender Notice for all purposes of the Indenture whether or not the Bonds referred to therein are delivered to the Tender Agent, provided that payment of the Purchase Price of any such Bonds shall be made only upon delivery and surrender thereof to the Tender Agent.

The Trustee shall give notice of the mandatory tender and purchase to the registered owners of the Bonds specifying: (i) the Mandatory Tender Date; (ii) that all Outstanding Bonds not tendered for purchase on or before the Mandatory Tender Date will be deemed to have been so tendered and shall be purchased on the Mandatory Tender Date at a price equal to the principal amount thereof plus interest accrued to such date; and (iii) that all Bonds must be surrendered to the Tender Agent for purchase not later than 11:00 a.m., New York City time, on such Mandatory Tender Date. Any Bond not tendered to the Tender Agent on or before the Mandatory Tender Date shall be deemed to have been tendered for purchase on such Mandatory Tender Date as described under this heading for all purposes of the Indenture.

Any Bond subject to mandatory tender pursuant to the provisions of the Indenture described under the heading "Purchase of Bonds on Demand" above from the date notice of mandatory purchase as described under this heading is given through the Mandatory Tender Date shall not be remarketed except to a purchaser who, at the time of such purchase, agrees that such Bond will be deemed tendered on the Mandatory Tender Date.

Unless a Letter of Credit meeting the requirements of the Loan Agreement and, to the extent required, a Standby Letter of Credit meeting the requirements of the Loan Agreement or Substitute Credit Facility meeting the requirements of the Loan Agreement is provided, the Bonds tendered or deemed tendered as described under this heading shall not be remarketed.

### **Limited Obligations**

THE BONDS ARE LIMITED OBLIGATIONS OF THE ISSUER, PAYABLE SOLELY FROM THE REVENUES AND OTHER FUNDS AND MONEYS PLEDGED AND ASSIGNED UNDER THE INDENTURE. NEITHER THE ISSUER, ANY OF ITS PROGRAM PARTICIPANTS, THE STATE OF CALIFORNIA (THE "STATE"), NOR ANY POLITICAL SUBDIVISION THEREOF (EXCEPT THE ISSUER, TO THE LIMITED EXTENT SET FORTH IN THE INDENTURE) NOR ANY PUBLIC AGENCY SHALL IN ANY EVENT BE LIABLE FOR THE PAYMENT OF THE PRINCIPAL OF, PREMIUM (IF ANY) OR INTEREST ON THE BONDS OR FOR THE PERFORMANCE OF ANY PLEDGE, OBLIGATION OR AGREEMENT OF ANY KIND WHATSOEVER EXCEPT AS SET FORTH IN THE INDENTURE, AND NONE OF THE BONDS OR ANY OF THE ISSUER'S AGREEMENTS OR OBLIGATIONS SHALL BE CONSTRUED TO CONSTITUTE AN INDEBTEDNESS OF OR A PLEDGE OF THE FAITH AND CREDIT OF OR A LOAN OF THE CREDIT OF OR A MORAL OBLIGATION OF ANY OF THE FOREGOING WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION WHATSOEVER. THE ISSUER HAS NO TAXING POWER.

No recourse shall be had for the payment of the principal of, premium, if any, or interest on any of the Bonds or for any claim based thereon or upon any obligation, covenant or agreement contained in the Indenture, against the Issuer, any past, present or future member of its governing body, its officers, attorneys, accountants, financial advisors, agents or staff, or the officers, attorneys, accountants, financial advisors, agents or staff of any successor public entity, as such, either directly or through the Issuer or any successor public entity, under any rule of law or penalty or otherwise, and all such liability of the Issuer,

any member of its governing body and its officers, attorneys, accountants, financial advisors, agents and staff is by the acceptance of the Bonds expressly waived and released as a condition of, and in consideration for, the execution of the Indenture and the issuance of any of the Bonds.

Notwithstanding any other provision of the Indenture, neither the Developer, the Trustee nor any Bondholder shall look to the Issuer for damages suffered by the Developer, the Trustee or such Bondholder as a result of the failure of the Issuer to perform any covenant, undertaking or obligation under the Indenture, the Loan Agreement, the Bonds or any of the other documents referred to in the Indenture, or as a result of the incorrectness of any representation made by the Issuer in any of such documents, nor for any other reason. Although the Indenture recognizes that such documents shall not give rise to any pecuniary liability of the Issuer, nothing contained in the Indenture shall be construed to preclude in any way any action or proceeding (other than that element of any action or proceeding involving a claim for monetary damages against the Issuer) in any court or before any governmental body, agency or instrumentality or otherwise against the Issuer or any of its officers or employees to enforce the provisions of any of such documents which the Issuer is obligated to perform and the performance of which the Issuer has not assigned to the Trustee or any other person; provided, however, that as a condition precedent to the Issuer proceeding pursuant to the provisions of the Indenture described under this heading, the Issuer shall have received satisfactory indemnification.

### **Book-Entry Only System**

*The information under this heading has been furnished by DTC, and has not been independently verified by the Issuer, the Trustee, the Developer, the Underwriter, the Remarketing Agent, the Credit Bank or the Standby Credit Bank. None of the Issuer, the Trustee, the Developer, the Underwriter, the Remarketing Agent, the Credit Bank or the Standby Credit Bank make any representation whatsoever as to the accuracy, adequacy or completeness of such information.*

The Depository Trust Company (“DTC”), New York, NY, will act as securities depository for the Bonds. The Bonds will be issued as fully-registered Bonds registered in the name of Cede & Co. (DTC’s partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered Bond certificate will be issued for each issue of the Bonds, each in the aggregate principal amount of such issue, and will be deposited with DTC. If, however, the aggregate principal amount of any issue exceeds \$500 million, one certificate will be issued with respect to each \$500 million of principal amount, and an additional certificate will be issued with respect to any remaining principal amount of such issue.

DTC, the world’s largest securities depository, is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments (from over 100 countries) that DTC’s participants (“Direct Participants”) deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities, through electronic computerized book-entry transfers and pledges between Direct Participants’ accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation (“DTCC”). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the

DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (“Indirect Participants”). DTC has a Standard & Poor’s rating of AA+. The DTC Rules applicable to its Participants are on file with the Securities and Exchange Commission. More information about DTC can be found at [www.dtcc.com](http://www.dtcc.com).

Purchases of Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Bonds on DTC’s records. The ownership interest of each actual purchaser of each Bond (“Beneficial Owner”) is in turn to be recorded on the Direct and Indirect Participants’ records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in Bonds, except in the event that use of the book-entry system for the Bonds is discontinued.

To facilitate subsequent transfers, all Bonds deposited by Direct Participants with DTC are registered in the name of DTC’s partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of Bonds with DTC and their registration in the name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Bonds; DTC’s records reflect only the identity of the Direct Participants to whose accounts such Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. Beneficial Owners of Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Bonds, such as redemptions, tenders, defaults, and proposed amendments to the Bond documents. For example, Beneficial Owners of Bonds may wish to ascertain that the nominee holding the Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the registrar and request that copies of notices be provided directly to them.

Redemption notices shall be sent to DTC. If less than all of the Bonds within an issue are being redeemed, DTC’s practice is to determine by lot the amount of the interest of each Direct Participant in such issue to be redeemed.

Neither DTC nor Cede & Co. (nor any other DTC nominee) will consent or vote with respect to Bonds unless authorized by a Direct Participant in accordance with DTC’s MMI Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to Issuer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.’s consenting or voting rights to those Direct Participants to whose accounts Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Redemption proceeds, distributions, and dividend payments on the Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC’s practice is to credit Direct Participants’ accounts upon DTC’s receipt of funds and corresponding detail information from Issuer or Agent, on payable date in accordance with their respective holdings shown on

DTC's records. Payments by Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC, Agent, or Issuer, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of redemption proceeds, distributions, and dividend payments to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of Issuer or Agent, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct and Indirect Participants.

A Beneficial Owner shall give notice to elect to have its Bonds purchased or tendered, through its Participant, to the Tender Agent and Remarketing Agent, and shall effect delivery of such Bonds by causing the Direct Participant to transfer the Participant's interest in the Bonds, on DTC's records, to the Tender Agent and Remarketing Agent. The requirement for physical delivery of Bonds in connection with an optional tender or a mandatory purchase will be deemed satisfied when the ownership rights in the Bonds are transferred by Direct Participants on DTC's records and followed by a book-entry credit of tendered Bonds to the Tender Agent or Remarketing Agent's DTC account, as applicable.

DTC may discontinue providing its services as depository with respect to the Bonds at any time by giving reasonable notice to Issuer or Agent. Under such circumstances, in the event that a successor depository is not obtained, Bond certificates are required to be printed and delivered.

The Issuer may decide to discontinue use of the system of book-entry-only transfers through DTC (or a successor securities depository). In that event, Bond certificates will be printed and delivered to DTC.

The information in this section concerning DTC and DTC's book-entry system has been obtained from sources that Issuer believes to be reliable, but Issuer takes no responsibility for the accuracy thereof.

## **REDEMPTION OF BONDS**

### **Terms of Redemption**

The Bonds are subject to redemption upon the circumstances, on the dates and at the prices set forth as follows:

(a) The Bonds are subject to optional redemption in whole or in part, on any Business Day during any Variable Period in connection with voluntary prepayments of the Loan from moneys received from the Credit Bank or the Standby Credit Bank following a draw on the Letter of Credit or Standby Letter of Credit, respectively, at a redemption prices equal to 100% of the principal amount of the Bonds called for redemption (provided, however, that following any such prepayment no Bond shall be Outstanding in an amount other than an Authorized Denomination), plus interest accrued thereon to the date fixed for redemption.

(b) The Bonds shall be subject to redemption in whole or in part on any Business Day at a price equal to the principal amount of Bonds redeemed, plus interest accrued thereon to the date fixed for redemption, without premium, upon prepayment of the Loan in whole or in part, from moneys received from the Credit Bank or the Standby Credit Bank following a draw on the Letter of Credit or Standby Letter of Credit, respectively, in an amount as nearly equal as possible to, but not exceeding, the amount of any Net Proceeds of insurance or condemnation awards not used to repair or replace the Project.

(c) The Bonds shall be subject to redemption in whole on any Business Day from moneys received from the Credit Bank or the Standby Credit Bank following a draw on the Letter of Credit or Standby Letter of Credit, respectively, at a price equal to the principal amount of Bonds redeemed, plus interest accrued thereon to the date fixed for redemption, without premium, upon acceleration of the Loan in whole or, at the request of or with the consent of the Credit Bank following (i) any other Event of Default under the Loan Agreement (except an Event of Default described in paragraph (d) under the heading “SUMMARY OF CERTAIN PROVISIONS OF THE LOAN AGREEMENT—Events of Default and Remedies—Events of Default” herein), in an amount as nearly equal as possible to, but not exceeding, the amount of the Loan so accelerated, or (ii) any Event of Default under the Credit Agreement as so notified by the Credit Bank; and in all cases on a date not later than 10 days following receipt of such notice, in an amount equal to the amount of the Bonds Outstanding.

(d) The Bonds shall be subject to redemption in whole from moneys received from the Credit Bank or the Standby Credit Bank following a draw on the Letter of Credit or Standby Letter of Credit, respectively, at a price equal to the principal amount thereof, plus interest accrued thereon to the date fixed for redemption, without premium, on the last Business Day that is not less than five days before the date of expiration of the Letter of Credit, unless, not less than 10 days before the expiration of the then existing Letter of Credit, the Trustee receives a renewal or extension of or replacement for such Letter of Credit meeting the requirements of the Loan Agreement.

(e) The Bonds shall be subject to redemption in whole from moneys received from the Standby Credit Bank following a draw on the Standby Letter of Credit, at a price equal to the principal amount of Bonds so called for redemption, plus interest accrued thereon to the date of redemption, without premium, on any Business Day not later than five days after the date on which the Credit Bank fails to honor a properly presented and conforming draw on the Letter of Credit or the Letter of Credit is repudiated.

Within five (5) Business Days of each payment by the Developer of principal on the Bonds pursuant to an optional or other redemption, the Trustee will notify the Issuer via mutually acceptable electronic means, with receipt confirmed by sender of the aggregate principal amount of Bonds that remain Outstanding or that no Bonds remain Outstanding.

The Trustee has been authorized and directed, and has agreed, to give notice of the call for redemption of Bonds at the times described in this paragraph, to fix the date for any such redemption within the periods described under the heading “Notice of Redemption” below, and, if moneys from the sources described above are available, to redeem the Bonds so called on the date so fixed by the Trustee and set forth in such notice. The Trustee shall give such redemption notice (i) in the case of redemption described in paragraph (b) above, not less than 90 days after receipt of the amounts from the Credit Bank or the Standby Credit Bank and, in the case of redemption described in paragraph (a) above, not less than 90 days after receipt of the amounts the Available Amounts to be applied to such redemption, or at any time and in any amount specified by the Developer or the Credit Bank in a written notice to the Trustee, delivered no less than 10 days prior to the date on which the Trustee is required to give such notice of redemption, certifying that the Credit Bank has agreed that the Letter of Credit may be drawn to cover such redemption (and in such event the Trustee is authorized to draw on the Letter of Credit in connection with such redemption); (ii) in the case of redemption pursuant to (d) above, at the time described under the heading “Notice of Redemption” below, without any further authorization or direction; (iii) in the case of redemption pursuant to (c) above, as soon as practicable, but not more than five days after receipt from the Credit Bank of a request for or consent to acceleration of the Loan following any Event of Default under the Loan Agreement or following any Event of Default under the Credit Agreement which request

or consent shall be delivered to the Trustee no later than six days prior to the redemption date; and (iv) in the case of a redemption pursuant to (e) above, as soon as practicable, but not more than two days after the Credit Bank has failed to honor a drawing made under the Letter of Credit or the Trustee has actual knowledge such Letter of Credit has been repudiated. For all purposes of the Indenture, such “actual knowledge” shall mean actual knowledge at the Principal Office of the Trustee by the officer of the Trustee with responsibility for the regular administration of matters related to the Indenture.

### **Selection of Bonds for Redemption**

When any redemption is made pursuant to any of the provisions of the Indenture and less than all of the Outstanding Bonds are to be redeemed, the Trustee shall select the Bonds to be redeemed by lot, in any manner the Trustee deems appropriate, in whole multiples of Authorized Denominations unless otherwise provided in the Indenture; provided, however, that Pledged Bonds shall be the first Bonds selected for redemption and then Bonds. In no event shall Bonds be redeemed in amounts other than whole multiples of Authorized Denominations. For purposes of redeeming Bonds in denominations greater than minimum Authorized Denominations, the Trustee shall assign to such Bonds a distinctive number for each such principal amount and, in selecting Bonds for redemption by lot, shall treat such amounts as separate Bonds. The Trustee shall promptly notify the Issuer in writing of the numbers of the Bonds selected for redemption.

If any Bonds tendered for purchase pursuant to the provisions of the Indenture described under the headings “THE BONDS—Purchase of Bonds on Demand” and “—Mandatory Purchase” herein and delivered pursuant to the Indenture shall have been selected for redemption, then the new Bond delivered pursuant to the Indenture shall be delivered with notice that it is subject to such redemption and shall be deemed to be the Bond so selected for redemption notwithstanding the notice period described under the heading “Notice of Redemption” below.

### **Notice of Redemption**

Notice of redemption shall be given by the Trustee, by first-class mail, postage prepaid, not more than 30 and not less than 10 days or, in the case of a redemption described in paragraphs (c) or (d) under the heading “Terms of Redemption” above, not less than five days prior to the redemption date or, in the case of a redemption described in paragraph (e) under the heading “Terms of Redemption” above, not less than three days prior to the redemption date, to the registered owner of each Bond called for redemption, at its address as it appears on the registration books, but neither failure to mail such notice to any Bondholder nor any defect in any notice so mailed shall affect the sufficiency of the proceedings for the redemption of any of the Bonds with respect to which such failure or defect shall have occurred. Each notice of redemption shall state the redemption date, the place of redemption, the source of the funds to be used for such redemption, the principal amount and, if less than all, the distinctive numbers of the Bonds to be redeemed, and shall also state that the interest on the Bonds in such notice designated for redemption shall cease to accrue from and after such redemption date and that on said date there will become due and payable on each of said Bonds the principal amount thereof to be redeemed, interest accrued thereon to the redemption date and the premium, if any, thereon (such premium to be specified). Neither the Issuer nor the Trustee shall have any responsibility for any defect in the CUSIP number that appears on any Bond or in any redemption notice with respect thereto, and any such redemption notice may contain a statement to the effect that CUSIP numbers have been assigned by an independent service for convenience of reference and that neither the Issuer nor the Trustee shall be liable for any inaccuracy in such numbers. The Trustee may provide a conditional notice of redemption upon the direction of the Credit Bank or the Developer (with the prior written consent of the Credit Bank).

Each redemption notice shall also be sent by facsimile transmission, overnight delivery service or other secure means, postage prepaid, to the Remarketing Agent, to certain municipal registered Securities Depositories that are known to the Trustee to be holding Bonds and to at least two of the national Information Services that disseminate securities redemption notices, at the time notice is provided to the registered owners prior to the redemption date, and in the case of the notice to Securities Depositories, when possible, at least two days prior to the mailing of notices required by the first paragraph under this heading. Failure to give notice by mailing to any Securities Depository or Information Service, failure to receive such notice, any defect of any notice so mailed or the failure to give timely notice of redemption shall not affect the validity of the proceedings for the redemption of any Bond.

### **Effect of Redemption**

Notice of redemption having been duly given as described under the heading “Notice of Redemption” above, and moneys for payment of the redemption price being held by the Trustee, the Bonds so called for redemption shall, on the redemption date designated in such notice, become due and payable at the redemption price specified in such notice, interest on the Bonds so called for redemption shall cease to accrue, said Bonds shall cease to be entitled to any lien, benefit or security under the Indenture, and the holders of said Bonds shall have no rights in respect thereof except to receive payment of the redemption price thereof.

All Bonds fully redeemed pursuant to the provisions of the Indenture shall be destroyed by the Trustee, which shall thereupon deliver to the Issuer a certificate evidencing such destruction.

### **Purchase in Lieu of Redemption**

If the Bonds shall become eligible for redemption as described in paragraphs (c), (d) or (e) under the heading “Terms of Redemption” above, the Bonds shall either (i) be redeemed in accordance with the applicable provisions of the Indenture or (ii) be purchased in lieu of redemption by the Credit Bank if the Credit Bank shall have given written notice to the Trustee no later than 10:00 a.m., Pacific time, on or before the second Business Day immediately preceding the date otherwise scheduled for redemption to the effect that the Credit Bank desires that all of the Bonds be purchased by the Credit Bank and not redeemed. If such a notice is provided to the Trustee by the Credit Bank, then the Bonds shall not be redeemed but shall be purchased by the Credit Bank. The purchase price for each Bond shall be equal to the redemption price which would otherwise apply as described under the heading “Terms of Redemption” above and shall be paid from the proceeds of a draw on the Letter of Credit or the Standby Letter of Credit.

## **SOURCES OF PAYMENT FOR THE BONDS**

### **Generally**

All of the Revenues have been irrevocably pledged by the Indenture first to the punctual payment of the principal of, premium, if any, and interest on the Bonds and second to the payment of all amounts owed to the Credit Bank under the Credit Agreement, subject to the provisions of the Indenture permitting the application of such Revenues for the purposes and on the terms and conditions set forth in the Indenture.

The Issuer has transferred in trust, granted a security interest in and assigned to the Trustee, for the benefit of the holders from time to time of the Bonds and the Credit Bank, all of its right, title and interest in the Revenues, as further provided in the Indenture, and in the Issuer Loan Documents (except for its Reserved Rights).

All Revenues shall be held in trust for the benefit of the holders from time to time of the Bonds and the Credit Bank, but shall nevertheless be disbursed, allocated and applied solely for the uses and purposes set forth in the Indenture.

### **The Letter of Credit**

The Developer will enter into the Credit Agreement with the Credit Bank wherein the Credit Bank will agree to issue and deliver the Letter of Credit in an amount set forth therein (as from time to time increased, reduced or reinstated as provided in the Letter of Credit, the “Letter of Credit Amount”). The Letter of Credit Amount shall be available for drawing by the Trustee as set forth below in amounts (a) not to exceed an amount equal to the principal amount of the Bonds as drawn down (as from time to time reduced or reinstated as provided in the Letter of Credit, the “Principal Component”) with respect to the unpaid principal of the Bonds, and (b) not to exceed interest on such amounts as set forth therein (as from time to time reduced and reinstated as provided in the Letter of Credit, the “Interest Component”) with respect to the accrued interest on the Bonds. The Letter of Credit will be effective immediately upon the issuance of the Bonds and will terminate in accordance with its terms upon the earlier of the expiration date of the Letter of Credit set forth on the cover hereof, or the date of payment of a final payment drawing under the Indenture for the redemption price of Bonds due under the Indenture for the principal of and interest on the Bonds.

The Letter of Credit is available to be drawn upon to pay (a) the principal of or interest on the Bonds on the scheduled dates for payment of such amounts, upon redemptions of the Bonds described in paragraphs (a), (b), (c) or (d) under the heading “REDEMPTION OF BONDS—Terms of Redemption” above or upon acceleration of the Bonds, and (b) the purchase price of any Bond tendered to and required to be purchased by the Trustee which has not been remarketed by the Remarketing Agent.

If a draft in a form attached to the Letter of Credit is presented to the Credit Bank at the address set forth in the Letter of Credit on any “Business Day,” as defined below (each, a “Drawing”), and is presented before 11:00 a.m., Los Angeles time, payment is to be made by the Credit Bank on or before 9:30 a.m., Los Angeles time (or, in the case of presentation on and after 11:00 a.m., Los Angeles time, prior to 1:00 p.m., Los Angeles time), on the next Business Day after presentation. “Business Day” means any day other than a Saturday, a Sunday or a day on which banks in Los Angeles, California are authorized or required by law to close. All payments under the Letter of Credit will be made only with funds of the Credit Bank.

Each Drawing honored under the Letter of Credit shall immediately reduce the Principal Component or the Interest Component (as the case may be) by the amount of payment of such Drawing, and the Letter of Credit Amount shall be correspondingly reduced. Upon such honor, the obligations of the Credit Bank in respect of such Drawing shall be discharged, and the Credit Bank shall have no further obligations with respect to such Drawing. The Principal Component and the Interest Component (and correspondingly the Letter of Credit Amount) so reduced shall be reinstated only as follows:

(a) The Interest Component (and correspondingly the Letter of Credit Amount) so reduced shall be reinstated, in the case of a reduction resulting from a Drawing for payments of interest on the Bonds only, upon the Credit Bank’s honoring of such drawing to an amount equal to 39 days’ interest on the Principal Component, calculated at the rate of 12% per annum on the basis of a 365-day year.

(b) The Interest Component and the Principal Component (and correspondingly the Letter of Credit Amount) so reduced shall be reinstated, in the case of a reduction resulting from a Drawing for the purchase price of Bonds tendered for purchase, in the case of the Interest



Component and the Principal Component, automatically upon the Credit Bank's receipt from the Trustee of a certificate indicating that it has received the proceeds of the remarketing of the Bonds. In each such case, the Principal Component shall be reinstated in an amount equal to the portion of such payment attributable to reimbursement of a Drawing for the purchase price of Bonds tendered for purchase representing principal of the Bonds and the Interest Component shall be reinstated in an amount equal to 39 days' interest on such principal amount calculated at the rate of 12% per annum on the basis of a 365-day year.

A form of the Letter of Credit is attached hereto as Appendix B.

### **The Standby Letter of Credit**

The Standby Letter of Credit issued by the Standby Credit Bank has the scheduled expiration date set forth on the cover hereof (the "Scheduled Expiration Date"). The amount that may be drawn under the Standby Letter of Credit is set forth therein. The Standby Letter of Credit terminates upon the earliest of (i) the Scheduled Expiration Date; (ii) the date the Standby Credit Bank honors any demand for payment under the Standby Letter of Credit; or (iii) the date the Standby Letter of Credit is surrendered to the Standby Credit Bank for cancellation. The Standby Credit Bank will honor draw requests presented in full compliance with the terms of the Standby Letter of Credit at or before 10:00 a.m., California time, on a Business Day (as defined below), by making payment of the Drawing amount by 10:30 a.m., California time, on the next Business Day. Documents received after 10:00 a.m., California time, will be deemed to have been received before 10:00 a.m., California time, on the next Business Day. As used in the Standby Letter of Credit, a "Business Day" is any day on which the Standby Credit Bank is open for business.

In the event the Standby Letter of Credit is drawn upon, all Outstanding Bonds will be redeemed or purchased in lieu of redemption.

A form of the Standby Letter of Credit is attached hereto as Appendix C.

### **Draws on the Letter of Credit and Standby Letter of Credit**

***Draws on the Letter of Credit.*** The Issuer has authorized and directed the Trustee, and the Trustee has agreed, to draw on the Letter of Credit in accordance with its terms, in order to receive payment thereunder on the following dates in the following amounts:

- (a) On the Business Day preceding each Interest Payment Date, in an amount that will be sufficient to pay the interest due and payable on such Interest Payment Date on all Outstanding Bonds;
- (b) To the extent allowed under any Letter of Credit then in effect, on the Business Day preceding any date fixed for redemption of Bonds, in an amount that will be sufficient to pay the redemption price, including accrued interest to the date of redemption, of such Bonds;
- (c) On the Business Day preceding the date fixed for payment of the Bonds in connection with any declaration of the acceleration of the maturity of the Bonds following an Event of Default, as provided in the Indenture, in an amount that will be sufficient to pay all principal and interest due on the Bonds as a result of such declaration on the date fixed for such payment;

(d) On the Business Day preceding each Demand Date, in an amount sufficient to pay the Purchase Price of any Bonds tendered pursuant to the provisions of the Indenture described under the headings “THE BONDS—Purchase of Bonds on Demand” and “—Mandatory Purchase” herein, such draw to be in an amount not less than the total Purchase Price of the Bonds so tendered, as such amounts are identified to the Trustee by the Remarketing Agent and the Tender Agent pursuant to the provisions of the Indenture;

(e) On the Business Day preceding the final maturity date of the Bonds, in an amount that will be sufficient to pay the principal and interest due on all Outstanding Bonds on such final maturity date; and

(f) On the Business Day prior to the date fixed for redemption of Bonds described in paragraphs (c), (d) or (e) under the heading “Terms of Redemption” above in the event that the Credit Bank shall have provided the notice required in connection with a purchase in lieu of redemption of the Bonds, in an amount sufficient to pay the Purchase Price of all Bonds to be purchased in lieu of redemption pursuant to the Indenture.

Each such drawing shall be made not later than the time required by the Letter of Credit in order to receive payment thereunder on the Business Day preceding the day on which payment of the amount of such drawing is required to be made to the holders of the Bonds pursuant to the Indenture so that the Trustee may timely draw on the Standby Letter of Credit if the Credit Bank fails to advance funds in accordance with any draw under the Indenture. The Trustee shall comply with all provisions of the Letter of Credit in order to realize upon any drawing thereunder, and will not draw upon the Letter of Credit at any time for payment of the principal or Purchase Price of and interest on any Bonds registered in the name of the Credit Bank or the Developer or any partner or guarantor of the Developer or the Issuer or known by the Trustee to be registered in the name of any nominee of the Credit Bank, the Developer, any partner or guarantor of the Developer, or the Issuer (provided that the Trustee shall have no duty to investigate whether Bonds are registered in the names of such nominees).

All draws made on a date when the applicable interest rate on the Bonds through the date proceeds of such draw will be applied to payment of the Bonds is unknown shall be made assuming that the interest rate will, on each Variable Rate Computation Date prior to the date such payment on the Bonds is made, be the Maximum Interest Rate.

***Draws on the Standby Letter of Credit.*** Except as otherwise described in the following paragraph, in the event the Credit Bank fails to honor a properly presented and conforming draw on the Letter of Credit in a timely manner or the Letter of Credit is repudiated, the Issuer has authorized and directed the Trustee, and the Trustee has agreed, to draw on the Standby Letter of Credit in the full stated amount of the Standby Letter of Credit in accordance with its terms, in order to immediately receive payment thereunder, on the date amounts drawn on the Letter of Credit were to be applied pursuant to the Indenture, as to allow the payments due and payable to the Bondholders to be made in a timely manner and to effect a redemption of the Bonds described in paragraph (e) under the heading “REDEMPTION OF BONDS—Terms of Redemption” herein.

Such drawing shall be made not later than the time required by the Standby Letter of Credit in order to receive payment thereunder on the Business Day on which payment of the amount of such drawing is required to be made to the holders of the Bonds pursuant to the Indenture. The Trustee shall comply with all provisions of the Standby Letter of Credit in order to realize upon any drawing thereunder, and will not draw upon the Standby Letter of Credit at any time for payment of the principal or Purchase Price of any Bonds registered in the name of the Credit Bank, the Developer, any partner or guarantor of the Developer, the Issuer, or known by the Trustee to be registered in the name of any

nominee of the Credit Bank, the Developer, any partner or guarantor of the Developer, or the Issuer (provided that the Trustee shall have no duty to investigate whether Bonds are registered in the names of such nominees).

### **East West Bank**

*The information under this heading has been furnished by the Credit Bank, and has not been independently verified by the Issuer, the Trustee, the Developer, the Underwriter, the Remarketing Agent or the Standby Credit Bank. None of the Issuer, the Trustee, the Developer, the Underwriter, the Remarketing Agent or the Standby Credit Bank make any representation whatsoever as to the accuracy, adequacy or completeness of such information.*

East West Bank, a California banking corporation ("East West Bank"), is organized under the laws of the State of California. East West Bank's principal office is located in Pasadena, California.

Neither the Issuer nor the Underwriter has made an independent determination of the financial position of East West Bank. Additional information on East West Bank, including available annual audits, is available, upon reasonable request, by writing East West Bank, 135 N. Los Robles Ave., 2nd Floor, Pasadena, California 91101.

### **Federal Home Loan Bank of San Francisco**

*The information under this heading has been furnished by the Standby Credit Bank, and has not been independently verified by the Issuer, the Trustee, the Developer, the Underwriter, the Remarketing Agent or the Credit Bank. None of the Issuer, the Trustee, the Developer, the Underwriter, the Remarketing Agent or the Credit Bank make any representation whatsoever as to the accuracy, adequacy or completeness of such information.*

Excerpts from the Standby Credit Bank's Annual Report on Form 10-K for the fiscal year ended December 31, 2013, and its Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2014, filed with the Securities and Exchange Commission appear in Appendix D hereto. The Standby Credit Bank has represented that such financial statements were prepared using generally accepted accounting principles in the United States and, except for the financial statements at and for the three months ending March 31, 2014, were audited using generally accepted auditing standards.

### **Substitute Letter of Credit, Standby Letter of Credit or Substitute Credit Facility**

***Effect of Delivery.*** Subject to certain exceptions described below, the Bonds are subject to mandatory tender in connection with the delivery of any substitute Letter of Credit, Standby Letter of Credit or Substitute Credit Facility. See "THE BONDS—Mandatory Purchase" herein.

Notwithstanding anything in the Loan Agreement or the Indenture to the contrary, an extension of the existing Letter of Credit or Standby Letter of Credit affected by an amendment, which amendment changes nothing other than the expiration date of the Letter of Credit or Standby Letter of Credit, need not comply with the requirements for substitute Letters of Credit or Standby Letters of Credit described below and such extensions shall not cause a mandatory tender of the Bonds under the Indenture. Notice of any such amendment shall be provided to the Remarketing Agent no fewer than 10 days in advance of the effectiveness thereof.

***Substitute Letter of Credit.*** There shall be provided and continuously available to the Trustee, as beneficiary, an irrevocable direct-pay Letter of Credit (whether in the form of a letter of credit or any other credit instrument) meeting the requirements of the Loan Agreement described below while the Bonds bear interest at a Variable Rate. The Developer shall have the right at any time, whether or not in connection with Conversion or any Reset Date or the pending expiration of any then outstanding Letter of Credit, to provide to the Trustee a substitute Letter of Credit which meets the requirements described below, and the Trustee has been directed pursuant to the Indenture to accept any such substitute Letter of Credit.

Notwithstanding anything in the Loan Agreement to the contrary, an extension of the existing Letter of Credit affected by an amendment, which amendment changes nothing other than the expiration date of the Letter of Credit, need not comply with the requirements for substitute Letters of Credit described below and such extension shall not cause a mandatory tender of the Bonds under the Indenture. Notice of any such amendment shall be provided to the Remarketing Agent no fewer than 10 days in advance of the effectiveness thereof.

The following requirements shall apply to any Letter of Credit provided while the Bonds bear interest at a Variable Rate:

(a) The Letter of Credit initially provided shall be effective from the Closing Date, and any substitute Letter of Credit shall be for a term commencing not later than the expiration date of the term of the prior Letter of Credit.

(b) Any substitute Letter of Credit shall be for a term of not less than one year (or, if shorter, the remaining term of the Bonds), provided that any Letter of Credit may provide that it shall terminate prior to its stated expiration date upon a Reset Date or the Conversion Date or upon receipt by the Credit Bank of notice from the Trustee that no Bonds remain outstanding or upon the date of issuance and delivery of a substitute Letter of Credit.

(c) Each Letter of Credit shall be in an amount at any date not less than the sum of the aggregate principal amount of the Bonds then outstanding, plus an amount equal to interest on the Bonds for a period of 39 days (or such greater or lesser period required by the Rating Agency) at the Maximum Interest Rate.

(d) Each Letter of Credit shall permit drawings thereunder to pay amounts due on the Bonds, whether as principal or interest, on the scheduled dates for payment of such amounts or upon redemption or acceleration and to pay the purchase price of Bonds tendered for purchase as described under the headings “THE BONDS—Purchase of Bonds on Demand” and “—Mandatory Purchase” herein, and provide for automatic and irrevocable reinstatement of the amount thereof upon any drawing thereunder to pay interest on the Bonds and shall be in a form acceptable to the Trustee.

(e) Each Letter of Credit shall be issued by an issuer acceptable to the Issuer and the Trustee.

(f) Each substitute Letter of Credit delivered to the Trustee must be accompanied by (A) an opinion of Bond Counsel addressed to the Trustee and the Remarketing Agent to the effect that delivery of such substitute Letter of Credit complies with the provisions of the Loan Agreement and the Indenture and will not cause interest on the Bonds to become includable in gross income for federal income tax purposes and (B) one or more opinions of counsel for the Credit Bank addressed to the Trustee to the effect, singly or together, that the Letter of Credit is

a legal, valid and binding obligation of the Credit Bank, enforceable against the Credit Bank in accordance with its terms, except as limited by applicable reorganization, insolvency, liquidation, readjustment of debt, moratorium or other similar laws affecting the enforcement of the rights of creditors generally as such laws may be applied in the event of a reorganization, insolvency, liquidation, readjustment of debt or other similar proceeding of or moratorium applicable to the Credit Bank and by general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

(g) Each substitute Letter of Credit delivered to the Trustee shall be accompanied by a written statement, signed by an officer of each Rating Agency which then maintains a rating on the Bonds, stating the expected rating on the Bonds as a result of such substitution, which rating, in any event, without the Issuer's approval, will not be lower than "A."

(h) The commitment to issue a Letter of Credit shall be delivered not later than 30 Business Days prior to the expiration or termination of the then existing Letter of Credit, the substitute Letter of Credit shall be delivered to the Trustee no less than 10 days before the expiration of the then existing Letter of Credit, and shall be effective on or prior to the stated expiration date or termination date of the then existing Letter of Credit; provided, however, that the then existing Letter of Credit may expire or be terminated any time on or after the effective date of any substitute Letter of Credit in the event that all Bonds tendered pursuant to the Indenture have been purchased prior to such expiration or termination.

***Substitute Standby Letter of Credit.*** At all times while the Bonds remain outstanding and a Standby Letter of Credit is required by the Rating Agency to maintain the then existing rating on the Bonds, the Developer shall provide to the Trustee, as beneficiary, an irrevocable Standby Letter of Credit or Substitute Credit Facility meeting the requirements of described under this heading or under the heading "Substitute Credit Facility" below, as the case may be. Notwithstanding anything in the Loan Agreement to the contrary, an extension of the existing Standby Letter of Credit affected by an amendment, which amendment changes nothing other than the expiration date of the Standby Letter of Credit, need not comply with the requirements for substitute Standby Letters of Credit described below and such extension shall not cause a mandatory tender of the Bonds under the Indenture. Notice of any such amendment shall be provided to the Remarketing Agent no fewer than 10 days in advance of the effectiveness thereof. The Developer shall provide or cause to be provided to the Trustee upon the expiration of the Standby Letter of Credit, a substitute Standby Letter of Credit or Substitute Credit Facility; or, in the alternative, the Credit Bank may provide a substitute Standby Letter of Credit or a Substitute Credit Facility resulting in a rating on the Bonds not lower than the rating on the Bonds prior to the expiration of the existing Standby Letter of Credit. The Credit Bank may, at any time, provide a substitute Standby Letter of Credit.

The following requirements shall apply to any Standby Letter of Credit provided in connection with the Bonds:

(a) The initial Standby Letter of Credit shall be accepted by the Trustee prior to any disbursement by the Trustee of moneys on deposit in the Program Fund.

(b) Each Standby Letter of Credit (other than the initial Standby Letter of Credit) shall be for a term expiring not earlier than one year after its effective date; provided, however, that such Standby Letter of Credit may provide that it shall terminate prior to its stated expiration date upon receipt by the Standby Letter of Credit Bank of notice from the Trustee that no Bonds remain Outstanding.

(c) Any Standby Letter of Credit shall be in an amount at any date not less than the sum of the aggregate principal amount of Bonds then outstanding plus an amount equal to interest on the Bonds for a period of 39 days (or such greater or lesser period required by the Rating Agency) at the Maximum Interest Rate for so long as the Bonds bear interest at the Variable Rate.

(d) Except for its term, each Standby Letter of Credit shall meet the requirements of the Rating Agency then rating the Bonds and shall be in a form acceptable to the Trustee.

(e) Each Standby Letter of Credit (other than the initial Standby Letter of Credit) must be accompanied by (i) an opinion of Bond Counsel addressed to the Trustee and the Remarketing Agent to the effect that delivery of the Standby Letter of Credit complies with the provisions of the Loan Agreement and the Indenture and will not cause interest on the Bonds to become includable in gross income for federal income tax purposes and (ii) one or more opinions of counsel to the Standby Credit Bank or other counsel to the effect, singly or together, that the Standby Letter of Credit is a legal, valid and binding obligation of the Standby Credit Bank, enforceable against the Standby Credit Bank in accordance with its terms, with such exceptions as are acceptable to the Rating Agency, including, but not limited to, an exception to the effect that such enforceability is limited by applicable reorganization, insolvency, liquidation, readjustment of debt, moratorium or other similar laws affecting the enforcement of the rights of creditors generally as such laws may be applied in the event of a reorganization, insolvency, liquidation, readjustment of debt or other similar proceeding of or moratorium applicable to the Standby Credit Bank and by general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

(f) Each Standby Letter of Credit (other than the initial Standby Letter of Credit) must be accompanied by (i) a written statement, signed by an officer of each Rating Agency which then maintains a rating on the Bonds, which states that the provision of any such Standby Letter of Credit will not cause a reduction or withdrawal of the then current rating on the Bonds subsequent to the delivery of such Standby Letter of Credit, and (ii) the Standby Credit Bank's address to which notices required to be given to the Standby Credit Bank under the Loan Agreement and under the Regulatory Agreement, the Indenture and the Remarketing Agreement shall be sent.

***Substitute Credit Facility.*** Subject to the terms of any supplemental indenture entered into in accordance with the Indenture and prior to the expiration of the initial Letter of Credit or any Substitute Credit Facility, the Credit Bank or the Developer shall have the right to provide to the Trustee a Substitute Credit Facility, which meets the requirements described under this heading. The Trustee has been directed pursuant to the Indenture to accept any such Substitute Credit Facility.

Subject to the terms of any supplemental indenture, the Developer may deliver a Substitute Credit Facility to the Trustee in substitution for the then existing Letter of Credit and/or Standby Letter of Credit, provided that the Substitute Credit Facility is delivered prior to, and shall become effective on or before, the stated expiration date of the then existing Letter of Credit. Any Substitute Credit Facility must be accompanied by the opinion of Bond Counsel described in paragraph (e) under the heading "Substitute Standby Letter of Credit" above and the statements described in paragraph (f) under the heading "Substitute Standby Letter of Credit" above, together with any other instruments, agreements or other documents set forth in any supplemental indenture for the Bonds or required by the Rating Agency.

## **First Deed of Trust**

The obligations of the Developer under the Loan Agreement will be secured by the First Deed of Trust. Pursuant to the provisions of the Intercreditor Agreement, the Trustee will agree not to exercise any rights and remedies with respect to the First Deed of Trust unless and until the Credit Bank fails to make a payment due and owing under the Letter of Credit.

## **Investment of Funds**

Proceeds held in the Funds and accounts under the Indenture, including the Program Fund, will be invested by the Trustee in Investment Securities selected and directed in writing by the Developer with the written approval of the Credit Bank.

## **CERTAIN BONDHOLDERS' RISKS**

The purchase of the Bonds will involve a number of risks. The following is a summary, which does not purport to be comprehensive or definitive, of some of such risk factors.

## **No Personal Liability of Developer**

Subject to various exceptions to nonrecourse liability for the benefit of the Credit Bank and the Issuer and the payment of the rebate amount, the Developer will not be liable for payments on the Loan or under the other documents executed in connection with the issuance of the Bonds and the making of the Loan. All payments on the Loan are expected to be derived from revenues generated by the Project.

## **Limited Liability**

THE BONDS ARE LIMITED OBLIGATIONS OF THE ISSUER, PAYABLE SOLELY FROM THE REVENUES AND OTHER FUNDS AND MONEYS PLEDGED AND ASSIGNED UNDER THE INDENTURE. NEITHER THE ISSUER, ANY OF ITS PROGRAM PARTICIPANTS, THE STATE OF CALIFORNIA (THE "STATE"), NOR ANY POLITICAL SUBDIVISION THEREOF (EXCEPT THE ISSUER, TO THE LIMITED EXTENT SET FORTH IN THE INDENTURE) NOR ANY PUBLIC AGENCY SHALL IN ANY EVENT BE LIABLE FOR THE PAYMENT OF THE PRINCIPAL OF, PREMIUM (IF ANY) OR INTEREST ON THE BONDS OR FOR THE PERFORMANCE OF ANY PLEDGE, OBLIGATION OR AGREEMENT OF ANY KIND WHATSOEVER EXCEPT AS SET FORTH IN THE INDENTURE, AND NONE OF THE BONDS OR ANY OF THE ISSUER'S AGREEMENTS OR OBLIGATIONS SHALL BE CONSTRUED TO CONSTITUTE AN INDEBTEDNESS OF OR A PLEDGE OF THE FAITH AND CREDIT OF OR A LOAN OF THE CREDIT OF OR A MORAL OBLIGATION OF ANY OF THE FOREGOING WITHIN THE MEANING OF ANY CONSTITUTIONAL OR STATUTORY PROVISION WHATSOEVER. THE ISSUER HAS NO TAXING POWER.

## **Early Redemption or Mandatory Tender**

Purchasers of Bonds should consider the fact that the Bonds are subject to redemption and mandatory tender at a redemption price equal to their principal amount plus accrued interest in the event such Bonds are redeemed prior to maturity or otherwise upon a mandatory tender date. This could occur, for example, in the event that the Loan is prepaid as a result of a casualty or condemnation affecting the Project or if there is a default under the Loan. See "THE BONDS—Mandatory Purchase" and "REDEMPTION OF BONDS" herein.

## **Economic Feasibility**

The economic feasibility of the Project depends in large part upon its being substantially occupied at projected rent levels. There can be no assurance that in the future the Developer will be able to rent units in the Project at rental rates which will enable it to make timely payments on the Loan.

## **Competing Facilities**

The Issuer, the Developer, and persons who may or may not be affiliated with the Issuer or the Developer may own, finance, develop, construct, and operate other facilities in the area of the Project that could compete with the Project. Any competing facilities, if so constructed, could adversely affect occupancy and revenues of the Project.

## **Enforceability and Bankruptcy**

The remedies available to the Trustee and the holders of the Bonds upon an event of default under the Loan Agreement, the Letter of Credit, or the Indenture are in many respects dependent upon regulatory and judicial actions which are often subject to discretion and delay. Under existing laws and judicial decisions, the remedies provided under the aforesaid documents may not readily be available or may be limited. The various legal opinions to be delivered concurrently with the delivery of the Bonds and the aforesaid documents will be qualified to the extent that the enforceability of certain legal rights related to the Bonds is subject to limitations imposed by bankruptcy, reorganization, insolvency or other similar laws affecting the rights of creditors generally and by equitable remedies and proceedings generally.

## **Additional Bonds and Subordinate Financing**

The Developer may obtain additional financing for the Project at a future date. Such additional financing could be in the form of additional bonds issued by the Issuer. Additional bonds could be issued on a parity basis with the Bonds pursuant to the Indenture. Such additional financing could also be in the form of additional conventional loans the payment obligations with respect to which would be subordinate to the Developer's payment obligations under the Loan. In either case, the increased repayment obligations of the Developer could increase the likelihood of an early redemption of the Bonds. Any such redemption would be at a price equal to the principal amount of the Bonds to be redeemed, plus accrued interest to the date of redemption, without premium.

## **THE ISSUER**

*The information under this heading has been furnished by the Issuer, and has not been independently verified by the Trustee, the Developer, the Underwriter, the Remarketing Agent, the Credit Bank or the Standby Credit Bank. None of the Trustee, the Developer, the Underwriter, the Remarketing Agent, the Credit Bank or the Standby Credit Bank make any representation whatsoever as to the accuracy, adequacy or completeness of such information.*

The Issuer is a joint exercise of powers authority organized pursuant to an Amended and Restated Joint Exercise of Powers Agreement among a number of California counties, cities and special districts, entered into pursuant to Chapter 5 of Division 7 of Title 1 (commencing with Section 6500) of the California Government Code. The Issuer is authorized to issue bonds and to loan the proceeds thereof to qualified borrowers for the purpose of financing or refinancing, among other things, the acquisition, construction or rehabilitation of multifamily housing projects on behalf of local agencies within the State of California pursuant to Chapter 7 of Part 5 of Division 31 of the California Health and Safety Code.



The Issuer has sold and delivered obligations other than the Bonds, which other obligations are and will be secured by instruments separate and apart from the Indenture and the Bonds. The holders of such obligations of the Issuer have no claim on the security for the Bonds, and the owners of the Bonds will have no claim on the security for such other obligations issued by the Issuer.

The Issuer has not reviewed any appraisal for the Project or any feasibility study or other financial analysis of the Project and has not undertaken to review or approve expenditures for the Project, to supervise the construction of the Project, or to obtain any financial statements of the Developer.

The Issuer has not reviewed this Official Statement and is not responsible for any information contained herein, except for the information in this section and under the caption “ABSENCE OF LITIGATION—The Issuer” herein.

## **THE DEVELOPER, THE PROJECT AND THE MANAGER**

*The information under this heading has been furnished by the Developer, and has not been independently verified by the Issuer, the Trustee, the Underwriter, the Remarketing Agent, the Credit Bank or the Standby Credit Bank. None of the Issuer, the Trustee, the Underwriter, the Remarketing Agent, the Credit Bank or the Standby Credit Bank makes any representation whatsoever as to the accuracy, adequacy or completeness of such information.*

### **The Developer**

The Developer is Heritage II, L.P., a California limited partnership. The managing general partner of the Developer is Foundation for Affordable Housing II, Inc., a California nonprofit public benefit corporation (the “Managing General Partner”). The co-general partner of the Developer is Investment Concepts, Inc., a California corporation (the “Co-General Partner”).

The Managing General Partner and its affiliates have been involved with the acquisition and development of multifamily and senior housing developments since 1991. As of May, 2014, the most recent month for which such information is available, the Managing General Partner has an ownership interest in more than 98 affordable housing projects containing approximately 11,514 units located in the states of California, Oregon, Washington, North Carolina and Texas. The principal office of the Managing General Partner is located at 384 Forest Avenue, Suite 14, Laguna Beach, California 92651.

The principals of the Co-General Partner have been involved in the multifamily housing industry for over 45 years. As of May, 2014, the most recent month for which such information is available, The Co-General Partner has acquired and/or built and managed over 5,800 apartments in the states of California, Arizona and Nevada during that time. The principal office of the Co-General Partner is located at 1667 East Lincoln Avenue, Orange, California 92865.

The Developer was formed for the sole purpose of acquiring, constructing, owning, operating and managing the Project. The Developer does not intend to acquire any substantial assets or engage in any substantial business activities other than those related to the ownership of the Project. However, affiliates of the Developer, the Managing General Partner, the Co-General Partner and affiliates of the Managing General Partner and the Co-General Partner are engaged and intend to continue to engage in the acquisition, development, ownership and management of similar types of housing projects and other real estate activities.

## The Project

The Project is a to-be-constructed multifamily rental housing development for persons aged 55-years and older known as Heritage II Apartments to be located on approximately 7.21 acres at Burton Mesa Boulevard in Lompoc, California. Construction of the Project is expected to commence contemporaneously with the issuance of the Bonds and to be complete in March, 2015.

The buildings comprising the Project will be wood framed with stucco siding with pitched roofs covered with flat tiled shingles. The Project will consist of 20 one-story buildings containing a total of 80-units. Amenities in each unit will include a dishwasher, a stacked washer and dryer, ceiling fans, a patio, vaulted ceilings, window coverings, high speed internet access and cable television. Amenities at the Project will include community gardens, walking trails, a dog park and lawn game area. In addition, the Project will have shared amenities with Heritage Villas next door, which consists of two recreational buildings each containing a kitchen, a business center, lawn games, barbecue area, gazebo, fitness center and community gardens. The Project also will include resident parking for 98 vehicles which includes approximately 36 attached garages for the two-bedroom units and approximately 62 uncovered spaces.

The Project will be adjacent to Heritage Village, a multifamily rental housing development with 101-units constructed in 2003 and owned by an affiliate of the Developer. The amenities described above are located at Heritage II and Heritage Village and will be shared pursuant to a use agreement to be executed by the owner of Heritage Village and the Developer.

Set forth below are the expected unit types, average square feet, income limits and average rents, as of May, 2014, the most recent month for which such information is available.

Unit Type	Approximate Average Sq. Feet	No. of Units	Income Limit (a percentage of Area Median Income)	Approximate Average Rent
One Bedroom—One Bath	633	39	60%	\$796
One Bedroom—One Bath	633	4	50	654
Two Bedroom—One Bath	965	32	60	959
Two Bedroom—One Bath	965	4	50	788
One Bedroom—One Bath	633	1	NA (manager's unit)	NA

## The Manager

Management of the Project will be handled by Investment Concepts, Inc. (the "Manager"). The Manager is an affiliate of the Developer. The Manager has extensive experience managing multifamily properties including projects financed with bond financing which are subject to regulatory agreements. As of May, 2014, the most recent month for which such information is available, the Manager is performing property management for 50 multifamily rental housing developments containing in excess of 5,951 units located in the states of California, Arizona and Nevada.

## Restrictive Covenants

*Bond Regulatory Agreement.* The Regulatory Agreement imposes certain requirements on the Developer with respect to the tax-exempt status of the Bonds under the Code, which include, among other

requirements, a requirement that 40% of the completed residential units in the Project be occupied by individuals whose income does not exceed 60% of the median gross income for the area in which the Project is located. In addition, the Regulatory Agreement restricts rents, which may be charged for occupancy of these units during the Qualified Project Period. See “SUMMARY OF CERTAIN PROVISIONS OF THE REGULATORY AGREEMENT” herein for a description of the requirements affecting the operation of the Project in order to assure compliance with the Code and state law.

*Tax Credit Regulatory Agreement.* In connection with the award of low-income housing tax credits to the Borrower with respect to the Project, the Borrower will execute the Tax Credit Regulatory Agreement. Pursuant to the Tax Credit Regulatory Agreement, the Borrower must, among other things, rent 40% of the residential rental units in the Project to individuals or households earning 60% or less of area median gross income for the area in which the Project is located, adjusted for household size, as determined by the United States Department of Housing and Urban Development. Monthly rents on such units in the Project are limited to 1/12 of 30% of 60% of the applicable area median gross income for the area in which the Project is located, adjusted for an imputed household size. The tenant income limits and rental restrictions under Section 42 of the Code assume that one-bedroom apartments are occupied by an average of 1.5 persons and two-bedroom apartments are occupied by an average of 3 persons. Violation of the tax credit covenants and restrictions may result in loss or recapture of tax credits and penalties against the members of the Borrower, among other things.

### **Limited Recourse to Developer**

The Developer and its partners will not (subject to certain exceptions to nonrecourse liability set forth in the Loan Agreement and the First Deed of Trust which may give rise to obligations by certain individual guarantors) be personally liable for payments on the Loan, the payments on which are to be applied to pay the principal of and interest on the Bonds; nor will the Developer or its partners be personally liable under the other documents executed in connection with the issuance of the bonds and the making of the Loan. Furthermore, no representation is made that the Developer will have substantial funds available for the Project. Accordingly, neither the Developer’s financial statements, nor those of its partners or members of the General Partner, is included in this Official Statement.

### **ESTIMATED SOURCES AND USES OF FUNDS**

The proceeds of the sale of the Bonds and certain other moneys are expected to be applied approximately as follows:

#### **SOURCES:**

Bond Proceeds	\$7,100,000
Developer Equity*	<u>1,494,129</u>
Total Sources	<u>\$8,594,129</u>

#### **USES:**

Project Acquisition, Construction Costs and Reserves	\$8,174,129
Costs of Issuance	<u>420,000</u>
Total Uses	<u>\$8,594,129</u>

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\* \$387,249 of this amount has already been expended.

## SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE

*The following is a brief summary of certain provisions of the Indenture. This summary does not purport to be comprehensive or definitive and is subject to all of the terms and provisions of the Indenture.*

### Revenues and Funds

The Indenture creates the following funds and accounts which will be held by the Trustee: (a) the Program Fund (and within such Fund, the "Project Account," the "Equity Account," the "Capitalized Interest Account" and the "Costs of Issuance Account" shall be established), (b) the Bond Fund and (c) the Rebate Fund. The following is a summary of these funds and accounts and their operation.

**Program Fund.** Moneys in the Program Fund, including any moneys in the accounts therein, shall be applied only as described below. The Credit Bank has been granted a security interest in the amounts held in the Program Fund to secure the Developer's repayment obligations under the Credit Agreement, said security interest to be subordinate to the pledge and lien on such amounts under the Indenture for the benefit of the Bondowners.

No moneys shall be disbursed from the Program Fund (other than the Costs of Issuance Account) until the Trustee shall have received evidence that the Regulatory Agreement and the First Deed of Trust have been recorded in the office of the appropriate county. The Trustee may conclusively rely on notification from the title company responsible for recording such documents (which may be telephonic) of such recordation.

The Trustee shall make all disbursements from the Program Fund only after compliance with the provisions for disbursement set forth in the Loan Agreement and described below, to pay or reimburse the Developer for Qualified Project Costs or Issuance Costs, as applicable.

Any provision in the Indenture to the contrary notwithstanding, the Trustee shall not disburse any moneys from the Program Fund (other than the Costs of Issuance Account and the Capitalized Interest Account therein) unless (i) it has received a Funding Requisition executed by an Authorized Developer Representative and approved in writing by an Authorized Bank Representative, representing that the full amount of such disbursement will be applied to pay or reimburse the Developer for the payment of Qualified Project Costs and such disbursement, if payable from the Project Account, when added to all previous disbursements from the Project Account of the Program Fund, will result in not less than 97% of all such disbursements having been used to pay or reimburse the Developer for Qualified Project Costs and no more than 25% of all such disbursements having been used for the acquisition of land or an interest therein, or (ii) it has received a Written Direction from the Credit Bank (which need not be approval by the Developer) identifying the amount to be withdrawn and representing that a copy of the request has been provided to the Developer and that the amount may be withdrawn by the Credit Bank, without the consent of the Developer, pursuant to the Credit Agreement.

Moneys on deposit in the Costs of Issuance Account shall be applied to pay Issuance Costs. Such costs shall be payable upon submission of a Funding Requisition executed by an Authorized Developer Representative. Any moneys remaining in the Cost of Issuance Account on the sixtieth day following the Closing Date shall be transferred to the Developer. Upon such transfer of moneys remaining in the Cost of Issuance Account, the Costs of Issuance Account shall be closed.

Two Business Days immediately preceding each Interest Payment Date, the Trustee shall transfer funds in the amount set forth in the Indenture from the Capitalized Interest Account to the Credit Bank to

(i) reimburse draws on the Letter of Credit to pay accrued interest on the Bonds through the date immediately preceding such Interest Payment Date, and (ii) pay the Credit Bank's accrued Annual Fee (as defined in the Credit Agreement) for the month immediately preceding such Interest Payment Date, without any requirement or condition of submission of any requisition. Such amount may be changed from time to time by a notice from the Credit Bank to the Trustee. After the completion of construction of the Project, amounts held in the Capitalized Interest Account shall be applied to pay Qualified Project Costs.

Neither the Trustee nor the Issuer shall be responsible for the application by the Credit Bank or the Developer of moneys disbursed to the Credit Bank or the Developer as described under this heading.

***Bond Fund.*** Moneys in the Bond Fund shall be applied only as described below.

The Trustee shall deposit in the Bond Fund from time to time, upon receipt thereof, (i) all amounts drawn by the Trustee under the Letter of Credit and the Standby Letter of Credit as provided in the Indenture; (ii) income received from the investment of moneys on deposit in the Bond Fund; and (iii) any other Revenues, including insurance proceeds, condemnation awards and other Loan prepayment amounts received from or for the account of the Developer. Amounts drawn under the Letter of Credit, the Standby Letter of Credit and other Available Amounts, including, but not limited to, Bond proceeds held in the Program Fund, shall not be commingled with other moneys in the Bond Fund and the Trustee shall set up separate subaccounts in the Bond Fund for amounts drawn under the Letter of Credit, the Standby Letter of Credit and other Available Amounts, including, but not limited to, Bond Proceeds held in the Program Fund, respectively. The Trustee shall have the sole right of withdrawal from the subaccounts of the Bond Fund in which amounts drawn under the Letter of Credit, the Standby Letter of Credit and other Available Amounts, including, but not limited to, Bond Proceeds held in the Program Fund, are deposited, and none of the Issuer, the Developer or any partner or guarantor of the Developer shall have any legal, equitable or beneficial right, title or interest in amounts on deposit therein.

Except as described under this heading and under the heading "Defeasance—Payment of Bonds After Discharge of Indenture" below, moneys in the Bond Fund shall be used solely for the payment of the principal of and premium, if any, and interest on the Bonds as the same shall become due, whether at maturity or upon redemption or acceleration or otherwise. In making such payments, the Trustee shall (a) use amounts drawn by the Trustee under the Letter of Credit, (b) then use amounts drawn by the Trustee under the Standby Letter of Credit, (c) then use Available Amounts held under the Indenture (except proceeds of a draw under the Letter of Credit or Standby Letter of Credit) and (d) then use any other Revenues received by the Trustee.

Any amounts remaining in the Bond Fund on the date set forth in the Indenture of each year that represent investment earnings on amounts on deposit in the Bond Fund shall be transferred on such date by the Trustee to the Credit Bank and applied to the reimbursement of the Credit Bank for drawings made on the Letter of Credit.

***Rebate Fund.*** The Developer shall, annually, within 30 days of the end of each Bond Year (or as otherwise required under the Tax Certificate), cause a Rebate Analyst to calculate, in accordance with the Regulations and the Tax Certificate, excess investment earnings to the extent required by Section 148(f) of the Code from amounts deposited with the Trustee as provided in the Loan Agreement. The Developer shall engage a Rebate Analyst (i) to make such calculations; (ii) to provide a written copy of all such calculations to the Issuer and written instructions to the Trustee of amounts to be paid from the Rebate Fund; and (iii) to demand in writing from the Developer any amounts required to be rebated to the federal government in accordance with such calculations pursuant to the Loan Agreement. Any fees or expenses

incurred by the Trustee or the Issuer under or pursuant to the Indenture provisions described under this heading shall be billed to the Developer under the Loan Agreement.

The Trustee shall not be responsible for calculating rebate amounts or for the adequacy or correctness or any rebate report or rebate calculations. The Trustee shall be deemed conclusively to have complied with the provisions of the Indenture regarding calculations and payments of rebate if it follows the directions as provided in the Indenture and it shall have no independent duty to review such calculations or enforce the compliance with such rebate requirements.

In order to provide for the administration of the provisions of the Indenture described under this heading, the Trustee may provide for the employment of independent attorneys (including Bond Counsel), accountants and consultants compensated on such reasonable basis as the Trustee may deem appropriate, and in addition to and without limitation of the other provisions of the Indenture, the Trustee may rely conclusively upon and shall be fully protected from all liability in relying upon the opinions, calculations, determinations, directions and advice of such attorneys, accountants and consultants employed by it under the Indenture.

The Trustee shall deposit to the Rebate Fund any amounts paid to the Trustee to be rebated to the federal government pursuant to the provisions of the Indenture described under this heading and the provisions of the Loan Agreement. Any amount deposited in the Rebate Fund, together with any earnings thereon, shall be for the sole benefit of the United States of America and shall not be subject to the lien of the Indenture or to the claim of any other person, including, without limitation, the Bondholders and the Issuer. The requirements of the Indenture described under this heading are subject to, and shall be interpreted in accordance with, Section 148(f) of the Code and the Treasury Regulations applicable thereto (the "Regulations") and shall apply except to the extent the Trustee and the Credit Bank are furnished with an opinion of Bond Counsel or other satisfactory evidence that the Regulations contain an applicable exception.

### **Investment of Moneys**

Except as otherwise described under this heading or in the Indenture, any moneys in any of the funds and accounts established by the Trustee pursuant to the Indenture shall be invested by the Trustee, if and to the extent then permitted by law, in Investment Securities selected and directed by the Developer in a Written Direction, as approved in writing by the Credit Bank, such direction to be given to the Trustee by noon, Pacific Time, on the second Business Day prior to such investment with respect to which payments of principal thereof and interest thereon are scheduled or otherwise payable not later than the date on which it is estimated that such moneys will be required by the Trustee. All investments shall be purchased at the price of par or lower (investments shall not be purchased at a premium).

In the absence of such Written Direction from the Developer, the Trustee shall invest solely in Investment Securities described in clause (e) of the definition thereof with maturities of 30 days or less, as needed. The Developer shall provide investment instructions such that amounts drawn under the Letter of Credit, the Standby Letter of Credit, any Collateral Funds and proceeds received from the remarketing of the Bonds shall be invested, if at all, only in Investment Securities described in clause (a) of the definition thereof (or money market funds comprised solely of such securities which are rated not lower than the rating on the Bonds) with maturities of 30 days or less as needed. The Developer shall provide investment instructions such that Available Amounts held in the Bond Fund, other than amounts drawn under the Letter of Credit, the Standby Letter of Credit and any Collateral Funds shall be invested only in Investment Securities described in clause (a) of the definition thereof (or money market funds comprised solely of such securities, which are rated not lower than the then current rating on the Bonds, but not in unit investment trusts comprised of securities described in such clause) maturing or subject to payment at

the principal amount thereof upon demand of the holder thereof within 30 days after the acquisition of any such investment and in any event not later than the date on which it is estimated that such moneys will be required by the Trustee. The Trustee shall have no liability or responsibility for any loss resulting from any investment made in accordance with the provisions of the Indenture described under this heading, except through its negligence or willful misconduct.

Except as otherwise described in the next sentence, all investments of amounts deposited in any fund or account created by or pursuant to the Indenture or otherwise containing gross proceeds of the Bonds (within the meaning of Section 148 of the Code) shall be acquired, disposed of and valued (as of the date that valuation is required by the Indenture or the Code) at Fair Market Value. Investments in funds or accounts (or portions thereof) that are subject to a yield restriction under applicable provisions of the Code shall be valued at their present value (within the meaning of Section 148 of the Code).

Any interest, profit or loss on such investment of moneys in any fund or account shall be credited or charged to the respective funds or accounts from which such investments are made. The Trustee may sell or present for redemption any obligations so purchased whenever it shall be necessary in order to provide moneys to meet any payment, and the Trustee shall not be liable or responsible for any loss resulting from such sale or redemption, except through its negligence or willful misconduct.

The Trustee may make any and all investments permitted under the provisions of the Indenture described under this heading through its own investment or bond department (or that of any of its affiliates) and may pay said bond or investment department reasonable, customary fees for placing such investments.

The Trustee or any of its affiliates may act as sponsor, advisor, manager or provide administrative services in connection with any Investment Securities purchased by the Trustee under the Indenture.

## **Defaults and Remedies**

***Events of Default.*** Each of the following events shall constitute an “Event of Default” under the Indenture:

- (a) failure to pay the principal of or premium (if any) on any Bond when and as the same shall become due and payable, whether at maturity as therein expressed, by proceedings for redemption, by declaration or otherwise;
- (b) failure to pay any installment of interest on any Bond when such interest installment shall become due and payable;
- (c) failure to pay the Purchase Price of any Bond tendered in accordance with the provisions of the Indenture described under the headings “THE BONDS—Purchase of Bonds on Demand” and “—Mandatory Purchase” herein when such Purchase Price shall become due and payable; and
- (d) failure by the Issuer to perform or observe any other of the covenants, agreements or conditions on its part in the Indenture or in the Bonds contained, and the continuation of such failure for a period of 60 days after written notice thereof, specifying such default and requiring the same to be remedied, shall have been given to the Issuer, the Developer and the Credit Bank by the Trustee, or to the Issuer, the Credit Bank, the Developer and the Trustee by the holders of not less than 25% in aggregate principal amount of the Bonds at the time Outstanding.

No default described in (d) above shall constitute an Event of Default unless the Issuer, the Developer or the Credit Bank shall have failed to correct such default within the applicable period; provided, however, that if the default shall be such that it cannot be corrected within such period, it shall not constitute an Event of Default if corrective action is instituted by the Issuer, the Developer or the Credit Bank within the applicable period and diligently pursued until the default is corrected. With regard to any alleged default concerning which notice is given to the Developer or the Credit Bank under the provisions of (d) above, the Issuer has granted the Developer and the Credit Bank, subject to the provisions of the Indenture described under the heading “Right of Credit Bank and Bondholders to Direct Proceedings” below, full authority for the account of the Issuer to perform any covenant or obligation the nonperformance of which is alleged in said notice to constitute a default in the name and stead of the Issuer with full power to do any and all things and acts to the same extent that the Issuer could do and perform any such things and acts and with power of substitution.

***Acceleration.*** In the event of an Event of Default and subject to the terms of the Intercreditor Agreement, unless the principal of all the Bonds shall have already become due and payable, the Trustee may, and upon the occurrence of any Event of Default described in (a), (b) or (c) above or upon the written request of the Credit Bank or the holders of not less than 25% in aggregate principal amount of the Bonds at the time Outstanding in the case of any other Event of Default, the Trustee shall, by notice in writing to the Issuer, the Credit Bank, the Developer and the Remarketing Agent, declare the principal of all the Bonds then Outstanding, and the interest accrued thereon, to be due and payable immediately, and upon any such declaration the same shall become and shall be immediately due and payable, anything in the Indenture or in the Bonds contained to the contrary notwithstanding. Upon any such declaration of acceleration the Trustee shall fix a date for payment of the Bonds, which date shall be as soon as practicable after such declaration, and shall draw upon any then outstanding Letter of Credit in accordance with its terms and the provisions of the Indenture and apply the amount so drawn to pay the principal of and interest on the Bonds so due and payable.

***Waiver of Default.*** The provisions of the Indenture described under the preceding paragraph, however, are subject to the condition that if, at any time after the principal of the Bonds shall have been so declared due and payable, and before any drawing is made under the Letter of Credit or any judgment or decree for the payment of the moneys due shall have been obtained or entered as provided in the Indenture, there shall have been deposited with the Trustee a sum sufficient to pay all the principal of the Bonds matured prior to such declaration and all matured installments of interest (if any) upon all the Bonds, with interest on such overdue installments of principal, and the reasonable fees and expenses of the Trustee, its agents and counsel, and any and all other defaults known to the Trustee (other than in the payment of principal of and interest on the Bonds due and payable solely by reason of such declaration) shall have been made good or cured to the satisfaction of the Trustee or provision deemed by the Trustee to be adequate shall have been made therefor, then, and in every such case, the holders of at least a majority in aggregate principal amount of the Bonds then Outstanding, by written notice to the Issuer and to the Trustee and with indemnification satisfactory to the Trustee and with the written approval of the Credit Bank, may, on behalf of the holders of all the Bonds, rescind and annul such declaration and its consequences and waive such default; but no such rescission and annulment shall extend to or shall affect any subsequent default, or shall impair or exhaust any right or power consequent thereon.

***Institution of Legal Proceedings by Trustee.*** If one or more of the Events of Default shall occur and subject to the terms of the Intercreditor Agreement, the Trustee in its discretion may, and upon the written request of the holders of a majority in principal amount of the Bonds then Outstanding and, in the case of an Event of Default described in paragraph (d) under the heading “Events of Default” above, upon the written request of the Credit Bank, and upon being indemnified to its satisfaction therefor the Trustee shall proceed to protect or enforce its rights or the rights of the holders of Bonds under the Indenture, the Loan Agreement and the Letter of Credit, by a suit in equity or action at law, either for the specific



performance of any covenant or agreement contained in the Indenture or therein, or in aid of the execution of any power in the Indenture or therein granted, or by mandamus or other appropriate proceeding for the enforcement of any other legal or equitable remedy as the Trustee shall deem most effectual in support of any of its rights or duties under the Indenture, provided that any such request from the Bondholders or the Credit Bank shall not be in conflict with any rule of law or with the Indenture, expose the Trustee to personal liability or be unduly prejudicial to Bondholders not joining therein.

***Application of Moneys Collected by Trustee.*** Any moneys collected by the Trustee pursuant to the provisions of the Indenture described under the heading “Institution of Legal Proceedings by Trustee” above and pursuant to certain other specified provisions of the Indenture (provided, however, any moneys realized from a draw on the Letter of Credit or the Standby Letter of Credit shall be applied only to the payment of the principal and Purchase Price of and interest on the Bonds) shall be applied in the following order, at the date or dates fixed by the Trustee and, in the case of distribution of such moneys on account of principal (or premium, if any) or interest, upon presentation of the Bonds and stamping thereon the payment, if only partially paid, and upon surrender thereof, if fully paid:

*First:* For payment of all amounts due to the Trustee under the Indenture relating to compensation of the Trustee.

*Second:* For deposit in the Bond Fund and applied to payment of the principal of all Bonds then due and unpaid and the premium, if any, and interest thereon, ratably to the persons entitled thereto without discrimination or preference; except that no payment of principal or premium or interest shall be made with respect to any Bonds known by the Trustee to be registered in the name of the Issuer, the Credit Bank or the Developer and/or a partner or any guarantor of the Developer to the extent certified in writing to the Trustee, until all amounts due on all Bonds not so registered have been paid.

*Third:* For payment of all other amounts due to any person under the Indenture or under the Loan Agreement as certified by the Credit Bank to the Trustee.

*Fourth:* To the Credit Bank to the extent of any amounts due it under the Credit Agreement.

***Right of Credit Bank and Bondholders To Direct Proceedings.*** Anything in the Indenture to the contrary notwithstanding and subject to the terms of the Intercreditor Agreement, the Credit Bank (so long as the Standby Credit Bank is not in default under the Standby Letter of Credit), and the Holders of a majority in aggregate principal amount of the Bonds then Outstanding shall have the right, by an instrument or concurrent instruments in writing executed and delivered to the Trustee, to direct the method of conducting all remedial proceedings taken by the Trustee under the Indenture, provided that such direction shall not be otherwise than in accordance with law and the provisions of the Indenture, and that the Trustee shall have the right to decline to follow any such direction which in the opinion of the Trustee would be unjustly prejudicial to Bondholders not parties to such direction or for which it has not been provided adequate indemnity. In the event of conflict between the directions of the Credit Bank and those of the registered owners with respect to an Event of Default, the directions of the Credit Bank shall prevail so long as the Standby Credit Bank is not in default under the Standby Letter of Credit.

***Limitation on Bondholders’ Right To Sue.*** No holder of any Bond issued under the Indenture shall have the right to institute any suit, action or proceeding at law or in equity, for any remedy under or upon the Indenture, unless (a) such holder shall have previously given to the Trustee written notice of the occurrence of an Event of Default under the Indenture; (b) the holders of at least a majority in aggregate principal amount of all the Bonds then Outstanding shall have made written request upon the Trustee to

exercise the powers granted in the Indenture or to institute such action, suit or proceeding in its own name; (c) said holders shall have tendered to the Trustee indemnity satisfactory to it against the costs, expenses and liabilities to be incurred in compliance with such request; (d) the Trustee shall have refused or omitted to comply with such request for a period of 30 days after such written request shall have been received by, and said tender of indemnity shall have been made to, the Trustee; and (e) so long as the Standby Credit Bank is not in default under the Standby Letter of Credit, the Credit Bank has given its consent to such suit, action or proceeding.

Such notification, request, tender of indemnity and refusal or omission have been declared, in every case, to be conditions precedent to the exercise by any holder of Bonds of any remedy under the Indenture; it being understood and intended that no one or more holders of Bonds shall have any right in any manner whatever by its or their action to enforce any right under the Indenture, except in the manner provided in the Indenture, and that all proceedings at law or in equity to enforce any provision of the Indenture shall be instituted, had and maintained in the manner provided in the Indenture and for the equal benefit of all holders of the Outstanding Bonds.

The right of any holder of any Bond to receive payment of the principal of (and premium, if any) and interest on such Bond out of Revenues, as provided in the Indenture and the Bonds, on and after the respective due dates expressed in such Bond, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder, notwithstanding the foregoing provisions of the Indenture described under this heading, under the heading “Right of Credit Bank and Bondholders To Direct Proceedings” above or any other provision of the Indenture.

***Limitation of Liability to Revenues.*** Notwithstanding anything contained in the Indenture, the Issuer shall not be required to advance any moneys of the Issuer, the State or by any political subdivision thereof or from any source of income of any of the foregoing other than the Revenues, for any of the purposes in the Indenture mentioned, whether for the payment of the principal of or interest on the Bonds or for any other purpose of the Indenture. The Bonds are limited obligations of the Issuer, and are payable from and secured by the Revenues only.

## **The Trustee**

***Duties, Immunities and Liabilities of Trustee.*** The Trustee shall, prior to an Event of Default, and after the curing of all Events of Default which may have occurred, perform such duties and only such duties as are specifically set forth in the Indenture, including the duty to draw on the Letter of Credit and the Standby Letter of Credit as required by the Indenture, and no additional covenants or duties of the Trustee shall be implied in the Indenture, the Issuer Loan Documents or otherwise. The Trustee shall, during the existence of any Event of Default (which has not been cured), exercise such of the rights and powers vested in it by the Indenture, and use the same degree of care and skill in their exercise, as a prudent person would exercise or use under similar circumstances in the conduct of its own affairs.

No provision of the Indenture shall be construed to relieve the Trustee from liability for its own negligent action or its own negligent failure to act, except that:

- (a) Prior to such an Event of Default under the Indenture and after the curing of all Events of Default which may have occurred, (i) the duties and obligations of the Trustee shall be determined solely by the express provisions of the Indenture, the Trustee shall not be liable except for the performance of such duties and obligations as are specifically set forth in the Indenture, and no implied covenants or obligations shall be read into the Indenture against the Trustee; and (ii) in the absence of bad faith on the part of the Trustee, the Trustee may

conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, upon any certificate or written opinion furnished to the Trustee conforming to the requirements of the Indenture; but in the case of any such certificate or written opinion which by any provision of the Indenture is specifically required to be furnished to the Trustee, the Trustee shall be under a duty to examine the same to determine whether or not it conforms to the requirements of the Indenture;

(b) At all times, regardless of whether or not any Event of Default shall exist, (i) the Trustee shall not be liable for any error of judgment made in good faith by a Responsible Officer or officers or by any agent or attorney of the Trustee appointed with due care unless the Trustee was negligent in ascertaining the pertinent facts; and (ii) the Trustee shall not be liable with respect to any action taken or omitted to be taken by it in good faith in accordance with the direction of the Credit Bank, accompanied by an opinion of Bond Counsel as provided in the Indenture or in accordance with the directions of the holders of not less than a majority, or such other percentage as may be required under the Indenture, in aggregate principal amount of the Bonds at the time Outstanding relating to the time, method and place of conducting any proceeding for any remedy available to the Trustee, or exercising any trust or power conferred upon the Trustee under the Indenture;

(c) The Trustee shall not be required to take notice or be deemed to have notice of (i) any default under the Indenture or under the Loan Agreement, except defaults described in paragraphs (a), (b) or (c) under the heading “Defaults and Remedies—Events of Default” herein, unless a Responsible Officer of the Trustee shall be specifically notified in writing of such default by the Issuer, the Credit Bank or the owners of at least 25% in aggregate principal amount of all Bonds then Outstanding, or (ii) any default under the Regulatory Agreement, including an Acceleration Default, unless a Responsible Officer of the Trustee shall be specifically notified in writing of such default by the Issuer;

(d) Before taking any action under the Indenture at the request or direction of the Bondholders the Trustee may require that a satisfactory indemnity bond be furnished by the Bondholders for the reimbursement of all expenses (including fees of its attorneys) to which it may be put and to protect it against all liability, except liability which is adjudicated to have resulted from its negligence or willful misconduct in connection with any action so taken;

(e) Upon any application or request by the Issuer to the Trustee to take any action under any provision of the Indenture, the Issuer shall furnish to the Trustee a Written Direction, Written Order or Written Request stating, among other things, that all conditions precedent, if any, provided for in the Indenture relating to the proposed action have been complied with, and, upon the request of the Trustee, an Opinion of Counsel stating that in the opinion of such Counsel all such conditions precedent, if any, have been complied with, except that in the case of any such application or request as to which the furnishing of such documents is specifically required by any provision of the Indenture relating to such particular application or request, no additional certificate or opinion need be furnished;

(f) The Trustee may execute any of the trusts or powers under the Indenture or perform any duties under the Indenture or under the Loan Agreement or the Regulatory Agreement either directly or through agents, receivers or attorneys;

(g) Neither the Credit Bank, the Remarketing Agent, the Issuer, the Tender Agent nor the Developer shall be deemed to be agents of the Trustee for any purpose, and the Trustee

shall not be liable for any noncompliance of any of them in connection with their respective duties under the Indenture or in connection with the transactions contemplated by the Indenture;

(h) The Trustee shall be entitled to rely upon telephonic notice for all purposes whatsoever so long as the Trustee reasonably believes such telephonic notice has been given by a person authorized to give such notice; and

(i) The immunities extended to the Trustee also extend to its directors, officers, employees and agents.

The Trustee is authorized and directed to execute in its capacity as Trustee the Regulatory Agreement, the Loan Agreement, the Intercreditor Agreement, the Remarketing Agreement and the Bond Pledge Agreement. Subsequent to the delivery of the Bonds, the Trustee is authorized and directed to execute such reconveyance documents as directed by the Developer, with the consent of, or concurrently with, the Credit Bank.

None of the provisions contained in the Indenture shall require the Trustee to expend or risk its own funds or otherwise incur individual financial liability in the performance of any of its duties or in the exercise of any of its rights or powers.

Anything to the contrary notwithstanding, the Trustee shall not be required to enter, take possession of, or take any other action whatsoever with respect to the Project, and shall not be required to initiate foreclosure proceedings with respect to the Project and the First Deed of Trust unless the Trustee is satisfied that the Trustee will not be subject to any liability under any local, state or federal environmental laws or regulations of any kind whatsoever or from any circumstances present at the Project relating to the presence, use management, disposal or, or contamination by any environmentally hazardous materials or substances of any kind whatsoever.

The Trustee shall not be liable for any actions taken or not taken by it in accordance with the direction of a majority (or other percentage provided for in the Indenture) in aggregate principal amount of Bonds outstanding relating to the exercise of any right, power or remedy available to the Trustee.

***Qualifications of Trustee.*** There shall at all times be a trustee under the Indenture, which shall be a banking association with trust powers organized and doing business under the laws of the United States or of a state thereof, authorized under such laws to exercise corporate trust powers, having (or, in the case of a corporation, its corporate parent shall have) a combined capital and surplus of at least \$50,000,000, and subject to supervision or examination by federal or state authority including but not limited to regulations regarding fiduciary funds on deposit similar to Title 12 of the U.S. Code of Federal Regulation section 9.10(b). The Trustee shall maintain all accounts with its corporate trust department and be acting in its fiduciary capacity. If such corporation or banking association publishes reports of condition at least annually, pursuant to law or to the requirements of any supervising or examining authority above referred to, then for the purposes of the provisions of the Indenture described under this heading the combined capital and surplus of such corporation or banking association shall be deemed to be its combined capital and surplus as set forth in its most recent report of condition so published. In case at any time the Trustee shall cease to be eligible in accordance with the provisions of the Indenture described under this heading, the Trustee shall resign immediately in the manner and with the effect described under the heading “Resignation and Removal of Trustee and Appointment of Successor Trustee” below.

***Resignation and Removal of Trustee and Appointment of Successor Trustee.*** The Trustee may at any time resign by giving written notice delivered to the Issuer, the Developer and the Credit Bank and

by giving written notice to the Bondholders by first-class mail. Upon receiving such notice of resignation, the Issuer shall promptly appoint a successor trustee by an instrument in writing. If no successor trustee shall have been so appointed and have accepted appointment within 45 days after the giving of such notice of resignation, the resigning trustee may petition any court of competent jurisdiction for the appointment of a successor trustee, or the Credit Bank or any Bondholder who has been a bona fide holder of a Bond for at least six months may, on behalf of itself and others similarly situated, petition any such court for the appointment of a successor trustee. Such court may thereupon, after such notice, if any, as it may deem proper and may prescribe, appoint a successor trustee.

In case at any time either (i) the Trustee shall cease to be eligible in accordance with the provisions of the Indenture described under the heading “Qualifications of Trustee” above and shall fail to resign after written request therefor by the Issuer or the Credit Bank or by any Bondholder who has been a bona fide holder of a Bond for at least six months, or (ii) the Trustee shall become incapable of acting, or shall be adjudged a bankrupt or insolvent, or a receiver of the Trustee or of its property shall be appointed, or any public officer shall take charge or control of the Trustee or of its property or affairs for the purpose of rehabilitation, conservation or liquidation, then, in any such case, the Issuer shall remove the Trustee and, upon such removal or upon any removal described in the following paragraph, except as otherwise described in the following paragraph, the Issuer shall appoint a successor trustee by an instrument in writing, with the consent of the Credit Bank (which consent shall not be unreasonably withheld and which consent shall be deemed given after 15 days if the Credit Bank has not responded to a request from the Issuer for such consent) and notice to the Remarketing Agent and the Developer, or any such Bondholder or the Credit Bank may, on behalf of itself and all others similarly situated, petition any court of competent jurisdiction for the removal of the Trustee and the appointment of a successor trustee. Such court may thereupon, after such notice, if any, as it may deem proper and may prescribe, remove the Trustee and appoint a successor trustee.

The Issuer, the Developer (with the consent of the Issuer and the Credit Bank) or the Credit Bank or, if the Issuer is in default under the Indenture, the holders of a majority in aggregate principal amount of the Bonds at the time Outstanding, may at any time remove the Trustee and may appoint a successor Trustee, by an instrument or concurrent instruments in writing signed by the Issuer or such Bondholders, as the case may be, and delivered to the Trustee, the Tender Agent, the Issuer, the Credit Bank, the Developer and the Remarketing Agent.

Any resignation or removal of the Trustee and appointment of a successor Trustee pursuant to any of the provisions of the Indenture described under this heading shall become effective only upon acceptance of appointment and assumption of duties by the successor trustee as provided in the Indenture, upon transfer of the Letter of Credit and the Standby Letter of Credit in accordance with its terms to the successor Trustee.

## **Modification of Indenture**

***Modification of Indenture Without Consent of Bondholders.*** The Issuer and the Trustee, from time to time and at any time, subject to the conditions and restrictions contained in the Indenture, may enter into an indenture or indentures supplemental to the Indenture, which indenture or indentures thereafter shall form a part of the Indenture, for any one or more of the following purposes:

- (a) to add to the covenants and agreements of the Issuer in the Indenture contained, other covenants and agreements thereafter to be observed, or to assign or pledge additional security for the Bonds, or to surrender any right or power reserved to or conferred upon the Issuer in the Indenture, provided that no such covenant, agreement, assignment, pledge or surrender shall materially adversely affect the interests of the holders of the Bonds;

(b) to evidence the succession of a new Trustee under the Indenture, or to provide for the appointment of a co-trustee or for a paying agent in addition to the Trustee;

(c) to make such provisions for the purpose of curing any ambiguity, inconsistency or omission, or of curing, correcting or supplementing any defective provision contained in the Indenture, or in regard to matters or questions arising under the Indenture, as the Issuer may deem necessary or desirable and not inconsistent with the Indenture and which shall not materially adversely affect the interests of the holders of the Bonds;

(d) to provide for the issuance of coupon bonds or to provide for the use of a book-entry system; provided, however, that the Issuer and the Trustee shall have received an opinion of Bond Counsel to the effect that issuance of the Bonds in coupon form or the use of a book-entry system, respectively, complies with all applicable laws and will not adversely affect the exclusion of interest on the Bonds from gross income for federal income tax purposes;

(e) to modify, amend or supplement the Indenture or any indenture supplemental to the Indenture in such manner as to permit the qualification of the Indenture or thereof under the Trust Indenture Act of 1939 or any similar federal statute in effect, and, if they so determine, to add to the Indenture or any indenture supplemental to the Indenture such other terms, conditions and provisions as may be permitted by said Trust Indenture Act of 1939 or similar federal statute, and which shall not materially adversely affect the interests of the holders of the Bonds;

(f) to make such additions, deletions or modifications as may be necessary to assure compliance with Section 142(d), 148(d)(3) or 148(f) of the Code, or otherwise to assure the exclusion from gross income under federal tax law of interest on the Bonds;

(g) to modify, alter, amend or supplement the Indenture in any other respect, including amendments which would otherwise be described under the heading “Modification of Indenture With Consent of Bondholders” below, if notice of the proposed supplemental indenture is given to Bondholders (in the same manner as notices of redemption are given) at least 30 days before the effective date thereof and, on or before such effective date, the Bondholders have the right to demand purchase of their Bonds pursuant to the Indenture;

(h) to modify, alter, amend or supplement the Indenture in any other respect, in connection with the providing of a substitute Letter of Credit or a substitute Standby Letter of Credit (including a Substitute Credit Facility as set forth in the Loan Agreement), and which shall not materially adversely affect the interests of the holders of the Bonds; or

(i) to modify, alter, amend or supplement the Indenture in any other respect, including amendments that would otherwise be described under the heading “Modification of Indenture With Consent of Bondholders” below, (1) if such supplemental indenture will take effect on a Demand Date (other than as described under the heading “THE BONDS—Purchase of Bonds on Demand” herein) following the mandatory purchase of Bonds, or (2) if notice of the proposed supplemental indenture is given to Bondholders (in the same manner as notices of redemption are given) at least 30 days before the effective date thereof and, on or before such effective date, the Bondholders have the right to demand purchase of their Bonds as described under the heading “THE BONDS—Purchase of Bonds on Demand” herein.

Any supplemental indenture authorized by the provisions of the Indenture described under this heading may be executed by the Issuer and the Trustee without the consent of or, except in the case of clause (g) above, notice to the holders of any of the Bonds at the time Outstanding, notwithstanding any

of the provisions of the Indenture described under the heading “Modification of Indenture With Consent of Bondholders” below, but (i) the Trustee shall not be obligated to enter into any such supplemental indenture which affects the Trustee’s own rights, duties or immunities under the Indenture or otherwise; (ii) the Trustee shall not enter into any such supplemental indenture which affects the rights or obligations of the Developer under the Indenture or under the Loan Agreement without first obtaining the written consent of the Developer, except as required in the opinion of Bond Counsel to maintain the tax-exempt status of interest on the Bonds, in which case the Trustee shall give notice thereof to the Developer; (iii) the Trustee shall not enter into any such supplemental indenture without first obtaining the written consent of the Credit Bank and the Standby Credit Bank, except as required in the opinion of Bond Counsel to maintain the tax-exempt status of interest on the Bonds, in which case the Trustee shall give notice thereof to the Credit Bank and the Standby Credit Bank and (iv) the Trustee shall not enter into any such supplemental indenture that materially adversely affects the rights or obligations of the Remarketing Agent under the Indenture without first obtaining the written consent of the Remarketing Agent, except as required in the opinion of Bond Counsel to maintain the tax-exempt status of interest on the Bonds, in which case the Trustee shall give notice thereof to the Remarketing Agent.

***Modification of Indenture With Consent of Bondholders.*** With the prior written consent of the Credit Bank and the consent of the holders of a majority in aggregate principal amount of the Bonds at the time Outstanding, evidenced as provided in the Indenture, the Issuer and the Trustee may from time to time and at any time enter into an indenture or indentures supplemental to the Indenture for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of the Indenture or of any supplemental indenture; provided, however, that, except to the extent permitted by the Indenture as described under the heading “Modification of Indenture Without Consent of Bondholders” above, no such supplemental indenture shall (a) extend the fixed maturity of any Bond or reduce the rate of interest thereon or extend the time of payment of interest, or reduce the amount of the principal thereof, or reduce any premium payable on the redemption thereof, without the consent of the holder of each Bond so affected, or (b) reduce the aforesaid percentage of holders of Bonds whose consent is required for the execution of such supplemental indentures, or permit the creation of any lien on the Revenues prior to or on a parity with the lien of the Indenture, except as permitted in the Indenture, or permit the creation of any preference of any Bondholder over any other Bondholder or deprive the holders of the Bonds of the lien created by the Indenture upon the Revenues, or impair the right of the owners of Bonds to demand purchase thereof as described under the heading “THE BONDS—Purchase of Bonds on Demand” herein, without in each case the consent of the holders of all the Bonds then Outstanding. Nothing described under this heading shall be construed as making necessary the approval of any Bondholder of any supplemental indenture permitted by the provisions of the Indenture described under the heading “Modification of Indenture Without Consent of Bondholders” above. Upon receipt by the Trustee of a Certified Resolution authorizing the execution of any such supplemental indenture, and upon the filing with the Trustee of evidence of the consent of Bondholders, as aforesaid, the Trustee shall join with the Issuer in the execution of such supplemental indenture, unless (i) such supplemental indenture affects the Trustee’s own rights, duties or immunities under the Indenture or otherwise, in which case the Trustee may in its discretion, but shall not be obligated to, enter into such supplemental indenture; (ii) such supplemental indenture affects the rights or obligations of the Developer under the Indenture or under the Loan Agreement, in which case the Trustee shall enter into such supplemental indenture only if the Trustee has received the Developer’s written consent thereto, except as required in the opinion of Bond Counsel to maintain the tax-exempt status of interest on the Bonds, in which case the Trustee shall give notice thereof to the Developer; (iii) such supplemental indenture affects the rights or obligations of the Tender Agent under the Indenture, in which case the Trustee shall enter into such supplemental indenture only if the Trustee has received the Tender Agent’s written consent thereto, except as required in the opinion of Bond Counsel to maintain the tax-exempt status of interest on the Bonds, in which case the Trustee shall give notice thereof to the Tender Agent; or (iv) such supplemental indenture materially adversely affects the rights or obligations of the Remarketing Agent under the Indenture, in which case

the Trustee shall enter into such supplemental indenture only if the Trustee has received the Remarketing Agent's written consent thereto, except as required in the opinion of Bond Counsel to maintain the tax-exempt status of interest on the Bonds, in which case the Trustee shall give notice thereof to the Remarketing Agent.

It shall not be necessary for the consent of the Bondholders to approve the particular form of any proposed supplemental indenture, but it shall be sufficient if such consent shall approve the substance thereof.

Promptly after the execution by the Issuer and the Trustee of any supplemental indenture pursuant to the provisions of the Indenture described under this heading, the Trustee shall give Bondholders, by first-class mail, a notice setting forth in general terms the substance of such supplemental indenture. Any failure of the Trustee to give such notice, or any defect therein, shall not, however, in any way impair or affect the validity of any such supplemental indenture.

***Opinion of Counsel as to Supplemental Indenture.*** Subject to the provisions of the Indenture described under the heading "The Trustee—Duties, Immunities and Liabilities of Trustee" above, the Trustee shall be entitled to receive, and shall be fully protected in relying upon, an Opinion of Counsel for the Issuer or Bond Counsel as conclusive evidence that any supplemental indenture executed pursuant to the provisions of the Indenture described under this heading "Modification of Indenture" authorized and permitted by the Indenture.

## **Defeasance**

***Discharge of Indenture.*** If the entire indebtedness on all Bonds Outstanding shall be paid and discharged in any one or more of the following ways:

- (a) by the payment of the principal of (including redemption premium, if any) and interest on all Bonds Outstanding; or
- (b) by the deposit or credit to the account of the Trustee, in trust, at or before maturity, of money or Government Obligations in the necessary amount (as described under the heading "Deposit of Money or Securities With Trustee" below) to pay or redeem Bonds Outstanding, whether by redemption or otherwise and prior receipt by the Trustee of written evidence from the Rating Agency that such deposit or credit will not cause a reduction or withdrawal of the then current rating on the Bonds; or
- (c) by the delivery to the Trustee, for cancellation by it, of all Bonds Outstanding;

and if all other sums payable under the Indenture by the Issuer and all amounts payable to the Credit Bank under the Credit Agreement shall be paid and discharged, then and in that case the Indenture shall cease, terminate and become null and void, except only as provided in the Indenture, and thereupon the Trustee shall, upon Written Request of the Issuer, and upon receipt by the Trustee of a Written Certificate of the Issuer and an Opinion of Counsel, each stating that in the opinion of the signers all conditions precedent to the satisfaction and discharge of the Indenture have been complied with, forthwith execute proper instruments acknowledging satisfaction of and discharging the Indenture. The fees and charges of the Trustee and the Tender Agent (including reasonable counsel fees) must be paid in order to effect such discharge. The satisfaction and discharge of the Indenture shall be without prejudice to the rights of the Trustee to charge and be reimbursed by the Developer for any expenditures which it may thereafter incur in connection herewith.



The Issuer or the Credit Bank or the Developer may at any time surrender to the Trustee for cancellation by it any Bonds previously authenticated and delivered which the Issuer or the Credit Bank or the Developer lawfully may have acquired in any manner whatsoever, and such Bonds upon such surrender and cancellation shall be deemed to be paid and retired.

Subject to the provisions of the Indenture described under the heading “Payment of Bonds After Discharge of Indenture” below and notwithstanding any other provision of the Indenture, the Loan Agreement or any other document, agreement or instrument executed in connection with the issuance and delivery of the Bonds, any amounts remaining in any fund or account established under the Indenture after the discharge of the Indenture pursuant to the provisions of the Indenture described under this heading “Defeasance” shall be paid to the Developer.

***Discharge of Liability on Bonds.*** Upon the deposit with the Trustee, in trust, at or before maturity, of money or securities in the necessary amount (as described under the heading “Deposit of Money or Securities With Trustee” below) to pay or redeem Outstanding Bonds (whether upon or prior to their maturity or the redemption date of such Bonds) provided that, if such Bonds are to be redeemed prior to the maturity thereof, notice of such redemption shall have been given as provided in the Indenture or provision satisfactory to the Trustee shall have been made for the giving of such notice, all liability of the Issuer in respect of such Bonds shall cease, terminate and be completely discharged, except only that thereafter the holders thereof shall be entitled to payment by the Issuer, and the Issuer shall remain liable for such payment, but only out of the money or securities deposited with the Trustee as aforesaid for their payment, subject, however, to the provisions of the Indenture described under the heading “Payment of Bonds After Discharge of Indenture” below.

***Payment of Bonds After Discharge of Indenture.*** Notwithstanding any provisions of the Indenture, any moneys deposited with the Trustee or any paying agent in trust for the payment of the principal of, or interest or premium on, any Bonds remaining unclaimed for two years after the principal of all the Outstanding Bonds has become due and payable (whether at maturity or upon call for redemption or by declaration as provided in the Indenture), shall then be paid to the Issuer, and the holders of such Bonds shall thereafter be entitled to look only to the Issuer for payment thereof, and only to the extent of the amount so paid to the Issuer, and all liability of the Trustee or any paying agent with respect to such moneys shall thereupon cease. In the event of the payment of any such moneys to the Issuer as aforesaid, the holders of the Bonds in respect of which such moneys were deposited shall thereafter be deemed to be unsecured creditors of the Issuer for amounts equivalent to the respective amounts deposited for the payment of such Bonds and so paid to the Issuer (without interest thereon).

***Deposit of Money or Securities With Trustee.*** Whenever in the Indenture it is provided or permitted that there be deposited with or credited to the account of or held in trust by the Trustee money or securities purchased with Available Amounts in the necessary amount to pay or redeem any Bonds (assuming for any Variable Period that the Bonds will bear interest at the Maximum Interest Rate from the date of such deposit or credit through the redemption or payment date), the money or securities so to be deposited or held shall be Available Amounts constituting:

- (a) lawful money of the United States of America in an amount equal to the principal amount of such Bonds and all unpaid interest thereon to maturity, except that, in the case of Bonds which are to be redeemed prior to maturity and in respect of which there shall have been furnished to the Trustee proof satisfactory to it that notice of such redemption on a specified redemption date has been duly given or provision satisfactory to the Trustee shall be made for such notice, the amount so to be deposited or held shall be the principal amount of such Bonds and interest thereon to the redemption date, together with the redemption premium, if any; or

(b) Government Obligations in such amounts and maturing at such times that the proceeds of said obligations received upon their respective maturities and interest payment dates, without further reinvestment, will provide funds sufficient, in the opinion of a nationally recognized firm of certified public accountants, to pay the principal, premium, if any, and interest to maturity, or to the redemption date, as the case may be, with respect to all of the Bonds to be paid or redeemed, as such principal, premium and interest become due, provided that the Trustee shall have been irrevocably instructed by the Issuer to apply the proceeds of said obligations to the payment of said principal, premium, if any, and interest with respect to such Bonds.

## **SUMMARY OF CERTAIN PROVISIONS OF THE LOAN AGREEMENT**

*The following is a brief summary of certain provisions of the Loan Agreement. This summary does not purport to be comprehensive or definitive and is subject to all of the terms and provisions of the Loan Agreement.*

### **Financing of the Project; Issuance of the Bonds**

***Agreement To Issue Bonds; Application of Bond Proceeds.*** To provide funds to finance the construction and development of the Project, the Issuer has agreed that it will issue under the Indenture, sell and cause to be delivered to the purchasers thereof, the Bonds, bearing interest at the rates and payable as to principal and interest at the times as set forth in the Indenture. The Issuer will, upon issuance and delivery of the Bonds, deposit the proceeds received from the sale of the Bonds with the Trustee as provided in the Indenture.

***Disbursement From the Program Fund.*** The Issuer has authorized and directed the Trustee to disburse from the Project Account of the Program Fund created pursuant to the Indenture to pay or to reimburse the Developer for Qualified Project Costs for the construction and development of the Project, but only if the Trustee shall have received a Funding Requisition, substantially in the form of an exhibit to the Loan Agreement, executed by an Authorized Developer Representative and approved by an Authorized Bank Representative (or a Written Direction executed by an Authorized Bank Representative, upon the Credit Bank's representation to the Trustee that a disbursement from the Program Fund is permitted without the Developer's consent in accordance with the terms of the Credit Agreement), with respect to each requested disbursement or advance.

Upon receipt of a properly signed Funding Requisition, the Trustee is authorized to act thereon without further inquiry and, except for the negligence or willful misconduct of the Trustee, the Developer shall hold the Trustee harmless against any and all losses, claims or liability incurred in connection with the Trustee directly making such disbursements from the Program Fund. Neither the Trustee nor the Issuer shall be responsible for the application by the Credit Bank or the Developer of moneys disbursed in as described under this heading.

***Investment of Moneys; Arbitrage.*** Upon written direction of the Developer, approved in writing by the Credit Bank, any moneys in any fund or account held by the Trustee shall be invested or reinvested by the Trustee in Investment Securities as provided in the Indenture, and the Developer has approved such provisions of the Indenture and directed the Trustee to make such investments, subject to the covenants set forth in the Loan Agreement relating to the tax-exempt status of the Bonds.

## **Loan of Proceeds; Payment Provisions**

***Loan of Bond Proceeds.*** The Issuer has agreed, upon the terms and conditions in the Loan Agreement, to make the Loan to the Developer in an amount equal to the aggregate principal amount of the Bonds issued, delivered and outstanding pursuant to the Indenture for the purpose of financing and refinancing the construction and development of the Project. Pursuant to such agreement, the Issuer will issue the Bonds upon the terms and conditions contained in the Loan Agreement and the Indenture and will cause the proceeds of the Bonds to be applied by the Trustee as provided in the Indenture and as described under the heading “Financing of the Project; Issuance of the Bonds—Disbursement From the Program Fund” above.

***Loan Repayment and Payment of Other Amounts.*** The Developer has acknowledged its indebtedness to the Issuer and agreed to repay the Loan in the amounts and at the times necessary to enable the Trustee, on behalf of the Issuer, to pay when due all amounts payable with respect to the Bonds when due, whether at maturity or by purchase, redemption or acceleration or otherwise. The Issuer has agreed that the Developer’s repayment obligations under the Loan Agreement shall be reduced from time to time by any amounts drawn under the Letter of Credit and applied to the payment of debt service on the Bonds. The Developer has agreed to cause the Letter of Credit and the Standby Letter of Credit to be delivered to the Trustee in accordance with the Loan Agreement.

The Developer has agreed (i) to pay to the Trustee from time to time reasonable compensation for all services rendered by it under the Indenture and the other agreements relating to the Bonds to which the Trustee is a party; (ii) except as otherwise expressly provided in the Indenture or such other agreements, to reimburse each of the Trustee and the Tender Agent upon its request for all reasonable expenses, disbursements and advances (including reasonable counsel fees) incurred or made by the Trustee or the Tender Agent in accordance with any provision of the Indenture or other agreements to which the Trustee or the Tender Agent is a party or pursuant to which it is required to act (including the reasonable compensation and the expenses and disbursements of its agents and counsel), except any such expense, disbursement or advance as may be attributable to its negligence, bad faith or willful misconduct; (iii) in accordance with the Loan Agreement, to indemnify the Trustee and the Tender Agent for, and hold each harmless against, any loss, liability or expense incurred without negligence, willful misconduct or bad faith on its part, arising out of or in connection with the acceptance or administration of the trusts under the Indenture or any other agreement relating to the Bonds to which the Trustee or the Tender Agent is a party or pursuant to which it is required to act, including the costs and expenses of defending itself against any claim or liability in connection with the exercise or performance of any of its powers or duties thereunder; and (iv) to pay any initial and annual fee of any Rating Agency then rating the Bonds, the fees of the Remarketing Agent, the Tender Agent and any paying agents, and any other amounts referred to in the provisions of the Indenture relating to the compensation of the Trustee and certain agents. The rights of the Trustee to compensation and indemnification under the Loan Agreement shall survive removal or resignation of the Trustee and discharge of the Indenture.

The Developer has also agreed to pay (i) within 30 days after receipt of request for payment thereof, which request shall set forth in detail the expenses with respect to the Project, all reasonable fees and expenses of the Issuer related to the Project and the financing thereof, which are not otherwise required to be paid by the Developer under the terms of the Loan Agreement and are not paid from the Cost of Issuance Fund under the Indenture, including, without limitation, legal fees and expenses incurred in connection with the amendment, interpretation and enforcement of any documents relating to the Project or the Bonds, and (ii) notwithstanding any prepayment of the Loan and a discharge of the Indenture, to the Trustee for remittance to the Issuer, an annual Issuer Fee in accordance with the Regulatory Agreement. In addition, in the event the Developer prepays the Loan pursuant to the Loan Agreement during the Qualified Project Period, the Developer has also agreed to pay amounts due and

payable pursuant to the Loan Agreement as described under the heading “Prepayment—Amount of Prepayment” below.

The Developer has also agreed to pay any fees and other costs required to be incurred by the Issuer and/or the Trustee to comply with the provisions of the Indenture relating to rebate, including but not limited to any expenses related to computations to determine if moneys are required to be rebated to the United States. The Developer shall promptly pay the amount required by the provisions of the Indenture relating to rebate to the Trustee to be used as provided in the Indenture.

The Developer has agreed to pay any fees of the Rating Agency to maintain a rating on the Bonds necessary in connection with the remarketing of the Bonds under the Indenture.

***Unconditional Obligation; Nonrecourse.*** The obligations of the Developer to make the payments required by the Loan Agreement as described under the heading “Loan Repayment and Payment of Other Amounts” above and to perform and observe the other agreements on its part contained in the Loan Agreement shall be absolute and unconditional, irrespective of any defense or any rights of setoff, recoupment or counterclaim it might otherwise have against the Issuer or the Trustee, and, during the term of the Loan Agreement, the Developer shall pay absolutely the payments required under the Loan Agreement, free of any deductions and without abatement, diminution or setoff. Until such time as the principal of, premium, if any, and interest on the Bonds shall have been fully paid, or provision for the payment thereof shall have been made as required by the Indenture, the Developer (a) will not suspend or discontinue any payments as described under the heading “Loan Repayment and Payment of Other Amounts” above; (b) will perform and observe all of its other covenants contained in the Loan Agreement; and (c) except as described under the heading “Prepayment” below, will not terminate the Loan Agreement for any cause, including, without limitation, the occurrence of any act or circumstances that may constitute failure of consideration, destruction of or damage to the Project, commercial frustration of purpose, any change in the tax or other laws of the United States of America or of the State of California or any political subdivision of either of these, or any failure of the Issuer or the Trustee to perform and observe any covenant, whether express or implied, or any duty, liability or obligation arising out of or connected with the Loan Agreement or the Indenture, except to the extent permitted by the Loan Agreement.

Notwithstanding any provision of the Loan Agreement, the Regulatory Agreement or the First Deed of Trust (collectively, the “Project Loan Documents”) to the contrary, the Developer shall not be personally liable for the amounts owing under the Loan Agreement (other than for indemnity and fees as described below) or under the Project Loan Documents, and the Issuer’s and the Trustee’s remedies in the event of a default under the Loan Agreement or under the Project Loan Documents shall be limited to those remedies described under the heading “Events of Default and Remedies—Remedies on Default” below and under the Regulatory Agreement. In the event of a default under the Loan Agreement or under the First Deed of Trust, except to the extent described in the next sentence, neither the Issuer nor the Trustee shall have the right to proceed directly against the Developer (rather than the Project) or the right to obtain a deficiency judgment after foreclosure. Nothing described under this heading shall preclude the Issuer, the Trustee or the Administrator from proceeding directly against the Developer in connection with the following: (i) the obligation of the Developer to indemnify the Issuer, the Trustee and the Administrator under the Loan Agreement or the Regulatory Agreement; (ii) the obligation of the Developer to make any payment to the Issuer, the Trustee or the Administrator required to be paid by the Developer pursuant to the provisions of the Loan Agreement or the Regulatory Agreement; (iii) the application by the Developer in violation of the First Deed of Trust or the Loan Agreement of any condemnation award or insurance awards attributable to the Project; (iv) the application of rents or security deposits attributable to the Project other than as permitted by the First Deed of Trust and applicable law; (v) the obligation of the Developer under any provision regarding hazardous materials (as

referenced in the Loan Agreement); and (vi) any amounts owing under indemnity provisions that relate to liabilities to third parties resulting from acts or omissions of Developer and/or from the ownership, occupancy or use of the Project, all of which obligations shall constitute recourse obligations of the Developer.

***Assignment of Issuer's Rights.*** As security for the payment of the Bonds, the Issuer has assigned in the Indenture certain of the Issuer's rights under the Loan Agreement and the Issuer Loan Documents to the Trustee, including the right to receive payments under the Loan Agreement (except for the Reserved Right of the Issuer), and the Issuer has directed the Developer to make the payments required under the Loan Agreement (except such payments for Issuer expenses and indemnification) directly to the Trustee. The Developer has assented to such assignment and agreed to make payments directly to the Trustee without defense or setoff by reason of any dispute between the Developer and the Issuer or the Trustee. By virtue of such assignment, the Trustee shall have the right to enforce the obligations of the Developer under the Loan Agreement.

In consideration for the undertaking by the Developer to reimburse the Credit Bank for amounts drawn under the Letter of Credit to purchase Bonds that are tendered for purchase and for which the Credit Bank has not been reimbursed from the proceeds of the remarketing of the Bonds, the Issuer has assigned to the Credit Bank, all of the Issuer's right, title and interest in and to any and all proceeds of any subsequent remarketing of any such Bonds so purchased and agreed to direct the Remarketing Agent to pay any such proceeds to the Credit Bank.

***Amounts Remaining in Bond Fund.*** After (a) payment in full of the Bonds, or provision for such payment having been made as provided in the Indenture, (b) payment of all fees, charges and expenses of the Trustee and any paying agents in accordance with the terms of the Indenture, and (c) payment of all other amounts required to be paid under the Loan Agreement, the Regulatory Agreement and the Indenture, any amounts remaining in the Bond Fund held by the Trustee under the Indenture, subject to the application of amounts in the Bond Fund to the payment of particular Bonds, shall be paid by the Trustee to the Credit Bank to the extent any amounts are due and payable to the Credit Bank under the Credit Agreement or the Credit Bank remains obligated on the Letter of Credit or under the Credit Agreement, or to the Developer, if no such amounts are due and payable under the Credit Agreement and if the obligations of the Credit Bank under the Letter of Credit and the Credit Agreement have been discharged and fully terminated, as provided in the Indenture, and the Issuer shall have no claim to such amounts.

## **Events of Default and Remedies**

***Events of Default.*** Any one of the following which occurs and continues shall constitute an Event of Default under the Loan Agreement:

(a) subject to the provisions of the Intercreditor Agreement, failure by the Developer to pay any amounts required to be paid as described under the heading "Loan Repayment and Payment of Other Amounts" above at the times specified in the Loan Agreement;

(b) subject to the provisions of the Intercreditor Agreement, failure by the Developer to observe and perform any other covenant, condition or agreement on its part required to be observed or performed by the Loan Agreement (including performance of its obligations under the Regulatory Agreement), and which continues for a period of 60 days after written notice, specifying such failure and requesting that it be remedied, given to the Developer by the Issuer or the Trustee, unless the Issuer and the Trustee shall, with the consent of the

Credit Bank, agree in writing to an extension of such time prior to its expiration; provided, however, that, if the failure stated in the notice cannot be corrected within such period, the Issuer and the Trustee will not unreasonably withhold their consent to an extension of such time if corrective action is instituted within such period and diligently pursued until the default is corrected;

(c) subject to the provisions of the Intercreditor Agreement, the making of any representation or warranty by the Developer in the Loan Agreement, in the Issuer Loan Documents or in any document executed in connection with the Loan Agreement which is false or misleading in any material respect when made; or

(d) subject to the provisions of the Loan Agreement described under the heading "Limitation on Rights of Credit Bank" below, receipt by the Trustee from the Credit Bank of notice of an event of default under the Credit Agreement and a request that it be treated as an Event of Default under the Loan Agreement.

The provisions of the Loan Agreement described in paragraph (b) above, except with respect to defaults under the Regulatory Agreement or under the provisions of the Loan Agreement relating to the tax-exempt status of interest on the Bonds, are subject to the limitation that the Developer shall not be deemed in default if and so long as the Developer is unable to carry out its agreements under the Loan Agreement by reason of strikes, lockouts or other industrial disturbances; acts of public enemies; orders of any kind of the government of the United States or of the State of California or any of their departments, agencies or officials, or any civil or military authority; insurrections, riots, epidemics, landslides; lightning; earthquake; fire; hurricanes; storms; floods; washouts; droughts; arrests; restraint of government and people; civil disturbances; explosions; breakage or accident to machinery, transmission pipes or canals; partial or entire failure of utilities; or any other cause or event not reasonably within the control of the Developer; it being agreed that the settlement of strikes, lockouts and other industrial disturbances shall be entirely within the discretion of the Developer, and the Developer shall not be required to make settlement of strikes, lockouts and other industrial disturbances by acceding to the demands of the opposing party or parties when such course is, in the judgment of the Developer, unfavorable to the Developer. This limitation shall not apply to any default except as described in paragraph (b) above.

***Remedies on Default.*** Subject to the terms of the Intercreditor Agreement, whenever any Event of Default shall have occurred and shall continue, after giving notice to the Credit Bank and subject to any right of the Credit Bank to cure any such default, the Issuer and the Trustee may take any one or more of the following remedial steps:

(a) The Trustee, by written notice to the Developer, shall immediately declare to be due and payable immediately the unpaid balance of the Loan.

(b) The Issuer or the Trustee may take whatever action at law or in equity as may be necessary or desirable to collect the payments and other amounts then due and thereafter to become due or to enforce performance and observance of any obligation, agreement or covenant of the Developer under the Loan Agreement.

(c) The Trustee may institute any action or proceeding at law or in equity for the collection of any sums due and unpaid, and may prosecute any such action or proceeding to judgment or final decree, and may enforce any such judgment or final decree against the Developer and collect in the manner provided by law the moneys adjudged or decreed to be

payable as limited only by the provisions of the Loan Agreement described under the heading “Loan of Proceeds; Payment Provisions—Unconditional Obligation; Nonrecourse” above.

In case the Trustee or the Issuer shall have proceeded to enforce its rights under the Loan Agreement and such proceedings shall have been discontinued or abandoned for any reason or shall have been determined adversely to the Trustee or the Issuer, then, and in every such case, the Developer, the Trustee, the Credit Bank and the Issuer shall be restored respectively to their several positions and rights under the Loan Agreement, and all rights, remedies and powers of the Developer, the Trustee, the Credit Bank and the Issuer shall continue as though no such action had been taken.

In case proceedings shall be pending for the bankruptcy or for the reorganization of the Developer under the federal bankruptcy laws or any other applicable law, or in case a receiver or trustee shall have been appointed for the property of the Developer, or in the case of any other similar judicial proceedings relative to the Developer, or the creditors or property of the Developer, then the Trustee shall be entitled and empowered, by intervention in such proceedings or otherwise, to file and prove a claim or claims for the whole amount owing and unpaid pursuant to the Loan Agreement and, in case of any judicial proceedings, to file such proofs of claim and other papers or documents as may be necessary or advisable in order to have the claims of the Trustee allowed in such judicial proceedings relative to the Developer, its creditors or its property, and to collect and receive any moneys or other property payable or deliverable on any such claims, and to distribute such amounts as provided in the Indenture after the deduction of its charges and expenses. Any receiver, assignee or trustee in bankruptcy or reorganization has been authorized to make such payments to the Trustee, and to pay to the Trustee any reasonable amount due it for compensation and expenses, including expenses and fees of counsel incurred by it up to the date of such distribution.

Notwithstanding anything in the Indenture, the First Deed of Trust or the Loan Agreement to the contrary, the Trustee shall not be required to initiate foreclosure proceedings with respect to the Project, and shall not otherwise be required to acquire possession of or take other action with respect to the Project that could cause it to be considered an “owner” or “operator” within the meaning of the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended from time to time, or any other law dealing with the environmental matters or hazardous substances, unless the Trustee has sufficient comfort, based on previous determinations by experts on which Trustee can rely, including an environmental report, that:

(a) the Project is in compliance with all Hazardous Materials Laws (as defined in the Environmental Indemnity referenced in the Loan Agreement) or, if not, that it would nevertheless be in the best economic interest of the Trustee and the Bondholders to take such actions as are necessary for the Project to comply therewith;

(b) there are no circumstances present at the Project relating to the use, management or disposal of any hazardous substances, hazardous materials, hazardous wastes or petroleum-based materials for which investigation, testing, monitoring, contaminant, cleanup or remedial action could be required under any Environmental Laws or that, if any such materials are present for which such action could be required, it would be nevertheless in the best economic interest of the Trustee and the Bondholders to take such actions with respect to the Project;

(c) if the Trustee has determined that it would be in the best economic interest of the Trustee and the Bondholders, the Trustee must be satisfied that it will suffer no unreimbursed liabilities and will be adequately reimbursed for all liabilities, expenses and costs from available funds in the Trustee’s possession and control; and

(d) if the Trustee has determined that it would be in the best economic interest of the Trustee and the Bondholders to take any such action and its aforementioned liabilities, expenses and costs are adequately reimbursed, the Trustee has so notified the Bondholders and has not received, within 30 days of such notification, instructions from owners of 60% or more in principal amount of the then Outstanding Bonds directing it not to take such action.

If the foregoing conditions are not satisfied and the Trustee is not willing to waive such conditions and initiate foreclosure proceedings, then the Trustee shall take such actions as are reasonably necessary or appropriate in order to facilitate the appointment of a co-trustee, being a person or entity designated by the Owners of a majority in principal amount of the Bonds then Outstanding and to assign to such person or entity (subject, however, to the trusts created pursuant to the Indenture) the beneficial interest under the First Deed of Trust which secures the obligations under the Loan Agreement, for the limited purpose of conducting a foreclosure of such First Deed of Trust and receiving and holding any title to real property obtained as a result of such foreclosure. Persons or entities appointed as co-trustees or agents of the Trustee as described under this heading shall not be required to meet the criteria of the Indenture relating to qualifications of Trustees, or any other criteria, in order to serve as such.

***Limitations on Rights of Credit Bank.*** All provisions in the Loan Agreement regarding consents, approvals, directions, waivers, appointments, requests, directions of proceedings or other actions by the Credit Bank shall be deemed not to require or permit such consents, approvals, directions, waivers, appointments, requests or other actions and shall be read as if the Credit Bank were not mentioned in such provisions (i) if the Standby Credit Bank is in default under the Standby Letter of Credit, or (ii) after the Standby Letter of Credit is declared to be null and void by final judgment of a court of competent jurisdiction; provided, however, that the Credit Bank's right to notices and the payment of amounts due to the Credit Bank shall continue in full force and effect.

## **Prepayment**

***Prepayment of Loan.*** The Loan shall not be prepaid except as described under this heading. No prepayment of the Loan shall relieve the Developer of its obligations under the Regulatory Agreement during the Qualified Project Period. The Developer shall be permitted or required to prepay, or shall be deemed to have prepaid, the Loan, in whole or in part, and the principal amount thereof shall be reduced accordingly, in an amount equal to the principal amount of Bonds redeemed and on the date of such redemption, as follows:

(a) Subject to the terms of the Intercreditor Agreement, the Developer shall be required to prepay the Loan in whole or in part from the amount of any Net Proceeds of any insurance or condemnation award which are not used to repair or replace the Project pursuant to the Loan Agreement.

(b) The Developer shall be permitted to prepay the Loan in whole or in part (i) at any time while the Bonds bear interest at a Variable Rate and (ii) before any date on which the Bonds are subject to redemption as described in paragraph (d) under the heading "REDEMPTION OF BONDS—Terms of Redemption" herein, provided at least 30 days' notice is given to the Trustee of such redemption and the Credit Bank agrees to include in the amount of the Letter of Credit or the Developer provides Available Amounts in the amount of any premium due on such redemption.

(c) The Developer shall be required to prepay the full remaining balance of the Loan, upon the acceleration of the Loan pursuant to the Loan Agreement.



(d) The Developer shall be required to prepay the Loan in whole or in part on the date necessary in order for the Bonds to be redeemed as described in paragraphs (c), (d) and (e) under the heading “REDEMPTION OF BONDS—Terms of Redemption” herein.

***Redemption of Bonds Upon Prepayment.*** Upon any prepayment of the Loan as described above, the Trustee is required by the Indenture to call all or part of the Bonds for redemption and to draw upon the Letter of Credit in the respective amounts set forth in the applicable paragraph under the heading “REDEMPTION OF BONDS—Terms of Redemption” herein.

***Amount of Prepayment.*** In the event of any prepayment described above, the amount of the Loan deemed to be prepaid shall be equal to the principal amount of Bonds redeemed as described in the Loan Agreement. In the case of prepayment of the Loan in full, the Developer shall pay to the Trustee an amount sufficient, together with other funds held by the Trustee and available for such purpose, to pay all reasonable and necessary fees and expenses (including attorneys’ fees) of the Issuer, the Trustee and any paying agent accrued and to accrue through final payment of the Bonds and all other liabilities of the Developer accrued and to accrue under the Loan Agreement and shall pay to the Issuer an amount described under the heading “Loan of Proceeds; Payment Provisions—Loan Repayment and Payment of Other Amounts” above. In the case of partial prepayment of the Loan, the Developer shall pay or cause to be paid to the Trustee an amount sufficient, together with other funds held by the Trustee and available for such purpose, to pay expenses of redemption of the Bonds to be redeemed upon such prepayment.

The Developer has agreed that it will not voluntarily prepay the Loan or any part thereof, except in amounts sufficient to redeem Bonds in whole multiples of \$100,000 plus any multiple of \$5,000 in excess thereof during any Variable Period, and to pay any applicable redemption premium and accrued interest to the redemption date.

#### **Amendments, Changes and Modifications**

Except as otherwise provided in the Loan Agreement or the Indenture, subsequent to the initial issuance of Bonds and prior to their payment in full, or provision for such payment having been made as provided in the Indenture, the Loan Agreement may be effectively amended, changed, modified, altered or terminated only by written instrument executed by the parties to the Loan Agreement and only with the written consent of the Credit Bank.

#### **SUMMARY OF CERTAIN PROVISIONS OF THE REGULATORY AGREEMENT**

*The following is a brief summary of certain provisions of the Regulatory Agreement. This summary does not purport to be comprehensive or definitive and is subject to all of the terms and provisions of the Regulatory Agreement.*

#### **Definitions**

“*Administrator*” means the Issuer or any administrator or program monitor appointed by the Issuer to administer the Regulatory Agreement, and any successor administrator appointed by the Issuer.

“*Area*” means the Metropolitan Statistical Area or County, as applicable, in which the Project is located as defined by the United States Department of Housing and Urban Development.

“*Available Units*” means residential units in the Project that are actually occupied and residential units in the Project that are vacant and have been occupied at least once after becoming available for occupancy, provided that (a) a residential unit that is vacant on the later of (i) the date the Project is

acquired or (ii) the issue date of the Bonds is not an Available Unit and does not become an Available Unit until it has been occupied for the first time after such date, and (b) a residential unit that is not available for occupancy due to renovations is not an Available Unit and does not become an Available Unit until it has been occupied for the first time after the renovations are completed.

“*CDLAC*” means the California Debt Limit Allocation Committee or its successors.

“*CDLAC Conditions*” has the meaning given such term in the Regulatory Agreement.

“*Certificate of Continuing Program Compliance*” means the Certificate to be filed by the Developer with the Administrator, on behalf of the Issuer, and the Trustee as described in paragraph (f) under the heading “Low Income Tenants; Reporting Requirements” below, which shall be substantially in the form attached to the Regulatory Agreement or in such other comparable form as may be provided by the Issuer to the Developer, or as otherwise approved by the Issuer.

“*City*” means the City of Lompoc, California.

“*Compliance Period*” means the period beginning on the first day of the Qualified Project Period and ending on the later of the end of the Qualified Project Period or such later date as set forth in the Regulatory Agreement.

“*County*” means the County of Santa Barbara, California.

“*Gross Income*” means the gross income of a person (together with the gross income of all persons who intend to reside with such person in one residential unit) as calculated in the manner prescribed in under Section 8 of the United States Housing Act of 1937.

“*Housing Act*” means the United States Housing Act of 1937, as amended, or its successor.

“*Housing Law*” means Chapter 7 of Part 5 of Division 31 of the California Health and Safety Code, as amended.

“*Income Certification*” means a Tenant Income Certification and a Tenant Income Certification Questionnaire in the form attached to the Regulatory Agreement or in such other comparable form as may be provided by the Issuer to the Developer, or as otherwise approved by the Issuer.

“*Low Income Tenant*” means a tenant occupying a Low Income Unit.

“*Low Income Unit*” means any Available Unit if the aggregate Gross Income of all tenants therein does not exceed limits determined in a manner consistent with determinations of “low-income families” under Section 8 of the Housing Act, provided that the percentage of median gross income that qualifies as low income hereunder shall be 60% of median gross income for the Area, with adjustments for family size. A unit occupied by one or more students shall only constitute a Low Income Unit if such students meet the requirements of Section 142(d)(2)(C) of the Code. The determination of an Available Unit’s status as a Low Income Unit shall be made by the Developer upon commencement of each lease term with respect to such unit, and annually thereafter, on the basis of an Income Certification executed by each tenant.

“*Manager*” means a property manager meeting the requirements of the Regulatory Agreement.

*“Project Status Report”* means the report to be filed by the Developer with the Administrator, on behalf of the Issuer, and the Trustee as described in paragraph (f) under the heading “Low Income Tenants; Reporting Requirements” below, which shall be substantially in the form attached to the Regulatory Agreement or in such other comparable form as may be provided by the Issuer to the Developer, or as otherwise approved by the Issuer.

*“Qualified Project Period”* means the period beginning on the first day on which at least 10% of the units in the Project are first occupied and ending on the later of the following:

(A) the date that is fifteen (15) years after the date on which at least fifty percent (50%) of the units in the Project are first occupied;

(B) the first date on which no Tax-Exempt private activity bonds with respect to the Project are Outstanding; or

(C) the date on which any assistance provided with respect to the Project under Section 8 of the Housing Act terminates

*“Regulations”* means the Income Tax Regulations of the Department of the Treasury applicable under the Code from time to time.

*“Rental Payments”* means the rental payments paid by the occupant of a unit, excluding any supplemental rental assistance to the occupant from the State, the federal government, or any other public agency, but including any mandatory fees or charges imposed on the occupant by the Developer as a condition of occupancy of the unit.

*“Tax-Exempt”* means with respect to interest on any obligations of a state or local government, including the Bonds, that such interest is excluded from gross income for federal income tax purposes; provided, however, that such interest may be includable as an item of tax preference or otherwise includable directly or indirectly for purposes of calculating other tax liabilities, including any alternative minimum tax or environmental tax, under the Code.

*“Transfer”* means the conveyance, assignment, sale or other disposition of all or any portion of the Project; and shall also include, without limitation to the foregoing, the following: (1) an installment sales agreement wherein the Developer agrees to sell the Project or any part thereof for a price to be paid in installments; and (2) an agreement by the Developer leasing all or a substantial part of the Project to one or more persons or entities pursuant to a single or related transactions.

### **Qualified Residential Rental Project**

The Developer has acknowledged and agreed that the Project is to be owned, managed and operated as a “residential rental project” (within the meaning of Section 142(d) of the Code) for a term equal to the Compliance Period. To that end, and for the term of the Regulatory Agreement, the Developer has represented, covenanted, warranted and agreed as follows:

(a) The Project will be constructed, developed and operated for the purpose of providing multifamily residential rental property. The Developer will own, manage and operate the Project as a project to provide multifamily residential rental property comprised of a building or structure or several interrelated buildings or structures, together with any functionally related and subordinate facilities, and no other facilities, in accordance with Section 142(d) of the Code,

Section 1.103-8(b) of the Regulations and the provisions of the Act and the Housing Law, and in accordance with such requirements as may be imposed thereby on the Project from time to time.

(b) All of the dwelling units in the Project (except for not more than one unit set aside for a resident manager or other administrative use) will be similarly constructed units, and each dwelling unit in the Project will contain complete separate and distinct facilities for living, sleeping, eating, cooking and sanitation for a single person or a family, including a sleeping area, bathing and sanitation facilities and cooking facilities equipped with a cooking range, refrigerator and sink.

(c) None of the dwelling units in the Project will at any time be utilized on a transient basis or rented for a period of less than 30 consecutive days, or will ever be used as a hotel, motel, dormitory, fraternity house, sorority house, rooming house, nursing home, hospital, sanitarium, rest home or trailer court or park; provided that the use of certain units for tenant guests on an intermittent basis shall not be considered transient use for purposes of the Regulatory Agreement.

(d) No part of the Project will at any time during the Compliance Period be owned by a cooperative housing corporation, nor shall the Developer take any steps in connection with a conversion to such ownership or use, and the Developer will not take any steps in connection with a conversion of the Project to condominium ownership during the Compliance Period (except that the Developer may obtain final map approval and the Final Subdivision Public Report from the California Department of Real Estate and may file a condominium plan with the City).

(e) All of the Available Units in the Project will be available for rental during the period beginning on the date of the Regulatory Agreement and ending on the termination of the Compliance Period on a continuous, "first-come, first-served" basis to members of the general public, which for purposes of the Regulatory Agreement means the general senior population, and the Developer will not give preference to any particular class or group in renting the dwelling units in the Project, except to the extent that dwelling units are required to be leased or rented in such a manner that they constitute Low Income Units.

(f) The Project consists of a parcel or parcels that are contiguous except for the interposition of a road, street or stream, and all of the facilities of the Project comprise a single geographically and functionally integrated project for residential rental property, as evidenced by the ownership, management, accounting and operation of the Project.

(g) No dwelling unit in the Project shall be occupied by the Developer; provided, however, that if the Project contains five or more dwelling units, this provision shall not be construed to prohibit occupancy of not more than one dwelling unit by a resident manager or maintenance personnel, any of whom may be the Developer.

(h) The Developer shall deliver to the Administrator and the Credit Bank, (i) within 30 days after the date on which 10% of the dwelling units in the Project are occupied, a written notice specifying such date, and (ii) within 30 days after the date on which 50% of the dwelling units in the Project are occupied, a written notice specifying such date.

### **Low Income Tenants; Reporting Requirements**

Pursuant to the requirements of the Code, the Developer has represented, warranted and covenanted with the Issuer and the Trustee as follows:

(a) During the Compliance Period, no less than 40% of the total number of completed units in the Project shall at all times be Low Income Units. For the purposes of this paragraph (a), a vacant unit that was most recently a Low Income Unit is treated as a Low Income Unit until reoccupied, other than for a temporary period of not more than 31 days, at which time the character of such unit shall be redetermined.

(b) No tenant qualifying as a Low Income Tenant upon initial occupancy shall be denied continued occupancy of a unit in the Project because, after admission, the aggregate Gross Income of all tenants in the unit occupied by such Low Income Tenant increases to exceed the qualifying limit for a Low Income Unit. However, should the aggregate Gross Income of tenants in a Low Income Unit, as of the most recent determination thereof, exceed one hundred forty percent (140%) of the applicable income limit for a Low Income Unit occupied by the same number of tenants, the next available unit of comparable or smaller size must be rented to (or held vacant and available for immediate occupancy by) Low Income Tenant(s). The unit occupied by such tenants whose aggregate Gross Income exceeds such applicable income limit shall continue to be treated as a Low Income Unit for purposes of the 40% requirement described in paragraph (a) above unless and until an Available Unit of comparable or smaller size is rented to persons other than Low Income Tenants.

(c) For the Compliance Period, the Developer will obtain, complete and maintain on file Income Certifications for each Low Income Tenant, including (i) an Income Certification dated immediately prior to the initial occupancy of such Low Income Tenant in the unit and a second Income Certification dated one year after the Low Income Tenant's initial move in date, and (ii) thereafter, an annual Income Certification with respect to each Low Income Tenant. In lieu of obtaining the annual Income Certifications required by clause (ii) of the preceding sentence, the Developer may, with respect to any particular twelve-month period ending on the date set forth in the Regulatory Agreement, deliver to the Administrator no later than fifteen days after such date a certification that as of the date set forth in the Regulatory Agreement, no residential unit in the Project was occupied within the preceding twelve months by a new resident whose income exceeded the limit applicable to Low Income Tenants upon admission to the Project. The Administrator may at any time and in its sole and absolute discretion notify the Developer in writing that it will no longer accept certifications of the Developer made pursuant to the preceding sentence and that the Developer will thereafter be required to obtain annual Income Certifications for tenants. The Developer will also provide such additional information as may be required in the future by the Code, the State or the Issuer, as the same may be amended from time to time, or in such other form and manner as may be required by applicable rules, rulings, policies, procedures, Regulations or other official statements now or hereafter promulgated, proposed or made by the Department of the Treasury or the Internal Revenue Service with respect to Tax-Exempt obligations. Upon request of the Administrator or the Issuer, copies of Income Certifications for Low Income Tenants commencing or continuing occupation of a Low Income Unit shall be submitted to the Administrator or the Issuer, as requested.

(d) The Developer shall make a good faith effort to verify that the income information provided by an applicant in an Income Certification is accurate by taking one or more of the following steps as a part of the verification process: (1) obtain pay stubs for the three most recent pay periods, (2) obtain an income tax return for the most recent tax year, (3) obtain a credit report or conduct a similar type credit search, (4) obtain an income verification from the applicant's current employer, (5) obtain an income verification from the Social Security Administration and/or the California Department of Social Services if the applicant receives assistance from either of such agencies, or (6) if the applicant is unemployed and does not have

an income tax return, obtain another form of independent verification reasonably acceptable to the Issuer.

(e) The Developer will maintain complete and accurate records pertaining to the Low Income Units, and will permit any duly authorized representative of the Issuer, the Trustee, the Department of the Treasury or the Internal Revenue Service to inspect the books and records of the Developer pertaining to the Project, including those records pertaining to the occupancy of the Low Income Units.

(f) The Developer will prepare and submit to the Administrator, on behalf of the Issuer, not less than quarterly, commencing not less than three months after the Closing Date, a Certificate of Continuing Program Compliance executed by the Developer in substantially the form attached to the Regulatory Agreement and a Project Status Report in substantially the form attached to the Regulatory Agreement. During the Compliance Period, the Developer shall submit a completed Internal Revenue Code Form 8703 or such other annual certification as required by the Code with respect to the Project to the Secretary of the Treasury on or before March 31 of each year (or such other date as may be required by the Code).

(g) For the Compliance Period, all tenant leases or rental agreements shall be subordinate to the Regulatory Agreement and the First Deed of Trust. All leases pertaining to Low Income Units shall contain clauses, among others, wherein each tenant who occupies a Low Income Unit: (i) certifies the accuracy of the statements made by such tenant in the Income Certification; (ii) agrees that the family income and other eligibility requirements shall be deemed substantial and material obligations of the tenancy of such tenant, that such tenant will comply promptly with all requests for information with respect thereto from the Developer, the Trustee, the Issuer or the Administrator on behalf of the Issuer, and that the failure to provide accurate information in the Income Certification or refusal to comply with a request for information with respect thereto shall be deemed a violation of a substantial obligation of the tenancy of such tenant; (iii) acknowledges that the Developer has relied on the statements made by such tenant in the Income Certification and supporting information supplied by the Low Income Tenant in determining qualification for occupancy of a Low Income Unit, and that any material misstatement in such certification (whether or not intentional) will be cause for immediate termination of such lease or rental agreement; and (iv) agrees that the tenant's income is subject to annual certification as described in paragraph (c) above and that if upon any such certification the aggregate Gross Income of tenants in such unit exceeds the applicable income limit described in paragraph (b) above, the unit occupied by such tenant may cease to qualify as a Low Income Unit and such unit's rent may be subject to increase.

For purposes of the provisions of the Regulatory Agreement described under this heading, no unit occupied by a residential manager shall be treated as a rental unit during the time of such occupation.

### **Requirements of the Housing Law**

In addition to the other requirements set forth in the Regulatory Agreement, the Developer has agreed that it shall comply with each of the requirements of Section 52080 of the Housing Law, including the following:

(a) Not less than 40% of the total number of units in the Project shall be Low Income Units. The units made available to meet this requirement shall be of comparable quality and offer a range of sizes and numbers of bedrooms comparable to the units that are available to other tenants in the Project.

(b) The Rental Payments for the Low Income Units paid by the tenants thereof (excluding any supplemental rental assistance from the State, the federal government or any other public agency to those tenants or on behalf of those units) shall not exceed 30% of an amount equal to 60% of the median adjusted gross income for the Area.

(c) The Developer shall accept as tenants, on the same basis as all other prospective tenants, low-income persons who are recipients of federal certificates or vouchers for rent subsidies pursuant to the existing program under Section 8 of the Housing Act. The Developer shall not permit any selection criteria to be applied to Section 8 certificate or voucher holders that is more burdensome than the criteria applied to all other prospective tenants.

(d) The units reserved for occupancy as described in paragraph (a) under the heading “Low Income Tenants; Reporting Requirements” above shall remain available on a priority basis for occupancy at all times on and after the Closing Date and continuing through the Compliance Period.

(e) During the three (3) years prior to the expiration of the Compliance Period, the Developer shall continue to make available to eligible households Low Income Units that have been vacated to the same extent that nonreserved units are made available to noneligible households.

(f) Following the expiration or termination of the Compliance Period, except in the event of foreclosure and redemption of the Bonds, deed in lieu of foreclosure, eminent domain, or action of a federal agency preventing enforcement, units reserved for occupancy as required by paragraph (a) above shall remain available to any eligible tenant occupying a reserved unit at the date of such expiration or termination, at the rent determined by subsection (b) of this Section, until the earliest of (1) the household’s income exceeds 140% of the maximum eligible income specified above, (2) the household voluntarily moves or is evicted for good cause (as defined in the Housing Law), (3) 30 years after the date of the commencement of the Compliance Period, or (4) the Developer pays the relocation assistance and benefits to households as provided in Section 7264(b) of the California Government Code.

(g) Except as provided in the Regulatory Agreement, the covenants and conditions of the Regulatory Agreement shall be binding upon successors in interest of the Developer.

(h) The Regulatory Agreement shall be recorded in the office of the County recorder, and shall be recorded in the grantor-grantee index under the name of the Developer as grantor and under the name of the Issuer as grantee.

## **Requirements of the Issuer**

In addition to other requirements set forth in the Regulatory Agreement and to the extent not prohibited by the requirements described under the headings “Low Income Tenants; Reporting Requirements” and “Requirements of the Housing Law” above, the Developer has agreed to comply with each of the requirements of the Issuer described under this heading, as follows:

(a) For the duration of the Compliance Period, notwithstanding any retirement of the Bonds or termination of the Loan Agreement, the Developer will pay to the Issuer all of the amounts required to be paid by the Developer under the Loan Agreement and will indemnify the Issuer and the Trustee as provided in the Regulatory Agreement.

(b) All tenant lists, applications and waiting lists relating to the Project shall at all times be kept separate and identifiable from any other business of the Developer and shall be maintained as required by the Issuer, in a reasonable condition for proper audit and subject to examination during business hours by representatives of the Issuer upon reasonable advance notice to the Developer.

(c) The Developer has acknowledged that the Issuer has appointed the Administrator to administer the Regulatory Agreement and to monitor performance by the Developer of the terms, provisions and requirements of the Regulatory Agreement. The Developer shall comply with any reasonable request made by the Administrator or the Issuer to deliver to any such Administrator, in addition to or instead of the Issuer, any reports, notices or other documents required to be delivered pursuant to the Regulatory Agreement, and to make the Project and the books and records with respect thereto available for inspection by the Administrator as an agent of the Issuer. The fees and expenses of the Administrator shall be paid by the Issuer.

(d) For purposes of paragraph (b) under the heading “Requirements of the Housing Law” above, the base rents shall be adjusted for household size, to the extent permitted by law.

(e) The Developer shall comply with the conditions set forth in Exhibit A to that certain CDLAC Resolutions relating to the Project (collectively, the “CDLAC Conditions”), as they may be modified or amended from time to time, which conditions are incorporated into the Regulatory Agreement by reference and made a part of the Regulatory Agreement. The CDLAC Conditions include, but are not limited to a requirement that 40% of the units in the Project be rented or held vacant for occupancy by persons or families whose income is at least 60% or below of the area median income, which conditions are effective for a period of 55 years. The Developer will prepare and submit to CDLAC, not later than each anniversary of the Closing Date, until the end of the Compliance Period, a Certificate of Continuing Program Compliance, in substantially the form attached to the CDLAC Conditions, executed by an authorized representative of the Developer. The Issuer and the Administrator shall have no obligation to monitor the Developer’s compliance with the CDLAC Conditions.

(f) Except as otherwise provided in the Regulatory Agreement, the Regulatory Agreement shall terminate on the date 55 years after the Closing Date, as required by the CDLAC Conditions.

Any of the foregoing requirements of the Issuer described under this heading (except (e) and (f) above, which may only be waived with the consent of CDLAC) may be expressly waived by the Issuer, in its sole discretion, in writing, but (i) no waiver by the Issuer of any requirement described under this heading shall, or shall be deemed to, extend to or affect any other provision of the Regulatory Agreement except to the extent the Issuer has received an opinion of Bond Counsel that any such provision is not required by the Act and the Housing Law and may be waived without adversely affecting the exclusion from gross income of interest on the Bonds for federal income tax purposes; and (ii) any requirement described under this heading shall be void and of no force and effect if the Issuer and the Developer receive a written opinion of Bond Counsel to the effect that compliance with any such requirement would cause interest on the Bonds to cease to be Tax-Exempt or to the effect that compliance with such requirement would be in conflict with the Act, the Housing Law or any other state or federal law.

### **Transfer of the Project**

For the Compliance Period, the Developer shall not Transfer the Project, in whole or in part, without the prior written consent of the Issuer, which consent shall not be unreasonably withheld or



delayed if the following conditions are satisfied: (A) the receipt by the Issuer of evidence acceptable to the Issuer that (1) the Developer shall not be in default under the Regulatory Agreement or under the Loan Agreement, if in effect (which may be evidenced by a Certificate of Continuing Program Compliance), or the transferee undertakes to cure any defaults of the Developer to the reasonable satisfaction of the Issuer; (2) the continued operation of the Project shall comply with the provisions of the Regulatory Agreement; (3) either (a) the transferee or its Manager has at least three years' experience in the ownership, operation and management of similar size rental housing projects, and at least one year's experience in the ownership, operation and management of rental housing projects containing below-market-rate units, without any record of material violations of discrimination restrictions or other state or federal laws or regulations or local governmental requirements applicable to such projects, or (b) the transferee agrees to retain a Manager firm with the experience and record described in subclause (a) above, or (c) the transferring owner or its management company will continue to manage the Project, or another management company reasonably acceptable to the Issuer will manage, for at least one year following such Transfer and, if applicable, during such period the transferring owner or its management company will provide training to the transferee and its manager in the responsibilities relating to the Low Income Units; and (4) the person or entity that is to acquire the Project does not have pending against it, and does not have a history of significant and material building code violations or complaints concerning the maintenance, upkeep, operation, and regulatory agreement compliance of any of its projects as identified by any local, state or federal regulatory agencies; (B) the execution by the transferee of any document reasonably requested by the Issuer with respect to the assumption of the Developer's obligations under the Regulatory Agreement and the Loan Agreement (if then in effect), including without limitation an instrument of assumption of the Regulatory Agreement and thereof, and delivery to the Issuer of an opinion of such transferee's counsel to the effect that each such document and the Regulatory Agreement are valid, binding and enforceable obligations of such transferee, subject to bankruptcy and other standard limitations affecting creditor's rights; (C) receipt by the Issuer and the Trustee of an opinion of Bond Counsel to the effect that any such Transfer will not adversely affect the Tax-Exempt status of interest on the Bonds; and (D) receipt by the Issuer of all fees and/or expenses then currently due and payable to the Issuer by the Developer.

It has been expressly stipulated and agreed that any Transfer of the Project in violation of the provisions of the Regulatory Agreement described under this heading shall be null, void and without effect, shall cause a reversion of title to the Developer, and shall be ineffective to relieve the Developer of its obligations under the Regulatory Agreement. The written consent of the Issuer to any Transfer of the Project shall constitute conclusive evidence that the Transfer is not in violation of the provisions of the Regulatory Agreement described under this heading. Nothing described under this heading shall affect any provision of any other document or instrument between the Developer and any other party requires the Developer to satisfy certain conditions or obtain the prior written consent of such other party in order to Transfer the Project. Upon any Transfer that complies with the Regulatory Agreement, the Developer shall be fully released from its obligations under the Regulatory Agreement to the extent such obligations have been fully assumed in writing by the transferee of the Project.

The foregoing notwithstanding, the Project may be transferred pursuant to a foreclosure, exercise of power of sale or deed in lieu of foreclosure or comparable conversion under the Deed of Trust without the consent of the Issuer or compliance with the provisions of the provisions of the Regulatory Agreement described under this heading. The Issuer has approved the transfer of limited partnership interests in the Developer to affiliates of the investor limited partner of the Developer, including, without limitation, the transfer of membership interests in the Developer from the investor limited partner and non-managing membership interests in the limited partner of Developer.

For the Compliance Period, the Developer shall not: (1) encumber any of the Project or grant commercial leases of any part thereof, or permit the conveyance, transfer or encumbrance of any part of

the Project, except for (A) Permitted Encumbrances, or (B) a Transfer in accordance with the terms of the Regulatory Agreement, in each case upon receipt by the Issuer and the Trustee of an opinion of Bond Counsel to the effect that such action will not adversely affect the Tax-Exempt status of interest on the Bonds (provided that such opinion will not be required with respect to any encumbrance, lease or transfer relating to a commercial operation or ancillary facility that will be available for tenant use and is customary to the operation of multifamily housing developments similar to the Project); (2) demolish any part of the Project or substantially subtract from any real or personal property of the Project, except to the extent that what is demolished or removed is replaced with comparable property or such demolition or removal is otherwise permitted by the Loan Agreement or the First Deed of Trust; or (3) permit the use of the dwelling accommodations of the Project for any purpose except rental residences.

## **Term**

The Regulatory Agreement and all and several of the terms of the Regulatory Agreement shall become effective upon its execution and delivery, and shall remain in full force and effect for the period provided in the Regulatory Agreement and shall terminate as to any provision not otherwise provided with a specific termination date and shall terminate in its entirety at the end of the Compliance Period, it being expressly agreed and understood that the provisions of the Regulatory Agreement are intended to survive the retirement of the Bonds and discharge of the Indenture and the Loan Agreement.

The terms of the Regulatory Agreement to the contrary notwithstanding, the requirements of the Regulatory Agreement shall terminate and be of no further force and effect in the event of involuntary noncompliance with the provisions of the Regulatory Agreement caused by fire or other casualty, seizure, requisition, foreclosure, transfer of title by deed in lieu of foreclosure, change in a federal law or an action of a federal agency after the Closing Date, which prevents the Issuer and the Trustee from enforcing such provisions, or condemnation or a similar event, but only if, within a reasonable period, either the Bonds are retired or amounts received as a consequence of such event are used to provide a project that meets the requirements of the Regulatory Agreement; provided, however, that the preceding provisions of this sentence shall cease to apply and the restrictions contained in the Regulatory Agreement shall be reinstated if, at any time subsequent to the termination of such provisions as the result of the foreclosure or the delivery of a deed in lieu of foreclosure or a similar event, the Developer or any related person (within the meaning of Section 1.103-10(e) of the Regulations) obtains an ownership interest in the Project for federal income tax purposes. The Developer has agreed that, following any foreclosure, transfer of title by deed in lieu of foreclosure or similar event, neither the Developer nor any such related person as described above will obtain an ownership interest in the Project for federal tax purposes. Notwithstanding any other provision of the Regulatory Agreement, the Regulatory Agreement may be terminated upon agreement by the Issuer, the Trustee and the Developer upon receipt by the Issuer and the Trustee of an opinion of Bond Counsel to the effect that such termination will not adversely affect the exclusion from gross income of interest on the Bonds for federal income tax purposes. Upon the termination of the terms of the Regulatory Agreement, the parties to the Regulatory Agreement agree to execute, deliver and record appropriate instruments of release and discharge of the terms of the Regulatory Agreement; provided, however, that the execution and delivery of such instruments shall not be necessary or a prerequisite to the termination of the Regulatory Agreement in accordance with its terms.

## **Default; Enforcement**

If the Developer defaults in the performance or observance of any covenant, agreement or obligation of the Developer set forth in the Regulatory Agreement, and if such default remains uncured for a period of 60 days after written notice thereof shall have been given by the Issuer or the Trustee to the Developer, or for a period of 60 days from the date the Developer should, with reasonable diligence,

have discovered such default, then the Issuer or the Trustee shall declare an “Event of Default” to have occurred under the Regulatory Agreement; provided, however, that if the default is of such a nature that it cannot be corrected within 60 days, such default shall not constitute an Event of Default under the Regulatory Agreement so long as (i) the Developer institutes corrective action within said 60 days and diligently pursues such action until the default is corrected, and (ii) in the opinion of Bond Counsel, the failure to cure said default within 60 days will not adversely affect the Tax-Exempt status of interest on the Bonds. The Issuer and the Trustee shall have the right to enforce the obligations of the Developer under the Regulatory Agreement within shorter periods of time than are otherwise provided in the Regulatory Agreement if necessary to insure compliance with the Housing Law or the Code.

Following the declaration of an Event of Default under the Regulatory Agreement, the Issuer or the Trustee, at the written direction of Issuer, subject to the terms of the Indenture, may take any one or more of the following steps, in addition to all other remedies provided by law or equity:

- (i) by mandamus or other suit, action or proceeding at law or in equity, including injunctive relief, require the Developer to perform its obligations and covenants under the Regulatory Agreement or enjoin any acts or things that may be unlawful or in violation of the rights of the Issuer or the Trustee under the Regulatory Agreement;
- (ii) have access to and inspect, examine and make copies of all of the books and records of the Developer pertaining to the Project
- (iii) take such other action at law or in equity as may appear necessary or desirable to enforce the obligations, covenants and agreements of the Developer under the Regulatory Agreement; and
- (iv) with the consent of the Credit Bank, which consent shall not be unreasonably withheld, declare a default under the Loan Agreement and proceed with any remedies provided therein.

The Developer has agreed that specific enforcement of the Developer’s agreements contained in the Regulatory Agreement is the only means by which the Issuer may fully obtain the benefits of the Regulatory Agreement made by the Developer in the Regulatory Agreement, and the Developer therefore has agreed to the imposition of the remedy of specific performance against it in the case of any Event of Default by the Developer under the Regulatory Agreement.

The Trustee shall have the right, in accordance with the provisions of the Regulatory Agreement described under this heading and the provisions of the Indenture, without the consent or approval of the Issuer, but with the consent of the Credit Bank, which consent shall not be unreasonably withheld, to exercise any or all of the rights or remedies of the Issuer under the Regulatory Agreement; provided that prior to taking any such action the Trustee shall give the Issuer written notice of its intended action. After the Indenture has been discharged, the Issuer may act on its own behalf to declare an “Event of Default” to have occurred and to take any one or more of the steps specified in the Regulatory Agreement to the same extent and with the same effect as if taken by the Trustee.

The Issuer and the Trustee have agreed that cure of any Event of Default made or tendered by any partner of the Developer shall be deemed to be a cure by the Developer and shall be accepted or rejected on the same basis as if made or tendered by the Developer.

All reasonable fees, costs and expenses (including reasonable attorney’s fees) of the Trustee and the Issuer incurred in taking any action described under this heading shall be the sole responsibility of the

Developer; provided, however, that in the event that any action arises under the Regulatory Agreement in which the Developer and the Trustee are adversaries, the prevailing party, if any, shall be entitled to recover legal fees and costs from the other party.

### **Amendments; Waivers**

Except as provided in the Regulatory Agreement, the Regulatory Agreement may be amended only by a written instrument executed by the parties to the Regulatory Agreement or their successors in title, and duly recorded in the real property records of the County, and only upon (i) receipt by the Issuer and the Trustee of an opinion from Bond Counsel that such amendment will not adversely affect the Tax-Exempt status of interest on the Bonds and is not contrary to the provisions of the Housing Law and (ii) the written consent of the Credit Bank, who shall receive a copy of any such amendment.

Anything to the contrary contained in the Regulatory Agreement notwithstanding, the Issuer, the Trustee and the Developer have agreed to amend the Regulatory Agreement to the extent required, in the opinion of Bond Counsel, in order that interest on the Bonds remains Tax-Exempt. The parties requesting such amendment shall notify the other parties to the Regulatory Agreement of the proposed amendment, with a copy of such proposed amendment to Bond Counsel and a request that Bond Counsel render to the Issuer and the Trustee an opinion as to the effect of such proposed amendment upon the Tax-Exempt status of interest on the Bonds. This provision shall not be subject to any provision of any other agreement requiring any party to the Regulatory Agreement to obtain the consent of any other person in order to amend the Regulatory Agreement.

Any waiver of, or consent to, any condition under the Regulatory Agreement must be expressly made in writing.

### **Third-Party Beneficiary**

The City and CDLAC are intended to be and shall be third-party beneficiaries of the Regulatory Agreement. The City shall have the right (but not the obligation) to enforce, separately or jointly with the Issuer and/or the Trustee or to cause the Issuer or the Trustee to enforce, the terms of the Regulatory Agreement and to pursue an action for specific performance or other available remedy at law or in equity in accordance with the provisions of the Regulatory Agreement described under the heading “Default; Enforcement” above. CDLAC shall have the right (but not the obligation) to enforce the CDLAC Conditions and to pursue an action for specific performance or other available remedy at law or in equity in accordance with the Regulatory Agreement, provided that any such action or remedy shall not materially adversely affect the interests and rights of the Holders of the Bonds.

### **Property Management**

The Developer agrees that at all times the Project shall be managed by a property manager (i) approved by the Issuer in its reasonable discretion and (ii) who has at least three years’ experience in the ownership, operation and management of similar size rental housing projects, and at least one year’s experience in the ownership, operation and management of rental housing projects containing below-market-rate units, without any record of material violations of discrimination restrictions or other state or federal laws or regulations or local governmental requirements applicable to such projects (the “Manager”). The Developer shall submit to the Issuer from time to time such information about the background, experience and financial condition of any existing or proposed Manager as the Issuer may reasonably require to determine whether such Manager meets the requirements for a Manager set forth in the Regulatory Agreement. The Issuer reserves the right to conduct periodic reviews of the management practices and of the Manager to determine if the Project is being operated and managed in accordance

with the requirements and standards of the Regulatory Agreement. The Developer agrees to cooperate with the Issuer in such reviews.

If the Issuer determines in its reasonable judgment that the Project is not being operated and managed in accordance with one or more of the material requirements or standards of the Regulatory Agreement, the Issuer may deliver notice to the Developer, the Trustee and the Credit Bank requesting replacement of the Manager, which notice shall state clearly the reasons for such request. The Developer agrees that, upon receipt of such notice, it shall within 60 days submit to the Issuer, with copies to the Trustee and the Credit Bank, a proposal to engage a new Manager meeting the requirements of described under this heading. Each of the Issuer and the Credit Bank shall respond within 30 days to such proposal or such approval shall be deemed given. Upon receipt of such consent or deemed consent, the Developer shall within 60 days terminate the existing Manager's engagement and engage the new Manager.

Notwithstanding any other provision of the Regulatory Agreement to the contrary, the Credit Bank may at any time by written instruction to the Issuer, the Trustee and the Developer deny the Issuer's request for a replacement Manager and direct that the existing Manager be retained.

### **SUMMARY OF CERTAIN PROVISIONS OF THE CREDIT AGREEMENT**

*The following is a brief summary of certain provisions of the Credit Agreement. This summary does not purport to be comprehensive or definitive and is subject to all of the terms and provisions of the Credit Agreement.*

The Credit Agreement sets forth the agreement of the initial Credit Bank to deliver the initial Letter of Credit and the obligation of the Developer to reimburse the initial Credit Bank for draws made under the initial Letter of Credit. This summary of the Credit Agreement is provided primarily to assist Bondholders in assessing the risk of an early redemption of the Bonds due to an event of default under the Credit Agreement. The Credit Agreement is subject to amendment by the Credit Bank and the Developer without the consent of, or notice to, the Issuer, the Trustee or the holders of the Bonds. Moreover, this is only a summary of the initial Credit Agreement; a new reimbursement agreement, which may have different default provisions, would be executed and delivered in connection with the delivery of a substitute Letter of Credit. Capitalized terms used under this heading that are not defined under this heading or elsewhere in this Official Statement shall have the meanings assigned thereto in the Credit Agreement and the Second Deed of Trust.

Pursuant to the Credit Agreement, the Developer has agreed to reimburse the initial Credit Bank for the full amount of each draw under the Letter of Credit. The Developer has further agreed to pay to the Credit Bank in monthly installments an annual fee. The obligations of the Developer under the Credit Agreement are secured by, among other things, the Second Deed of Trust.

The occurrence of any of the following shall be an "Event of Default" under the initial Credit Agreement:

- (a) the Developer's failure to pay when due any amount under any Credit Document, Financing Document, Rate Hedge or secured by the Credit Bank Deed of Trust;
- (b) (i) the Developer's failure to maintain the insurance required to be maintained under the Credit Agreement, (ii) the occurrence of any "Transfer," (iii) the failure of the Developer to cooperate in making the Project available for inspections under the Credit Agreement, (iv) the Developer's failure to deliver any of the reports required by the Credit

Agreement within ten days following written demand from the Credit Bank or (v) the Developer's failure to rebalance this credit as required by the Credit Agreement;

(c) the failure of the Developer, within 30 days following written notice from the Credit Bank to the Developer, to observe or perform any covenant or other agreement contained in any Credit Document other than those covenants and agreements set forth in certain specified sections of the Credit Agreement; provided, however, that the notice and 30-day grace period set forth above shall be applicable only to a failure to observe or perform any covenant or other agreement which is reasonably susceptible of being cured and only so long as such failure does not result in a material impairment of the Credit Bank's security or have a material adverse effect on the Developer's ability to complete the construction of the Improvements in accordance with the requirements of the Credit Agreement by the Completion Date; provided further, that should the Developer be unable to cure its failure within such 30-day period despite beginning to cure such failure promptly after receipt of notice and prosecuting such attempt diligently during such 30-day period, the cure period shall be extended an additional 60 days so long as the Developer continues diligently to prosecute the cure during such additional period and so long as the Developer's failure to observe or perform does not result in a material impairment of the Credit Bank's security;

(d) any written representation, warranty or financial statement given by the Developer, any General Partner or any Guarantor in any Credit Document or the Loan Agreement or any financial statement delivered to the Credit Bank shall have been untrue in any material respect when given;

(e) the occurrence of a default under any of the Credit Documents or the Financing Documents, and the failure of any such default to be cured after applicable notice and expiration of the permitted time, if any, for such cure;

(f) any of the Developer, the General Partners or any Guarantor shall be unable or shall admit in writing its inability to pay its debts when due, or shall make an assignment for the benefit of creditors; or any of them shall apply for or consent to the appointment of any receiver, trustee or similar officer for such person or for all or any substantial part of such person's property; or any of them shall institute (by petition, application, answer, consent or otherwise) any bankruptcy, insolvency, reorganization, arrangement, readjustment of debts, dissolution, liquidation, or similar proceedings relating to such person under the laws of any jurisdiction;

(g) if a receiver, trustee or similar officer shall be appointed for any of the Developer, any General Partner or any Guarantor, or for all or any substantial part of any such person's property without the application or consent of such person, and such appointment shall continue undischarged for a period of 60 days (whether or not consecutive); or any bankruptcy, insolvency, reorganization, arrangement, readjustment of debt, dissolution, liquidation or similar proceedings shall be instituted (by petition, application or otherwise) against any such person and shall remain undismissed for a period of 60 days (whether or not consecutive);

(h) the Project or all or any material part of the assets of the Developer, any General Partner or any Guarantor or any part of the Program Fund, the Deposit Account, the Sinking Fund, the Replacement Reserve, the Rate Hedge Reserve or the Bond Disbursement Account shall become subject to attachment, execution or judicial seizure (whether by enforcement of money judgment, by writ or warrant of attachment, or by any other process);

(i) the Developer shall be in default in the payment of any Debt or the performance of any other obligation secured by a lien on the Project and such default is declared and is not cured, after the giving of all required notices, within the time, if any, specified for such a cure in any applicable agreement;

(j) any of the Credit Documents shall cease to be a valid, binding and enforceable obligation of the person purported to be bound; or the lien of the Credit Bank Deed of Trust or any Credit Document securing any of the Developer's obligations shall cease to be a valid, enforceable and perfected lien on the property it purports to encumber subject only to such other liens as are contemplated by the Credit Agreement; or the Developer shall assert such cessation or failure in writing;

(k) the Developer is enjoined, restrained or in any way prevented by court order from conducting all or a substantial portion of its business, and such proceedings or injunction have not been dismissed or stayed within 60 days from the date of filing of such proceeding or entry of such injunction; is enjoined, restrained or in any way prevented by court order from constructing the Improvements or developing the Project or otherwise conducting all or a substantial portion of its business, and such proceedings or injunction have not been dismissed or stayed within 60 days from the date of filing of such proceeding or entry of such injunction;

(l) the Credit Bank's reasonable determination that construction of the Improvements has fallen more than 30 days behind the schedule set forth in the Construction Schedule and such construction has not been rescheduled in a manner acceptable to the Credit Bank within ten days after the Credit Bank's determination, unless such construction shall have fallen behind schedule for reasons solely beyond the Developer's control, in which case the Developer shall resume work immediately after the reason for such cessation shall have terminated; provided, however, under no circumstances shall construction fall more than 60 days behind the Construction Schedule, irrespective of the cause of such delay;

(m) the death of or a material adverse change in the financial condition of the Guarantor;

(n) interest on the Bonds is no longer excluded from income for purposes of state or federal taxation; or

(o) after the date which is three months after the Extension Date, the Debt Service Coverage Ratio is less than the percentage set forth in the Credit Agreement during any period of three consecutive months and the Developer fails to cure in the ways and at the times described in the Credit Agreement.

AN EVENT OF DEFAULT UNDER THE CREDIT AGREEMENT COULD, AT THE DIRECTION OF THE CREDIT BANK, BE TREATED AS AN EVENT OF DEFAULT UNDER THE LOAN AGREEMENT AND CAUSE A REDEMPTION OF THE BONDS AT PAR (SEE "REDEMPTION OF BONDS" HEREUNDER).

## SUMMARY OF CERTAIN PROVISIONS OF THE INTERCREDITOR AGREEMENT

*The following is a brief summary of certain provisions of the Intercreditor Agreement. This summary does not purport to be comprehensive or definitive and is subject to all of the terms and provisions of the Intercreditor Agreement.*

The Intercreditor Agreement is dated as of the date of the Indenture and was entered into by and among the Issuer, the Trustee and the Credit Bank. The Intercreditor Agreement governs the exercise of the rights and remedies by the Issuer, the Trustee and the Credit Bank under the Indenture, the Loan Agreement, the Regulatory Agreement, the First Deed of Trust and all other related documents entered into for the purpose of issuing the Bonds and securing their repayment (the “Bond Documents”) and under the Credit Agreement, the Credit Bank Deed of Trust and all other related agreements entered into for the purpose of evidencing the Developer’s obligations to the Credit Bank (the “Credit Bank Documents”).

Generally, the Intercreditor Agreement provides the Credit Bank the right to enforce any of its rights or implement any of its remedies under the Credit Agreement and the other Credit Bank Documents so long as the Standby Credit Bank is not in default under the Standby Letter of Credit. The Intercreditor Agreement further provides that, so long as the Standby Credit Bank is not in default under the Standby Letter of Credit, neither the Issuer nor the Trustee shall, without the Credit Bank’s prior written consent, accelerate the maturity of the Loan, cause the redemption of the Bonds or enforce any right or implement any remedy against the Developer under the First Deed of Trust, except for remedies granted the Issuer or the Trustee for the Developer’s failure to pay their fees or reimburse their expenses or for a breach of the Regulatory Agreement.

## SELECTED DEFINITIONS

*In addition to the terms defined elsewhere in this Official Statement, the following are definitions of certain terms used in this Official Statement. Terms used but not otherwise defined herein shall have the meanings assigned to such terms in the Indenture or the Loan Agreement.*

“*Act of Bankruptcy*” means the filing of a petition in bankruptcy (or other commencement of a bankruptcy or similar proceeding) by or against the Developer and/or a partner or any guarantor of the Developer, under any applicable bankruptcy, insolvency or similar law as now or hereafter in effect, provided that any filing of a petition against the Developer or any partner or guarantor of the Developer (or other involuntary commencement of a bankruptcy or similar proceeding), shall not constitute an Act of Bankruptcy if a court of competent jurisdiction dismisses such petition (or such proceeding) within 60 days of the filing thereof.

“*Administrator*” means the Issuer, or a substitute or replacement administrator, if any, appointed by the Issuer, in any case acting as agent of the Issuer in the administration of the Regulatory Agreement, and may include the Credit Bank.

“*Agents*” means the Remarketing Agent, the Tender Agent and any paying agents under the Indenture.

“*Authorized Amount*” means the authorized aggregate principal amount of the Bonds permitted to be issued and delivered under the Indenture.

“*Authorized Bank Representative*” means any person who at the time and from time to time may be designated as such, by written certificate furnished to the Issuer, the Developer and the Trustee by the



Credit Bank or the Standby Credit Bank containing the specimen signature of such person and signed on behalf of the Credit Bank or the Standby Credit Bank by any officer or agent of the Credit Bank or the Standby Credit Bank, respectively, which certificate may designate an alternate or alternates.

*“Authorized Denominations”* means \$100,000 and any integral multiple of \$5,000 in excess thereof during any Variable Period, and means \$5,000 and any integral multiple thereof during any Reset Period or on and after the Conversion Date.

*“Authorized Developer Representative”* means any person who at the time and from time to time may be designated as such by written certificate furnished to the Issuer and the Trustee containing the specimen signature of such person and signed on behalf of the Developer by an authorized representative of the Developer, which certificate may designate an alternate or alternates.

*“Available Amounts”* means moneys that are (a) continuously on deposit with the Trustee in trust for the benefit of the owners of the Bonds in a separate and segregated account in which only Available Amounts are held and (b) any of the following: (i) amounts drawn under the Letter of Credit, (ii) amounts drawn under the Standby Letter of Credit, (iii) proceeds of sale of the Bonds, (iv) any other amounts for which in each case the Trustee has received, at the time such amounts are deposited with the Trustee, an opinion of nationally recognized counsel experienced in bankruptcy matters or Bond Counsel to the effect that the use of such amounts to make payments on the Bonds would not be voidable as preferential payments or recoverable under the United States Bankruptcy Code should the Issuer, the Developer, any partner, guarantor of the Developer become a debtor in proceedings commenced thereunder and (v) income from the investment of any of the foregoing.

*“Bond Counsel”* means any attorney at law or firm of attorneys, acceptable to the Issuer and the Credit Bank, of nationally recognized standing in matters pertaining to the federal tax exemption of interest on bonds issued by states and political subdivisions, and duly admitted to practice law before the highest court of any state of the United States of America or the District of Columbia, but shall not include counsel for the Developer or the Credit Bank.

*“Bond Fund”* means the fund established pursuant to the Indenture.

*“Bond Pledge Agreement”* means the Pledge and Security Agreement dated as of the date of the Indenture, by and among the Developer, the Trustee and the Credit Bank, as amended, restated or supplemented and any similar document with the issuer of any substitute Letter of Credit or other credit instrument.

*“Bond Purchase Agreement”* shall mean the Bond Purchase Agreement, by and among the Issuer, the Developer and the Underwriter, pursuant to which the Bonds are subject to purchase.

*“Bond Year”* means the period of 12 consecutive months ending on the date set forth in the Indenture in each year in which Bonds are or will be Outstanding, provided that the first Bond Year shall commence on the Closing Date and end on the date set forth in the Indenture.

*“Business Day”* means any day, not including Saturday or Sunday, on which banks in the City of New York, New York, banks and trust companies in the city in which the Principal Office of the Trustee is located and banks in the city in which the Principal Office of the Credit Bank or the Standby Credit Bank is located are not required or authorized by law to remain closed, on which the Credit Bank and the Standby Credit Bank are not closed, and on which the New York Stock Exchange is not closed.

*“Closing Date”* means the date of initial issuance and delivery of the Bonds.

“*Code*” means the Internal Revenue Code of 1986 as in effect on the date of issuance of the Bonds or (except as otherwise referenced in the Indenture) as it may be amended to apply to obligations issued on the date of issuance of the Bonds, together with applicable temporary, proposed and final regulations promulgated, and applicable official public guidance published, under the Code.

“*Collateral Funds*” means any amounts realized by the Trustee from the liquidation of Eligible Collateral.

“*Conversion*” means establishment of the interest rate on the Bonds at the Fixed Rate, pursuant to the Indenture.

“*Conversion Date*” means the date on which the Fixed Rate becomes effective.

“*Daily Mode*” means any period during which the interest rate on the Bonds is reset on each Business Day, as provided in the Indenture.

“*Debt Service*” means the scheduled amount of interest and amortization of principal payable on the Bonds during the period of computation, excluding amounts scheduled during such period which relate to principal which has been retired before the beginning of such period.

“*Demand Date*” means any date on which any Bond is required to be purchased pursuant to the provisions of the Indenture described under the headings “THE BONDS—Purchase of Bonds on Demand” and “—Mandatory Purchase” herein.

“*Designated Officer*” means any member of the Commission of the Issuer, or any other person as may be designated and authorized to sign for the Issuer pursuant to a resolution adopted thereby.

“*Determination of Taxability*” means (a) the failure of the Credit Bank or the Developer to consent within 45 days to any amendment to the Indenture, the Loan Agreement or the Regulatory Agreement, which in the written opinion of Bond Counsel is necessary to preserve the exclusion from gross income for federal income tax purposes of interest on the Bonds, or (b) the enactment of legislation or a final judgment or order of a court of original jurisdiction, a final order of any other court of competent jurisdiction, or a final ruling or decision of the Internal Revenue Service, in any such case to the effect that the interest on the Bonds (other than interest on any Bond for any period during which such Bond is held by a “substantial user” of any facility financed with the proceeds of the Bonds or a “related person,” as such terms are used in Section 147(a) of the Code) is includable for federal income tax purposes in the gross income of all recipients thereof subject to federal income taxes. With respect to clause (b) above, a judgment or order of a court or a ruling or decision of the Internal Revenue Service shall be considered final only if no appeal or action for judicial review has been filed and the time for filing such appeal or action has expired.

“*Eligible Collateral*” means cash, noncallable Government Obligations maturing on or prior to the applicable Interest Payment Dates or other collateral, which shall be rated “AAA” (or the equivalent) by the Rating Agency, which collateral may be provided pursuant to a collateral pledge agreement acceptable to the Issuer and the Rating Agency.

“*Event of Default*” as used in the Indenture other than with respect to defaults under the Loan Agreement shall have the meaning described under the heading “SUMMARY OF CERTAIN PROVISIONS OF THE INDENTURE—Defaults and Remedies” herein, and as used in the Loan Agreement shall have the meaning described under the heading “SUMMARY OF CERTAIN

PROVISIONS OF THE LOAN AGREEMENT—Events of Default and Remedies—Events of Default” herein.

“*Fair Market Value*” means the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm’s-length transaction (determined as of the date the contract to purchase or sell the investment becomes binding) if the investment is traded on an established securities market (within the meaning of Section 1273 of the Code) and, otherwise, the term “Fair Market Value” means the acquisition price in a bona fide arm’s length transaction (as referenced above) if (a) the investment is a certificate of deposit that is acquired in accordance with applicable regulations under the Code, (b) the investment is an agreement with specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate (for example, a guaranteed investment contract, a forward supply contract or other investment agreement) that is acquired in accordance with applicable regulations under the Code, (c) the investment is a United States Treasury Security-State and Local Government Series that is acquired in accordance with applicable regulations of the United States Bureau of Public Debt, or (d) the investment is the Local Agency Investment Fund, but only if at all times during which the investment is held its yield is reasonably expected to be equal to or greater than the yield on a reasonably comparable direct obligation of the United States. The Trustee shall have no duty in connection with the determination of Fair Market Value other than to follow the investment directions of the Developer in any written direction of the Developer.

“*Fixed Rate*” means the interest rate borne by the Bonds after Conversion and until the maturity date of the Bonds, determined in accordance with the Indenture.

“*Funding Requisition*” means the requisition form requesting disbursement of moneys from the Program Fund in the form attached as an exhibit to the Loan Agreement.

“*Government Obligations*” means noncallable and nonprepayable direct obligations of the United States of America or obligations which as to full and timely payment of principal and interest constitute full faith and credit obligations of the United States of America (excluding therefrom unit investment trusts and money market funds comprised of such securities).

“*holder*” or “*Bondholder*” or “*owner*” means the person in whose name any Bond is registered.

“*Information Services*” means Financial Information, Inc. “Daily Called Bond Service,” 10th Floor, 30 Montgomery Street, Jersey City, New Jersey 07302, Attention: Editor; Kenny Information Services, “Called Bond Service,” 28th Floor, 55 Broad Street, New York, New York 10004; Moody’s Investors Service “Municipal and Government,” 8th Floor, 99 Church Street, New York, New York 10007, Attention: Municipal News Reports; and Standard & Poor’s Ratings Group “Called Bond Record,” 25 Broadway, New York, New York 10004; or, in accordance with then current guidelines of the Securities and Exchange Commission, such other addresses and/or such other services providing information with respect to called bonds, or any other such services as the Issuer may designate in writing to the Trustee.

“*Interest Payment Date*” means, for interest accrued during any Variable Period, the first Business Day of each month commencing on the first Interest Payment Date specified on the cover hereof.

“*Interest Period*” means each period commencing on an Interest Payment Date and ending on the day before the next succeeding Interest Payment Date, except that the first Interest Period shall begin on the Closing Date and shall end on the day before the first Interest Payment Date.

*“Investment Property”* means any security (as said term is defined in Section 165(g)(2)(A) or (B) of the Code), obligation, annuity or investment-type property, excluding, however, obligations the interest on which is excluded from gross income under Section 103 of the Code.

*“Investment Securities”* means any of the following (including any funds comprised of any of the following, which may be funds maintained, available to or managed by the Trustee or its affiliates and which are rated in the highest rating category by the Rating Agency): (a) United States Treasury notes, bonds, bills or certificates of indebtedness, or those for which the full faith and credit of the United States are pledged for the full and timely payment of principal and interest (including state and local government series); (b) obligations, participation or other instruments of or issued by a federal agency or a United States government-sponsored enterprise, the principal of and interest on which is unconditionally guaranteed by the United States; (c) any obligations on which the interest is exempt from federal income taxation and which are rated by the Rating Agency in one of its two highest long-term rating categories or its highest short-term rating category; (d) certificates of deposit issued by, or time or demand deposits or other banking arrangements with, a nationally- or state-chartered bank (including the Credit Bank, the Standby Credit Bank and the Trustee or its affiliates) or savings and loan association which, to the extent they are not insured by federal deposit insurance, are collateralized by securities eligible to secure public deposits in the state, or which are issued by or with such an institution having a minimum capital of \$500,000,000 and rated within the top two ratings of a nationally recognized rating service; (e) money market portfolios rated “AAA” by the Rating Agency; (f) repurchase agreements, which may include repurchase agreements of the Trustee, secured by any of the obligations referred to in (a) and (b) above and the debt of the issuer of the repurchase agreement is rated at least in one of two highest rating categories of the Rating Agency; and (g) any other investments selected by the Developer and approved by the Credit Bank, the unsecured general obligations of the provider of which are rated at least in one of the two highest rating categories of the Rating Agency.

*“Issuance Costs”* means all costs and expenses of issuance of the Bonds including, but not limited to: (a) underwriters’ fees; (b) counsel fees, including Bond Counsel, underwriters’ counsel, Developer’s counsel and Issuer attorneys’ fees, as well as any other specialized counsel fees incurred in connection with the borrowing; (c) the Issuer fees and expenses incurred in connection with the issuance of the Bonds; (d) Rating Agency fees; (e) initial Trustee’s fees and Trustee’s counsel fees, and initial fees of the Remarketing Agent and Tender Agent; (f) paying agent and certifying and authenticating agent fees related to issuance of the Bonds; (g) accountant fees related to issuance of the Bonds; (h) printing costs of the Bonds and of the preliminary and final official statement; and (i) publication costs associated with the financing proceedings.

*“Issuer Fee”* means the annual fee payable to the Issuer pursuant to the Loan Agreement.

*“Issuer Loan Documents”* means the Loan Agreement, the Regulatory Agreement and the First Deed of Trust and such other agreements and instruments executed for the purpose of granting the Issuer or the Trustee a senior lien upon the Project.

*“Letter of Credit”* means that certain irrevocable, direct-pay letter of credit issued by the Credit Bank on or before the Closing Date, naming the Trustee as beneficiary, or any reissuance or extension thereof or any substitute letter of credit or other credit instrument, as they may from time to time be supplemented or amended, provided during any Variable Period meeting the requirements of the Loan Agreement; it being understood that no more than one Letter of Credit shall be required in order to secure payment of the Bonds.

*“Loan”* shall mean the Loan made by the Issuer to the Developer pursuant to the Loan Agreement, the principal amount of which originally shall be equal to the principal amount of Bonds

originally issued and delivered and shall be subject to increase in the event the second installment of the purchase price of the Bonds is received by the Trustee.

*“Maturity Date”* means the maturity date for the Bonds specified on the cover hereof.

*“Maximum Interest Rate”* means the lesser of 12% or any maximum rate permitted by law (as set forth in an Opinion of Counsel) to be paid on the Bonds or to be charged on the Loan.

*“Net Proceeds,”* when used with respect to any insurance proceeds or condemnation award, means the amount remaining after deducting from the gross proceeds thereof all expenses (including attorneys’ fees) incurred in the collection of such proceeds or award and, when used with respect to the Bonds, means the proceeds of the Bonds received by or for the Issuer on the Closing Date, less amounts, if any, used to pay Issuance Costs.

*“Nonpurpose Obligation”* means any Investment Property which is acquired with the Gross Proceeds of the Bonds other than the Loan.

*“Opinion of Counsel”* means a written opinion of counsel in form and substance satisfactory to the Credit Bank, which counsel shall not be unsatisfactory to the Credit Bank and, may be counsel for the Issuer or Bond Counsel or counsel for the Trustee or counsel for the Developer.

*“Outstanding,”* when used as of any particular time with reference to Bonds, means, subject to the provisions of the Indenture, all Bonds previously authenticated and delivered by the Trustee or the Tender Agent under the Indenture except:

(a) Bonds cancelled by the Trustee or surrendered to the Trustee for cancellation;

(b) Bonds for the payment or redemption of which moneys or securities in the necessary amount (as provided in the Indenture) shall have theretofore been deposited with the Trustee (whether upon or prior to the maturity or the redemption date of such Bonds), provided that, if such Bonds are to be redeemed prior to the maturity thereof, notice of such redemption shall have been given as provided in the Indenture or provision satisfactory to the Trustee shall have been made for the giving of such notice; and

(c) Bonds in lieu of or in substitution for which other Bonds shall have been authenticated and delivered by the Trustee pursuant to the terms of the Indenture.

*“person”* means an individual, a corporation, a partnership, a trust, an unincorporated organization or a government or any agency or political subdivision thereof.

*“Pledged Bonds”* means Bonds purchased by the Trustee with the proceeds of a draw on the Letter of Credit so long as the Bonds are held pursuant to the Bond Pledge Agreement.

*“Principal Office”* with respect to the Trustee means the corporate trust office of the Trustee located at the address set forth in the Indenture, or at such other place as the Trustee shall designate by notice given under the Indenture or such office designated by the Trustee in writing for the payment, transfer, exchange or registration of the Bonds; and with respect to the Developer means its office located at the address set forth in the Indenture, or at such other place as the Developer shall designate to the Trustee as provided in the Indenture; and with respect to the Remarketing Agent means its office located at the address set forth in the Indenture, or at such other place as the Remarketing Agent shall designate to the Trustee as provided in the Indenture; and with respect to the Credit Bank means its office located at

the address set forth in the Indenture, or at such other place as the Credit Bank shall designate as provided in the Indenture; and with respect to the Standby Credit Bank means its office located at the address set forth in the Indenture or at such other place as the Standby Credit Bank shall designate as provided in the Indenture; and with respect to the Tender Agent means its office located at the address set forth in the Indenture, or at such other place as the Tender Agent shall designate to the Trustee as provided in the Indenture.

*“Program Fund”* means the fund established pursuant to the Indenture.

*“Purchase Price,”* with respect to any Bond required to be purchased pursuant to the provisions of the Indenture described under the headings “THE BONDS—Purchase of Bonds on Demand” and “—Mandatory Purchase” herein, means the principal amount of such Bond plus interest accrued thereon to the Demand Date. *“Purchase Price,”* for the purpose of computation of the Yield of the Bonds, has the same meaning as the term “issue price” in Sections 1273(b) and 1274 of the Code, and, in general, means the initial offering price to the public (not including bond houses and brokers, or similar persons or organizations acting in the capacity of underwriters or wholesalers) at which price a substantial amount of the Bonds are sold or, if the Bonds are privately placed, the price paid by the first buyer of the Bonds or the acquisition cost of the first buyer. The term *“Purchase Price,”* for the purpose of computation of the Yield of Nonpurpose Obligations, means the Fair Market Value of the Nonpurpose Obligations on the date of use of Gross Proceeds of the Bonds for acquisition thereof, or if later, on the date that Investment Property constituting a Nonpurpose Obligation becomes a Nonpurpose Obligation of the Bonds.

*“Qualified Project Costs”* means “Good Costs” as defined in the Tax Certificate.

*“Rating Agency”* means Standard & Poor’s Ratings Services, a Standard & Poor’s Financial Services LLC business, or its successors and assigns, or any other nationally recognized rating agency designated by the Issuer with the consent of the Credit Bank.

*“Rebate Analyst”* means a certified public accountant, financial analyst or attorney, or any firm of the foregoing, or a financial institution (which may include the Trustee) experienced in making the arbitrage and rebate calculations required pursuant to Section 148 of the Code and retained by the Developer to calculate the amount of rebatable arbitrage.

*“Record Date”* means, with respect to each Interest Payment Date during a Variable Period, the close of business on the Business Day before such Interest Payment Date.

*“Regulations”* means the Income Tax Regulations promulgated by the Department of the Treasury pursuant to the Code from time to time or pursuant to any predecessor statute to the Code.

*“Remarketing Date”* means the date, on or prior to each Demand Date, by which the Remarketing Agent is required to notify the Trustee, the Tender Agent and the Credit Bank of the Bonds for which it has found purchasers, as set forth in the Indenture.

*“Reserved Rights”* means those certain rights of the Issuer under the Issuer Loan Documents to indemnification and to payment or reimbursement of fees and expenses of the Issuer, its right to enforce the Regulatory Agreement and to enforce the provisions of the Loan Agreement relating to the Issuer’s rights to notice and reporting requirements and restrictions on transfer of ownership, its right to inspect and audit the books, records and premises of the Developer and the Project, its right to collect attorneys’ fees and related expenses, its right to enforce the Developer’s covenant to comply with applicable federal tax law and State law (including the Act and the rules of the Issuer, if any), its right to grant or withhold

consents or waivers under the Issuer Loan Documents, and its right to amend the Issuer Loan Documents in accordance with the provisions thereof.

*“Reset Date”* means any date upon which the Bonds begin to bear interest at a Reset Rate for the succeeding Reset Period, at a Variable Rate following a Reset Period or in a Variable Rate of a different mode.

*“Reset Period”* means each period during which the Bonds bear interest at a Reset Rate.

*“Reset Rate”* means the rate of interest borne by the Bonds as determined in accordance with the Indenture.

*“Responsible Officer”* of the Trustee means and includes any Vice President, Assistant Vice President or other officer of the Trustee having regular responsibility for corporate trust matters related to the Indenture.

*“Revenues”* means all amounts pledged under the Indenture to the payment of principal of, premium, if any, and interest on the Bonds, consisting of the following: (a) all moneys drawn by the Trustee under the Letter of Credit and the Standby Letter of Credit; (b) any portion of the Net Proceeds of the Bonds deposited with the Trustee under the provisions of the Indenture relating to initial deposits of funds; (c) Collateral Funds; (d) any income earned on investments pursuant to the Indenture; and (e) any repayments of the Loan made by the Developer pursuant to the Loan Agreement and any amounts derived from or in connection with the Developer or the Issuer Loan Documents, including all amounts obtained through the exercise of the remedies provided in the Issuer Loan Documents upon the occurrence of an event of default thereunder; but such term shall not include payments to the United States, the Issuer, the Administrator or the Trustee, for its account, pursuant to the Loan Agreement, the Regulatory Agreement or the Indenture; nor shall Revenues include remarketing proceeds or amount drawn on the Letter of Credit to pay the Purchase Price.

*“Securities Depositories”* means The Depository Trust Company, 711 Stewart Avenue, Garden City, New York 11530, Fax: (516) 227-4171 or 4190; or in accordance with the then current guidelines of the Securities and Exchange Commission, such other addresses and/or such other securities depositories as the Issuer may designate in writing to the Trustee and the Credit Bank.

*“Standby Letter of Credit”* means the certain irrevocable standby letter of credit issued by the Standby Credit Bank on or before the Closing Date, naming the Trustee as beneficiary, or any reissuance or extensions thereof or any substitute standby letter of credit meeting the requirements of the Loan Agreement, but only to the extent required by the Loan Agreement.

*“State”* means the State of California.

*“Substitute Credit Facility”* means bond insurance or third-party guarantees, Eligible Collateral, direct pay and standby letter of credit, liquidity facilities, loans to lenders or other credit instruments, or any combination of the foregoing, acceptable to the Issuer and the Rating Agency, and meeting the requirements of the Loan Agreement.

*“supplemental indenture”* or *“indenture supplemental to the Indenture”* means any indenture duly authorized and entered into between the Issuer and the Trustee in accordance with the provisions of the Indenture.

“*Tax Certificate*” means the Tax Certificate and Agreement, dated the Closing Date, executed and delivered by the Issuer and the Developer, as may be amended from time to time.

“*Tender Agent*” means the Trustee.

“*Tender Notice*” means a notice of demand for purchase of Bonds given by any Bondholder pursuant to the provisions of the Indenture described under the heading “THE BONDS—Purchase of Bonds on Demand” herein.

“*Variable Interest Accrual Period*” means (i) during any Variable Period that the Bonds bear interest in a Weekly Mode, a period beginning on any Thursday and ending on the following Wednesday, except that the first Variable Interest Accrual Period, which shall begin on the Closing Date and end on the following Wednesday (the Remarketing Agent may, by prior written notice to the Trustee, cause the Variable Interest Accrual Period to begin on any Tuesday and end on the following Monday, to begin on any Wednesday and end on the following Tuesday, or to begin on any Friday and end on the following Thursday), and (ii) during any Variable Period that the Bonds bear interest in a Daily Mode, a period beginning on each Business Day and ending on the following Business Day.

“*Variable Interest Computation Date*” means, with respect to any Variable Interest Accrual Period (other than the first Interest Accrual Period), the last Business Day before the first day of such Variable Interest Accrual Period.

“*Variable Period*” means each period during which the Bonds bear interest at a Variable Rate.

“*Variable Rate*” means the variable rate of interest borne by the Bonds as determined in accordance with the Indenture.

“*Variable Rate Adjustment Date*” means any date upon which the Bonds begin to bear interest at a Variable Rate for the succeeding Variable Period.

“*Weekly Mode*” means any period during which the interest rate on the Bonds is reset once each week, as provided in the Indenture.

“*Written Certificate*,” “*Written Consent*,” “*Written Demand*,” “*Written Direction*,” “*Written Election*,” “*Written Notice*,” “*Written Order*,” “*Written Request*” and “*Written Requisition*” means, respectively, a written certificate, consent, demand, direction, election, notice, order, request or requisition signed on behalf of the Issuer by a Designated Officer or on behalf of the Credit Bank by an Authorized Bank Representative.

“*Yield*” means that yield which, when used in computing the present worth of all payments of principal and interest (or other payments in the case of Nonpurpose Obligations which require payments in a form not characterized as principal and interest) on a Nonpurpose Obligation or on the Bonds produces an amount equal to the Purchase Price of such Nonpurpose Obligation or the Bonds, all computed as prescribed in applicable Regulations and, in the case of variable rate obligations, as further prescribed in the Indenture.

## **ENFORCEMENT OF REMEDIES**

The remedies available to the Trustee and the owners of the Bonds upon an event of default under the Letter of Credit, the Indenture, the Regulatory Agreement or the Loan Agreement are in many respects dependent upon regulatory and judicial actions which are often subject to discretion and delay.



Under existing law and judicial decisions, the remedies provided for under such documents may not be readily available or may be limited. The various legal opinions to be delivered concurrently with the delivery of the Bonds and such documents will be qualified as to enforceability of the various legal instruments by limitations imposed by bankruptcy, reorganization, insolvency or other similar laws affecting the rights of creditors generally and by equitable remedies and proceedings generally.

## **TAX MATTERS**

In the opinion of Orrick, Herrington & Sutcliffe LLP (“Bond Counsel”), Bond Counsel to the Issuer, based upon an analysis of existing laws, regulations, rulings and court decisions, and assuming, among other matters, the accuracy of certain representations and compliance with certain covenants, interest on the Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986 (the “Code”), except that no opinion is expressed as to the status of interest on any Bond for any period that such Bond is held by a “substantial user” of the facilities financed or refinanced by the Bonds or by a “related person” within the meaning of Section 147(a) of the Code. In the further opinion of Bond Counsel, interest on the Bonds is not a specific preference item for purposes of the federal individual and corporate alternative minimum taxes, nor is it included in adjusted current earnings when calculating corporate alternative minimum taxable income. Bond Counsel is also of the opinion that interest on the Bonds is exempt from State of California personal income taxes. A complete copy of the proposed form of opinion of Bond Counsel is set forth in Appendix A hereto.

The Code imposes various restrictions, conditions and requirements relating to the exclusion from gross income for federal income tax purposes of interest on obligations such as the Bonds. The Issuer and the Developer have made certain representations and covenanted to comply with certain restrictions, conditions and requirements designed to ensure that interest on the Bonds will not be included in federal gross income. Inaccuracy of these representations or failure to comply with these covenants may result in interest on the Bonds being included in gross income for federal income tax purposes, possibly from the date of original issuance of the Bonds. The opinion of Bond Counsel assumes the accuracy of these representations and compliance with these covenants. Bond Counsel has not undertaken to determine (or to inform any person) whether any actions taken (or not taken), or events occurring (or not occurring), or any other matters coming to Bond Counsel’s attention after the date of issuance of the Bonds may adversely affect the value of, or the tax status of interest on, the Bonds. Accordingly, the opinion of Bond Counsel is not intended to, and may not, be relied upon in connection with any such actions, events or matters.

Although Bond Counsel is of the opinion that interest on the Bonds is excluded from gross income for federal income tax purposes and is exempt from State of California personal income taxes, the ownership or disposition of, or the accrual or receipt of amounts treated as interest on, the Bonds may otherwise affect a Beneficial Owner’s federal, state or local tax liability. The nature and extent of these other tax consequences depends upon the particular tax status of the Beneficial Owner or the Beneficial Owner’s other items of income or deduction. Bond Counsel expresses no opinion regarding any such other tax consequences.

Current and future legislative proposals, if enacted into law, clarification of the Code or court decisions may cause interest on the Bonds to be subject, directly or indirectly, in whole or in part, to federal income taxation or to be subject to or exempted from state income taxation, or otherwise prevent Beneficial Owners from realizing the full current benefit of the tax status of such interest. For example, Representative Dave Camp, Chair of the House Ways and Means Committee released draft legislation that would subject interest on the Bonds to a federal income tax at an effective rate of 10% or more for individuals, trusts, and estates in the highest tax bracket, and the Obama Administration proposed legislation that would limit the exclusion from gross income of interest on the Bonds to some extent for

high-income individuals. The introduction or enactment of any such legislative proposals or clarification of the Code or court decisions may also affect, perhaps significantly, the market price for, or marketability of, the Bonds. Prospective purchasers of the Bonds should consult their own tax advisors regarding the potential impact of any pending or proposed federal or state tax legislation, regulations or litigation, as to which Bond Counsel is expected to express no opinion.

The opinion of Bond Counsel is based on current legal authority, covers certain matters not directly addressed by such authorities, and represents Bond Counsel's judgment as to the proper treatment of the Bonds for federal income tax purposes. It is not binding on the Internal Revenue Service ("IRS") or the courts. Furthermore, Bond Counsel cannot give and has not given any opinion or assurance about the future activities of the Issuer or the Developer, or about the effect of future changes in the Code, the applicable regulations, the interpretation thereof or the enforcement thereof by the IRS. The Issuer and the Developer have covenanted, however, to comply with the requirements of the Code.

Bond Counsel's engagement with respect to the Bonds ends with the issuance of the Bonds, and, unless separately engaged, Bond Counsel is not obligated to defend the Issuer, the Developer or the Beneficial Owners regarding the tax-exempt status of the Bonds in the event of an audit examination by the IRS. Under current procedures, parties other than the Issuer, the Developer and their appointed counsel, including the Beneficial Owners, would have little, if any, right to participate in the audit examination process. Moreover, because achieving judicial review in connection with an audit examination of tax-exempt bonds is difficult, obtaining an independent review of IRS positions with which the Issuer or the Developer legitimately disagrees, may not be practicable. Any action of the IRS, including but not limited to selection of the Bonds for audit, or the course or result of such audit, or an audit of bonds presenting similar tax issues may affect the market price for, or the marketability of, the Bonds, and may cause the Issuer, the Developer or the Beneficial Owners to incur significant expense.

## **UNDERWRITING**

Hutchinson, Shockey, Erley & Co. and Stern Brothers & Co. (together, the "Underwriter") have agreed to purchase the Bonds for a price of 100% of the principal amount thereof. Upon issuance of the Bonds, the Developer will pay the Underwriter a fee in an amount equal to \$78,100. The Underwriter has committed to purchase all of the Bonds if any of such Bonds are purchased and to use its best efforts to sell the Bonds. The Bonds are being offered for sale to the public at the price set forth on the cover page of this Official Statement, which price may be changed by the Underwriter from time to time without notice. The Bonds may be offered and sold to dealers, including the Underwriter and dealers acquiring Bonds for their own account or an account managed by them, at prices lower than the public offering price.

## **CONTINUING DISCLOSURE**

The Issuer has not made and will not make any provision to provide any annual financial statements or other credit information of the Developer to investors on a periodic basis. The Issuer has determined that no financial or operating data concerning the Issuer is material to an evaluation of the offering of the Bonds or to any decision to purchase, hold or sell the Bonds and the Issuer will not provide any such information. The Developer has undertaken all responsibilities for any continuing disclosure to the Beneficial Owners and Holders of any of the Bonds as described below, and the Issuer shall have no liability to the Beneficial Owners or Holders of any of the Bonds or any other person with respect to Rule 15c2-12 promulgated by the Securities and Exchange Commission (the "Rule").

The Developer and the Trustee, as dissemination agent (the "Dissemination Agent") have entered into a Continuing Disclosure Agreement, dated as of the date of the Indenture (the "Continuing

Disclosure Agreement”). The Continuing Disclosure Agreement obligates the Developer to send, or cause to be sent, certain financial information with respect to the Project to the Municipal Securities Rulemaking Board and to provide notice, or cause notice to be provided, to the Municipal Securities Rulemaking Board upon the occurrence of certain enumerated events for the benefit of the Beneficial Owners and Holders of any of the Bonds. The form of the Continuing Disclosure Agreement is attached as Appendix E hereto. The Developer has not entered into any other such undertaking with respect to the Rule.

A failure by the Developer to comply with the provisions of the Continuing Disclosure Agreement will not constitute a default under the Indenture or the Loan Agreement (although Bondholders will have any available remedy at law or in equity). Nevertheless, such a failure to comply must be reported in accordance with the Rule and must be considered by any broker, dealer or municipal securities dealer before recommending the purchase or sale of the Bonds in the secondary market. Consequently, such a failure may adversely affect the transferability and liquidity of the Bonds.

## **RATINGS**

Standard & Poor’s Ratings Services, a Standard & Poor’s Financial Services LLC business (“S&P”), has assigned to the Bonds the ratings set forth on the cover hereof. Such ratings express only the views of such rating agency. There is no assurance that such ratings will continue for any given period of time or will not be revised or withdrawn entirely by the rating agency if, in its judgment, circumstances so warrant. The ratings may be changed, suspended or withdrawn as a result of changes in, or unavailability of, information. None of the Issuer, the Trustee, the Underwriter, the Remarketing Agent, the Developer, the Credit Bank or the Standby Credit Bank has undertaken any responsibility to bring to the attention of the holders of the Bonds any proposed downward revision or withdrawal of the ratings of the Bonds, or to oppose any such proposed downward revision or withdrawal. Any such downward revision in or withdrawal of such ratings may have an adverse effect on the market price of the Bonds.

## **CERTAIN LEGAL MATTERS INCIDENT TO THE ISSUANCE OF THE BONDS**

Legal matters incident to the authorization and issuance of the Bonds are subject to the approving opinion of Orrick, Herrington & Sutcliffe LLP, San Francisco, California, Bond Counsel to the Issuer. Bond Counsel undertakes no responsibility for the accuracy, fairness or completeness of this Official Statement. Certain legal matters will be passed on for the Credit Bank by its in-house counsel, for the Standby Credit Bank by its in-house counsel, for the Developer by its counsel, Chernove & Associates, Inc., Encino, California, , for the Trustee by Fox Rothschild LLP, Los Angeles, California, and for the Underwriter by its counsel, Eichner Norris & Neumann PLLC , Washington, D.C. Payment of the fees and expenses of certain of the foregoing counsel is contingent upon the issuance of the Bonds.

## **ABSENCE OF LITIGATION**

### **The Issuer**

To the best knowledge of the Issuer, there is no action, suit or proceeding known by the Issuer to be pending or threatened restraining or enjoining the issuance, sale, execution or delivery of the Bonds, the Indenture, the Loan Agreement or the Regulatory Agreement, or in any way contesting or affecting the validity of the foregoing.

## **The Developer**

There is no controversy or litigation of any nature now pending for which the Developer has received service of process or, for which it has knowledge, threatened (a) which contests or otherwise affects the Loan Agreement or any Loan Documents, or (b) wherein an unfavorable decision, ruling or finding would materially and adversely affect the Developer's financial condition or operations or the validity of the authorization, execution, delivery or performance by the Developer under the Loan Agreement or any Loan Document.

## **MISCELLANEOUS**

The information contained above is subject to change without notice, and no implication is to be derived therefrom or from the sale of the Bonds that there has been no change in the affairs of the Issuer, the Developer or the Credit Bank from the date of such information. The Official Statement is submitted in connection with the sale of the securities referred to herein and may not be reproduced or used, as a whole or in part, for any other purpose. Any statements in this Official Statement involving matters of opinion, whether or not expressly so stated, are intended as such and not as representations of fact. This Official Statement is not to be construed as a contract or agreement between the Issuer and the purchasers or owners of any of the Bonds. The Issuer has caused this Official Statement to be executed by its authorized representative.

[Remainder of page left blank intentionally]

[Issuer's Signature Page to Official Statement]

CALIFORNIA STATEWIDE COMMUNITIES  
DEVELOPMENT AUTHORITY

By /s/ Laura Campbell

Authorized Signatory

[Developer's Signature Page to Official Statement]

HERITAGE II, L.P., a California limited partnership

By Foundation for Affordable Housing II, Inc., a  
California nonprofit public benefit corporation  
Its Managing General Partner

By /s/ Thomas E. Willard  
Thomas E. Willard, President

By Investment Concepts, Inc., a California corporation  
Its Co-General Partner

By /s/ George Chami  
George Chami, Chief Executive Officer

## **APPENDIX A**

### **PROPOSED FORM OF BOND COUNSEL OPINION**

[Closing Date]

California Statewide Communities  
Development Authority  
Sacramento, California

California Statewide Communities Development Authority  
Variable Rate Demand Multifamily Housing Revenue Bonds  
(Heritage II Apartments Project), 2014 Series G  
(Final Opinion)

Ladies and Gentlemen:

We have acted as bond counsel to the California Statewide Communities Development Authority (the “Issuer”) in connection with the issuance of its \$7,100,000 aggregate principal amount of Variable Rate Demand Multifamily Housing Revenue Bonds (Heritage II Apartments Project), 2014 Series G (the “Bonds”). The Bonds are issued pursuant to Chapter 5 of Division 7 of Title 1 of the California Government Code, together with the provisions of Chapter 7 of Part 5 of Division 31 of the California Health and Safety Code, as amended (collectively, the “Act”), and an Indenture of Trust, dated as of May 1, 2014 (the “Indenture”), between the Issuer and Wilmington Trust, National Association, as trustee (the “Trustee”). The Indenture provides that the Bonds are issued for the purpose of making a loan of the proceeds thereof to Heritage II, L.P., a California limited partnership (the “Borrower”) pursuant to a Loan Agreement, dated as of May 1, 2014 (the “Loan Agreement”), among the Issuer, the Trustee and the Borrower. Capitalized terms not otherwise defined herein shall have the meanings ascribed thereto in the Indenture.

In such connection, we have reviewed the Indenture, the Loan Agreement, the Regulatory Agreement, the Tax Certificate and Agreement, dated the date hereof (the “Tax Certificate”), between the Issuer and the Borrower, certificates of the Issuer, the Borrower, the Trustee and others, opinions of counsel to the Borrower, the Trustee and others, and such other documents, opinions and matters to the extent we deemed necessary to render the opinions set forth herein.

The opinions expressed herein are based on an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. Such opinions may be affected by actions taken or omitted or events occurring after the date hereof. We have not undertaken to determine, or to inform any person, whether any such actions are taken or omitted or events do occur or any other matters come to our attention after the date hereof. Accordingly, this letter speaks only as of its date and is not intended to, and may not, be relied upon or otherwise used in connection with any such actions, events or matters. Our engagement with respect to the Bonds has concluded with their issuance, and we disclaim any obligation to update this letter. We have assumed the genuineness of all documents and signatures presented to us (whether as originals or as copies) and the due and legal execution and delivery thereof by, and validity against, any parties other than the Issuer. We have assumed, without undertaking to verify, the accuracy of the factual matters represented, warranted or certified in the documents, and of the legal conclusions contained in the opinions, referred to in the second paragraph hereof. Furthermore, we have assumed compliance with all covenants and agreements contained in the Indenture, the Loan Agreement, the Regulatory Agreement and the Tax Certificate, including (without

limitation) covenants and agreements compliance with which is necessary to assure that future actions, omissions or events will not cause interest on the Bonds to be included in gross income for federal income tax purposes. We call attention to the fact that the rights and obligations under the Bonds, the Indenture, the Loan Agreement, the Regulatory Agreement and the Tax Certificate and their enforceability may be subject to bankruptcy, insolvency, receivership, reorganization, arrangement, fraudulent conveyance, moratorium and other laws relating to or affecting creditors' rights, to the application of equitable principles, to the exercise of judicial discretion in appropriate cases and to the limitations on legal remedies against joint exercise of powers agencies in the State of California (the "State"). We express no opinion with respect to any indemnification, contribution, liquidated damages, penalty (including any remedy deemed to constitute a penalty) right of set-off, arbitration, judicial reference, choice of law, choice of forum, choice of venue, non-exclusivity of remedies, waiver or severability provisions contained in the foregoing documents, nor do we express any opinion with respect to the state or quality of title to or interest in any of the real or personal property described in or as subject to the lien of the Indenture or the Loan Agreement or the accuracy or sufficiency of the description contained therein of, or the remedies available to enforce liens on, any such property. Our services did not include financial or other non-legal advice. Finally, we undertake no responsibility for the accuracy, completeness or fairness of the Official Statement or other offering material relating to the Bonds and express no opinion with respect thereto.

Based on and subject to the foregoing, and in reliance thereon, as of the date hereof, we are of the following opinions:

1. The Issuer is a joint exercise of powers agency, duly organized and validly existing under the laws of the State, and has lawful authority to issue the Bonds.
2. The Bonds constitute the valid and binding limited obligations of the Issuer, payable solely from the Revenues pledged therefor under the Indenture.
3. The Indenture has been duly executed and delivered by, and constitutes the valid and binding obligation of, the Issuer. The Indenture creates a valid pledge, to secure the payment of the principal of, premium, if any, and interest on the Bonds, of the Revenues and any other amounts (including proceeds of the sale of the Bonds) held by the Trustee in any fund or account established pursuant to the Indenture, except the Rebate Fund, subject to the provisions of the Indenture permitting the application thereof for the purposes and on the terms and conditions set forth in the Indenture.
4. The Bonds do not constitute a debt or liability of the Issuer, the State or any political subdivision thereof, or a pledge of the faith and credit of the State or any such political subdivision, other than the Issuer to the extent provided in the Indenture.



5. Interest on the Bonds is excluded from gross income for federal income tax purposes under Section 103 of the Internal Revenue Code of 1986. Interest on the Bonds is not a specific preference item for purposes of the federal individual or corporate alternative minimum taxes, nor is it included in adjusted current earnings when calculating corporate alternative minimum taxable income. Interest on the Bonds is exempt from State of California personal income taxes. We express no opinion regarding other tax consequences related to the ownership or disposition of, or the amount, accrual or receipt of interest on, the Bonds.

Faithfully yours,

ORRICK, HERRINGTON & SUTCLIFFE LLP

per

**APPENDIX B**

**FORM OF LETTER OF CREDIT**

## **IRREVOCABLE LETTER OF CREDIT NO. 14OSL02948**

May 29, 2014

Wilmington Trust, National Association  
650 Town Center Drive, Suite 600  
Costa Mesa, California 92626

Ladies and Gentlemen:

At the request and for the account of Heritage II, L.P., a California limited partnership (the "Applicant"), we establish this irrevocable letter of credit (this "Letter of Credit"), in the aggregate amount of U.S. \$7,191,036 (as from time to time reduced or reinstated as provided in this Letter of Credit, the "Letter of Credit Amount"), in your favor as trustee under the Indenture of Trust dated as of May 1, 2014 (as it may from time to time be supplemented or amended, the "Indenture") between you and California Statewide Communities Development Authority (the "Issuer"), pursuant to which the Issuer is issuing \$7,100,000 of its Variable Rate Demand Multifamily Housing Revenue Bonds (Heritage II Apartments Project) 2014 Series G (the "Bonds").

The Letter of Credit Amount shall be available for drawing by you as set forth below in amounts (a) not to exceed \$7,100,000 (as from time to time reduced or reinstated as provided in this Letter of Credit, the "Principal Component") with respect to the unpaid principal of the Bonds, and (b) not to exceed \$91,036 (as from time to time reduced or reinstated as provided in this Letter of Credit, the "Interest Component") with respect to the accrued interest (or interest to be accrued) on the Bonds.

This Letter of Credit shall expire on the earlier of May 29, 2017 or the date we honor a drawing under Annex E to this Letter of Credit (such earlier date being the "Expiration Date").

Subject to the provisions of this Letter of Credit, demands for payment under this Letter of Credit may be made by you from time to time on or before the Expiration Date by presentation of your certificate in the form of:

- (a) Annex B (for payments of interest on the Bonds);
- (b) Annex C (for the purchase price of Bonds tendered for purchase);
- (c) Annex D (for payment of less than all principal of and accrued interest owing on the Bonds); or

- (d) Annex E (for payment of all principal of and accrued interest owing on the Bonds);

together in each case with your draft in the form of Annex A drawn on us at 135 North Los Robles Avenue, 2<sup>nd</sup> Floor, Pasadena, California 91101, Attention: International Operations Department (or at such other address in California as we may designate in a written notice delivered to you), on any "Business Day" (as defined below) (each such demand and presentation, a "Drawing"). If a Drawing is presented before 11:00 a.m., Los Angeles time, payment against conforming documents presented under this Letter of Credit shall be made by us on or before 9:30 a.m., Los Angeles time (or, in the case of presentation on and after 11:00 a.m., Los Angeles time, prior to 1:00 p.m., Los Angeles time), on the next Business Day after presentation. "Business Day" means any day other than a Saturday, a Sunday or a day on which banks in the city in which our principal office is located (currently Los Angeles, California) are authorized or required by law to close.

Each Drawing we honor under this Letter of Credit shall immediately reduce the Principal Component and the Interest Component, as applicable, to the extent that each was included in the amount of such Drawing, and the Letter of Credit Amount shall be correspondingly reduced. Upon such honor, our obligations in respect of such Drawing shall be discharged, and we shall have no further obligations with respect to such Drawing. The Principal Component and the Interest Component (and correspondingly the Letter of Credit Amount) so reduced shall be reinstated only as follows:

(a) The Interest Component (and correspondingly the Letter of Credit Amount) so reduced shall be reinstated, in the case of a reduction resulting from a drawing under Annex B only, upon our honoring such drawing to an amount equal to 39 days' interest on the Principal Component, calculated at the rate of 12% per annum on the basis of a 365-day year.

(b) The Interest Component and the Principal Component (and correspondingly the Letter of Credit Amount) so reduced shall be reinstated, in the case of a reduction resulting from a drawing under Annex C, in the case of the Interest Component and the Principal Component, automatically upon our receipt from you of a certificate in the form of Annex F (a "Reimbursement Certificate"). In each such case, the Principal Component shall be reinstated in an amount equal to the amount of principal which such Annex F indicates was reimbursed and the Interest Component shall be reinstated in an amount equal to the amount of interest which such Annex F indicates was reimbursed.

No other reinstatement of the Letter of Credit Amount will be permitted. The Letter of Credit Amount shall also be permanently reduced upon our receipt of your certificate in the form of Annex G (a "Reduction Certificate") by the amount stated in such certificate.

Reductions of the amount available under this Letter of Credit provided for above shall reduce the amounts that you may draw hereunder, notwithstanding:

(a) the fact that such reduction is the result of a payment under this Letter of Credit against presentation of a sight draft or certificate that does not substantially comply with the terms of this Letter of Credit (including, without limitation, (i) the fact that any draft or certificate presented under this

Letter of Credit (or any endorsement thereon) proves to be forged, fraudulent, invalid, unenforceable or insufficient in any respect or any statement therein proves to be inaccurate in any respect whatsoever, or (ii) the failure of any document to bear reference or to bear adequate reference to this Letter of Credit);

(b) the use to which this Letter of Credit may be put or any of your acts or omissions in connection therewith; or

(c) any other circumstance or happening whatsoever, whether or not similar to any of the foregoing, in making payment under this Letter of Credit, so long as the subject payment under this Letter of Credit does not constitute our gross negligence or willful misconduct.

In furtherance and not in limitation of the foregoing, we may accept documents that appear on their face to be in order, without responsibility for further investigation, regardless of any notice or information to the contrary.

All documents presented to us in connection with any Drawing and all other communications and notices to us with respect to this Letter of Credit shall be in writing, dated the date of presentation, and delivered to us at the address set forth in the fourth paragraph of this Letter of Credit and shall specifically refer to "East West Bank, Irrevocable Letter of Credit No. 14OSL02948." Any such documents, communications and notices may be delivered by confirmed facsimile transmission to us at (626) 817-8857 (or at such other number as we may notify you in writing) confirmed by telephone at (626) 768-6608 (or to such other number as we may notify you in writing), followed by delivery of original documents to the address specified above (which delivery is not a condition of our honoring a Drawing).

The failure to make any Drawing permitted by this Letter of Credit shall not, in and of itself, result in this Letter of Credit ceasing to be available for future such Drawings.

All payments under this Letter of Credit will be made with our funds and not the Applicant's.

This Letter of Credit is transferable in its entirety to any transferee and may be successively transferred to any subsequent transferee, in each case upon presentation to us of the original of this Letter of Credit accompanied by a certificate in the form of Annex H (a "Transfer Certificate").

This Letter of Credit sets forth in full our undertaking, and such undertaking shall not in any way be modified, amended, amplified or limited by any document, instrument or agreement (including, without limitation, the Indenture and the Bonds) referred to in this Letter of Credit or in any certificate presented by you under this Letter of Credit.

Except as otherwise provided in this Letter of Credit, this Letter of Credit is governed by and shall be construed in accordance with the Uniform Customs and Practice for Documentary Credits, 2007 Revision, International Chamber of Commerce Publication No. 600 (the "Uniform Customs"). Notwithstanding Article 36 of the Uniform Customs, if this Letter of Credit expires during an interruption of business as a result of one or more of the occurrences specified in such Article 36, it shall

Wilmington Trust, National Association  
May 29, 2014  
LC No. 14OSL02948  
Page 4

be automatically extended to the date which is three Business Days following the end of such interruption. As to matters not covered by the Uniform Customs, except as otherwise provided in this Letter of Credit, this Letter of Credit shall be governed by the internal laws of the State of California.

Very truly yours,

EAST WEST BANK,  
a California banking corporation

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Title: \_\_\_\_\_

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Title: \_\_\_\_\_

**East West Bank  
Irrevocable Letter of Credit  
No. 14OSL02948**

**ANNEX A**  
**FORM OF DRAFT**

East West Bank  
135 North Los Robles Avenue, 2<sup>nd</sup> Floor  
Pasadena, California 91101

Dated: \_\_\_\_\_

Pay to the order of [Trustee] the amount of \$\_\_\_\_\_ drawn on East West Bank, as issuer of its Irrevocable Letter of Credit No. 14OSL02948 dated May 29, 2014.

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee

By: \_\_\_\_\_  
Authorized Officer

**East West Bank  
Irrevocable Letter of Credit  
No. 14OSL02948**

**ANNEX B**

**INTEREST CERTIFICATE**

The undersigned, a duly authorized officer of the undersigned Trustee (the "Trustee"), certifies as follows to East West Bank, as issuer of the above-referenced letter of credit (the "Letter of Credit"):

1. All terms defined in the Letter of Credit are used in this Certificate with the same meanings.

2. The Trustee is the Trustee under the Indenture and is entitled to present this Certificate. The Bonds bear interest at a "Variable Rate" in the "Weekly Mode" (as both are defined in the Indenture). No other "Letter of Credit" or any "Substitute Credit Facility" (excluding the "Standby Letter of Credit," as all are defined in the Indenture) has become effective with respect to the Bonds.

3. Pursuant to the Indenture, the Trustee has concurrently presented its draft drawn on you in the amount of \$\_\_\_\_\_. The amount of such draft represents \_\_\_\_ days' accrued interest (or interest which will have accrued) on the Bonds due on an "Interest Payment Date" (as defined in the Indenture). Such amount was computed in accordance with the terms and conditions of the Indenture; does not include any amount for any Bonds known by us to be registered in your name or the name of the Applicant or any affiliate or guarantor of the Applicant; does not exceed the amount available to be drawn under the Letter of Credit in respect of the payment of interest on the Bonds; and shall be used solely for the purpose of paying accrued interest on the Bonds pursuant to the Indenture.

Dated:\_\_\_\_\_

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee

By: \_\_\_\_\_  
Authorized Officer



**East West Bank  
Irrevocable Letter of Credit  
No. 14OSL02948**

**ANNEX C**

**PURCHASE CERTIFICATE**

The undersigned, a duly authorized officer of the undersigned Trustee (the "Trustee"), certifies as follows to East West Bank, as issuer of the above-referenced letter of credit (the "Letter of Credit"):

1. All terms defined in the Letter of Credit are used in this Certificate with the same meanings.

2. The Trustee is the Trustee under the Indenture and is entitled to present this Certificate. The Bonds bear interest at a "Variable Rate" in the "Weekly Mode" (as both are defined in the Indenture). No other "Letter of Credit" or any "Substitute Credit Facility" (excluding the "Standby Letter of Credit," as all are defined in the Indenture) has become effective with respect to the Bonds.

3. Pursuant to the Indenture, the Trustee has presented herewith its draft drawn on you in the amount of \$\_\_\_\_\_. The amount of such draft represents the principal portion in the amount of \$\_\_\_\_\_, and the accrued interest portion (or interest which will have accrued) in the amount of \$\_\_\_\_\_, of the purchase price of the Bonds tendered pursuant to Section 2.03(a) of the Indenture. Such amount was computed in accordance with the terms and conditions of the Indenture; does not include any amount for any Bonds known by us to be registered in your name or the name of the Applicant or any affiliate or guarantor of the Applicant; does not exceed the amount available to be drawn under the Letter of Credit in respect of principal of and interest on the Bonds; and shall be used solely for the purpose of purchasing Bonds pursuant to 2.03(a) of the Indenture.

Dated:\_\_\_\_\_

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee

By: \_\_\_\_\_  
Authorized Officer

**East West Bank  
Irrevocable Letter of Credit  
No. 14OSL02948**

**ANNEX D**

**PARTIAL PAYMENT CERTIFICATE**

The undersigned, a duly authorized officer of the undersigned Trustee (the "Trustee"), certifies as follows to East West Bank, as issuer of the above-referenced letter of credit (the "Letter of Credit"):

1. All terms defined in the Letter of Credit are used in this Certificate with the same meanings.

2. The Trustee is the Trustee under the Indenture and is entitled to present this Certificate. The Bonds bear interest at a "Variable Rate" in the "Weekly Mode" (as both are defined in the Indenture). No other "Letter of Credit" or any "Substitute Credit Facility" (excluding the "Standby Letter of Credit," as all are defined in the Indenture) has become effective with respect to the Bonds.

3. Pursuant to the Indenture, the Trustee has concurrently presented its draft drawn on you in the amount of \$\_\_\_\_\_. The amount of such draft represents unpaid principal in the amount of \$\_\_\_\_\_ and \_\_\_\_ days' accrued interest (or interest to be accrued) in the amount of \$\_\_\_\_\_ due with respect to **choose one**: [the redemption of less than all of the Bonds pursuant to Section 4.01(a) of the Indenture] [the redemption of less than all of the Bonds pursuant to Section 4.01(b) of the Indenture]. Such amount was computed in accordance with the terms and conditions of the Indenture; does not include any amount for any Bonds known by us to be registered in your name or the name of the Applicant or any affiliate or guarantor of the Applicant; does not exceed the amount available to be drawn under the Letter of Credit in respect of principal of and interest on the Bonds; and shall be used solely for the purpose of redeeming the Bonds pursuant to the provision of the Indenture referred to above.

Dated: \_\_\_\_\_

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee

By: \_\_\_\_\_  
Authorized Officer

**East West Bank  
Irrevocable Letter of Credit  
No. 14OSL02948**

**ANNEX E**

**FINAL PAYMENT CERTIFICATE**

The undersigned, a duly authorized officer of the undersigned Trustee (the "Trustee"), certifies as follows to East West Bank, as issuer of the above-referenced letter of credit (the "Letter of Credit"):

1. All terms defined in the Letter of Credit are used in this Certificate with the same meanings.

2. The Trustee is the Trustee under the Indenture and is entitled to present this Certificate. The Bonds bear interest at a "Variable Rate" in the "Weekly Mode" (as both are defined in the Indenture). No other "Letter of Credit" or any "Substitute Credit Facility" (excluding the "Standby Letter of Credit," as all are defined in the Indenture) has become effective with respect to the Bonds.

3. Pursuant to the Indenture, the Trustee has concurrently presented its draft drawn on you in the amount of \$\_\_\_\_\_. The amount of such draft represents unpaid principal in the amount of \$\_\_\_\_\_ and \_\_\_\_ days' accrued interest (or interest to be accrued) in the amount of \$\_\_\_\_\_ due with respect to **choose one**: [tender of the Bonds pursuant to Section 2.03(b) of the Indenture] [the redemption of all of the Bonds pursuant to Section 4.01(a) of the Indenture] [the redemption of all of the Bonds pursuant to Section 4.01 (b) of the Indenture] [the redemption of all of the Bonds pursuant to Section 4.01(c) of the Indenture] [the redemption of all of the Bonds pursuant to Section 4.01(d) of the Indenture] [your purchase of the Bonds in lieu of redemption pursuant to Section 4.06 of the Indenture] [the acceleration of the Bonds pursuant to Section 7.01 of the Indenture]. Such amount was computed in accordance with the terms and conditions of the Indenture; does not include any amount for any Bonds known by us to be registered in your name or the name of the Applicant or any affiliate or guarantor of the Applicant; does not exceed the amount available to be drawn under the Letter of Credit in respect of principal of and interest on the Bonds; and shall be used solely for the purpose of paying for Bonds pursuant to the provision of the Indenture referred to above.

4. The Letter of Credit is concurrently being surrendered.

Dated: \_\_\_\_\_

*[Signature appears on following page.]*

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee

By: \_\_\_\_\_  
Authorized Officer

**East West Bank  
Irrevocable Letter of Credit  
No. 14OSL02948**

**ANNEX F**

**REIMBURSEMENT CERTIFICATE**

The undersigned, a duly authorized officer of the undersigned Trustee (the "Trustee"), certifies as follows to East West Bank, as issuer of the above-referenced letter of credit (the "Letter of Credit"):

1. All terms defined in the Letter of Credit are used in this Certificate with the same meanings.

2. The Trustee is the Trustee under the Indenture and is entitled to present this Certificate. The Bonds bear interest at a "Variable Rate" in the "Weekly Mode" (as both are defined in the Indenture). No other "Letter of Credit" or any "Substitute Credit Facility" (excluding the "Standby Letter of Credit," as all are defined in the Indenture) has become effective with respect to the Bonds.

3. The Trustee has today paid to you by wire transfer of immediately available funds the amount of \$\_\_\_\_\_ for the reimbursement to you of \$\_\_\_\_\_ of unpaid principal and \$\_\_\_\_\_ of accrued interest (or interest to be accrued) on the Bonds in connection with the drawing under Annex C honored pursuant to the Trustee's draft dated \_\_\_\_\_, 20\_\_ in the aggregate amount of \$\_\_\_\_\_ and hereby notifies you that Bonds with respect to which such drawing under Annex C was made, in the amount of \$\_\_\_\_\_, have been remarketed, to the Trustee's best knowledge, to a person other than the Applicant or an affiliate or guarantor of the Applicant or you.

Dated:\_\_\_\_\_

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee

By: \_\_\_\_\_  
Authorized Officer

**East West Bank  
Irrevocable Letter of Credit  
No. 14OSL02948**

**ANNEX G**

**REDUCTION CERTIFICATE**

The undersigned, a duly authorized officer of the undersigned Trustee (the Trustee"), certifies as follows to East West Bank, as issuer of the above-referenced letter of credit (the "Letter of Credit"):

1. All terms defined in the Letter of Credit are used in this Certificate with the same meanings.
2. The Trustee is the Trustee under the Indenture and is entitled to present this Certificate. The Bonds bear interest at a "Variable Rate" in the "Weekly Mode" (as both are defined in the Indenture). No other "Letter of Credit" or any "Substitute Credit Facility" (excluding the "Standby Letter of Credit," as all are defined in the Indenture) has become effective with respect to the Bonds.
3. The Trustee notifies you that, on or prior to the date of this Certificate, Bonds in the principal amount of \$\_\_\_\_\_ have been redeemed, defeased or otherwise are no longer "Outstanding" (as defined in the Indenture).
4. The Trustee consents to a reduction in the Letter of Credit Amount in the amount of \$\_\_\_\_\_, representing a reduction in the Principal Component equal to \$\_\_\_\_\_ of the aggregate principal amount of Bonds referred to in the preceding paragraph, plus a reduction in the Interest Component, representing 39 days' accrued interest on such principal calculated at the rate of 12% per annum on the basis of a 365-day year, equal to \$\_\_\_\_\_.
5. The foregoing amounts were computed in accordance with the terms and conditions of the Indenture.

Dated:\_\_\_\_\_

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee

By: \_\_\_\_\_  
Authorized Officer

**East West Bank  
Irrevocable Letter of Credit  
No. 14OSL02948**

**ANNEX H**

**INSTRUCTION TO TRANSFER**

The undersigned, a duly authorized officer of the undersigned beneficiary of the above-referenced letter of credit (the "Letter of Credit"), irrevocably instructs East West Bank, as issuer of the Letter of credit, as follows:

1. For value, received, the undersigned beneficiary irrevocably transfers to:

\_\_\_\_\_  
[Name of Transferee]

\_\_\_\_\_  
[Address]

all rights of the undersigned beneficiary under the Letter of Credit. The transferee has succeeded the undersigned as Trustee under the "Indenture" (as defined in the Letter of Credit).

2. By this transfer, all rights of the undersigned beneficiary in the Letter of Credit are transferred to the transferee, and the transferee shall from the date of this Instruction have sole rights as beneficiary of the Letter of Credit; provided, however, that no rights shall be deemed to have been transferred to the transferee until such transfer complies with the requirements of the Letter of Credit pertaining to transfers.

3. The Letter of Credit is returned with this Instruction, and in accordance with the Letter of Credit the undersigned asks that this transfer be effective and that you transfer the same to the transferee or that, if so requested by the transferee, you issue a new irrevocable letter of credit in favor of the transferee with provisions consistent with the Letter of Credit.

Dated: \_\_\_\_\_

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee

By: \_\_\_\_\_  
Authorized Officer

## **APPENDIX C**

### **FORM OF STANDBY LETTER OF CREDIT**



IRREVOCABLE STANDBY LETTER OF CREDIT

Date: May 29, 2014

No: 2014-39

Wilmington Trust, National Association  
650 Town Center Drive, Suite 600  
Costa Mesa, California 92626

Greetings:

At the request and for the account of our customer, East West Bank, Pasadena, California (the "Member"), we (the "Bank") hereby establish this Irrevocable Standby Letter of Credit (the "Letter of Credit") in your favor as Trustee under the Indenture of Trust dated as of May 1, 2014 (as it may from time to time be further supplemented or amended, the "Indenture") between Wilmington Trust, National Association (the "Trustee") and California Statewide Communities Development Authority (the "Issuer"), pursuant to which the Issuer is issuing \$7,100,000 of its Variable Rate Demand Multifamily Housing Revenue Bonds (Heritage II Apartments Project) 2014 Series G (the "Bonds"). Subject to the terms and conditions herein, this Letter of Credit authorizes you to draw on us an amount not exceeding \$7,191,036 (the "Credit Amount").

This Letter of Credit will expire at 4:00 p.m., California time, on the date (the "Expiration Date") that is the earliest of: (i) May 29, 2017; (ii) the date of any demand for payment honored by the Bank under this Letter of Credit; or (iii) the date you surrender this Letter of Credit to the Bank for cancellation.

Subject to the other provisions of this Letter of Credit, you may demand payment under this Letter of Credit at or before 10:00 a.m., California time, on or prior to the Expiration Date by presenting your certificate in the form of Annex A, prepared in the form of a letter on your letterhead, signed by your authorized officer, with the blanks appropriately completed (the "Certification"), delivered to the Bank at 600 California Street, San Francisco, California 94108, Attention: Portfolio Operations/Letters of Credit. All payments under this Letter of Credit will be made with funds of the Bank and not from funds of the Issuer or the Member.

The Bank will honor a Certification presented in full compliance with the terms of this Letter of Credit (a "Drawing") at or before 10:00 a.m., California time, on a Business Day by making payment to you, in immediately available funds, of the Drawing amount specified in the Certification (up to the Credit Amount) at or before 10:30 a.m. California time, on the next Business Day. Documents received after 10:00 a.m., California time, will be deemed to have been received before 10:00 a.m. on the next Business Day. As used in this Letter of Credit, a "Business Day" is any day on which the Bank is open for business.

Upon honoring a Drawing under this Letter of Credit, the Bank's obligations in respect of the Drawing are discharged and the Bank will have no further obligations with respect to the Drawing. If you make a demand for payment under this Letter of Credit that does not conform, in any instance, to the terms of this Letter of Credit, we will give you notice that the purported demand does not conform with the terms of the Letter of Credit and we may hold the documents at your disposal or return them to you, at our option. You may attempt to correct your nonconforming demand for payment if, and to the extent that, you are entitled (without regard to the provisions of this sentence) and able to do so. Any correction or resubmission of your demand for payment will be considered a new demand.

By honoring a Drawing under this Letter of Credit, we make no representation as to the correctness of the amount of the Drawing, the authority of any person signing on your behalf or your representations on the Certification.

Upon the Bank's receipt of your request for reduction in the form of Annex B ("Request for Reduction"), the Credit Amount shall be reduced to the amount stated in the Request for Reduction by an amendment to this Letter of Credit, effective on the later of the date set forth in the Request for Reduction or the date of the Bank's receipt of such Request for Reduction.

The Bank will transfer this Letter of Credit to a successor Trustee under the Indenture if you present the Letter of Credit accompanied by a certificate designating the successor Trustee.

This Letter of Credit will be governed by and construed in accordance with the Uniform Customs and Practice for Documentary Credits (2007 Revision), International Chamber of Commerce Publication 600 (the "Uniform Customs and Practice"), and, to the extent not inconsistent with the Uniform Customs and Practice, the laws of the State of California. Notwithstanding anything in Article 36 of the Uniform Customs and Practice to the contrary, if you may properly draw on this Letter of Credit prior to the Expiration Date during an interruption of business as described in said Article, then the Bank shall be specifically authorized and agrees to effect payment in accordance with such drawing, so long as this Letter of Credit is drawn on within three Business Days of the Bank's written notice to you that the Bank has resumed business.

Communications with respect to this Letter of Credit must be in writing, must specifically refer to the number of this Letter of Credit, and must be delivered to the Bank at the address indicated above.

Wilmington Trust, National Association

May 29, 2014

Page 3

This Letter of Credit, including Annexes A and B, sets forth in full our undertaking, which may not be modified, amplified or limited by reference to any document, instrument, or agreement (including, without limitation, the Bonds and the Indenture), and any such reference will not be deemed to incorporate by reference any document, instrument or agreement.

Very truly yours,

FEDERAL HOME LOAN BANK  
OF SAN FRANCISCO

By: \_\_\_\_\_

Title: \_\_\_\_\_

By: \_\_\_\_\_

Title: \_\_\_\_\_

ANNEX A

CERTIFICATION

Federal Home Loan Bank of San Francisco  
600 California Street  
San Francisco, CA 94108  
Attention: Portfolio Operations/Letters of Credit

Letter of Credit No. 2014-39

The undersigned, a duly authorized officer of the Trustee, certifies as follows to the Federal Home Loan Bank of San Francisco, as issuer of the above-referenced Letter of Credit:

1. All terms defined in the Letter of Credit are used in this certification with the same meanings.

2. The Trustee is the Trustee under the Indenture, is the beneficiary under the Letter of Credit, and is entitled to present this certificate.

3. The Member has not timely honored a draw, the Trustee is precluded by operation of law from timely drawing on or the Member has repudiated the Member's Irrevocable Standby Letter of Credit No. 14OSL02948, dated May 29, 2014.

4. The Trustee is entitled to draw \$\_\_\_\_\_ under the above-referenced Letter of Credit, which amount does not exceed the Credit Amount of the Letter of Credit.

5. Wire Instructions: \_\_\_\_\_  
\_\_\_\_\_

Dated: \_\_\_\_\_

Wilmington Trust, National Association

By: \_\_\_\_\_

Title: \_\_\_\_\_

Authorized Officer

*[Beneficiary Letterhead]*

ANNEX B

REQUEST FOR REDUCTION

Date: \_\_\_\_\_

Federal Home Loan Bank  
of San Francisco  
600 California Street  
San Francisco, CA 94108  
Attention: Portfolio Operations/Letters of Credit

Re: Letter of Credit No. 2014-39

Greetings:

At the request of Wilmington Trust, National Association, the Beneficiary, please reduce the Credit Amount for the above-referenced Letter of Credit to \$\_\_\_\_\_, effective on the later of \_\_\_\_\_, 20\_\_ or receipt of this letter.

Sincerely,

Wilmington Trust, National Association

By: \_\_\_\_\_

Title: \_\_\_\_\_

Authorized Signature

**APPENDIX D**

**FINANCIALS OF FEDERAL HOME LOAN BANK OF SAN FRANCISCO**

**Federal Home Loan Bank of San Francisco**  
**Statements of Condition**

(In millions-except par value)	December 31, 2013	December 31, 2012
<b>Assets:</b>		
Cash and due from banks	\$ 4,906	\$ 104
Securities purchased under agreements to resell	—	1,500
Federal funds sold	7,498	10,857
Trading securities <sup>(a)</sup>	3,208	3,191
Available-for-sale securities <sup>(a)</sup>	7,047	7,604
Held-to-maturity securities (fair values were \$17,352 and \$17,584, respectively) <sup>(b)</sup>	17,507	17,376
Advances (includes \$7,069 and \$7,390 at fair value under the fair value option, respectively)	44,395	43,750
Mortgage loans held for portfolio, net of allowance for credit losses of \$2 and \$3, respectively	905	1,289
Accrued interest receivable	81	101
Premises, software, and equipment, net	25	26
Derivative assets, net	116	529
Other assets	86	94
<b>Total Assets</b>	<b>\$ 85,774</b>	<b>\$ 86,421</b>
<b>Liabilities:</b>		
Deposits	\$ 193	\$ 227
Consolidated obligations:		
Bonds (includes \$10,115 and \$27,884 at fair value under the fair value option, respectively)	53,207	70,310
Discount notes	24,194	5,209
Total consolidated obligations	77,401	75,519
Mandatorily redeemable capital stock	2,071	4,343
Accrued interest payable	95	175
Affordable Housing Program payable	151	144
Derivative liabilities, net	47	23
Other liabilities	107	377
<b>Total Liabilities</b>	<b>80,065</b>	<b>80,808</b>
Commitments and Contingencies (Note 21)		
<b>Capital:</b>		
Capital stock—Class B—Putable (\$100 par value) issued and outstanding:		
35 shares and 42 shares, respectively	3,460	4,160
Unrestricted retained earnings	317	246
Restricted retained earnings	2,077	2,001
<b>Total Retained Earnings</b>	<b>2,394</b>	<b>2,247</b>
Accumulated other comprehensive income/(loss)	(145)	(794)
<b>Total Capital</b>	<b>5,709</b>	<b>5,613</b>
<b>Total Liabilities and Capital</b>	<b>\$ 85,774</b>	<b>\$ 86,421</b>

(a) At December 31, 2013, and December 31, 2012, none of these securities were pledged as collateral that may be repledged.

(b) At December 31, 2013, none of these securities were pledged as collateral that may be repledged. At December 31, 2012, \$2 of these securities were pledged as collateral that may be repledged.

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

**Federal Home Loan Bank of San Francisco**  
**Statements of Income**

(In millions)	For the Years Ended December 31,		
	2013	2012	2011
<b>Interest Income:</b>			
Advances	\$ 340	\$ 520	\$ 692
Prepayment fees on advances, net	5	65	17
Securities purchased under agreements to resell	1	5	—
Federal funds sold	15	12	22
Trading securities	7	22	25
Available-for-sale securities	276	317	238
Held-to-maturity securities	392	476	679
Mortgage loans held for portfolio	50	77	113
Total Interest Income	1,086	1,494	1,786
<b>Interest Expense:</b>			
Consolidated obligations:			
Bonds	432	574	707
Discount notes	17	21	34
Mandatorily redeemable capital stock	155	51	12
Total Interest Expense	604	646	753
<b>Net Interest Income</b>	482	848	1,033
Provision for/(reversal of) credit losses on mortgage loans	(1)	(1)	4
<b>Net Interest Income After Mortgage Loan Loss Provision</b>	483	849	1,029
<b>Other Income/(Loss):</b>			
Net gain/(loss) on trading securities	2	(11)	(7)
Total other-than-temporary impairment (OTTI) loss	(14)	(55)	(437)
Net amount of OTTI loss reclassified to/(from) accumulated other comprehensive income/(loss)	7	11	24
Net OTTI loss, credit-related	(7)	(44)	(413)
Net gain/(loss) on advances and consolidated obligation bonds held under fair value option	(23)	(15)	25
Net gain/(loss) on derivatives and hedging activities	26	(101)	(256)
Other	7	7	6
Total Other Income/(Loss)	5	(164)	(645)
<b>Other Expense:</b>			
Compensation and benefits	63	63	61
Other operating expense	53	52	46
Federal Housing Finance Agency	7	12	10
Office of Finance	5	5	6
Other	—	2	3
Total Other Expense	128	134	126
<b>Income/(Loss) Before Assessments</b>	360	551	258
REFCORP	—	—	17
Affordable Housing Program	52	60	25
Total Assessments	52	60	42
<b>Net Income/(Loss)</b>	\$ 308	\$ 491	\$ 216

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



**Federal Home Loan Bank of San Francisco**  
**Statements of Comprehensive Income**

(In millions)	For the Years Ended December 31,		
	2013	2012	2011
<b>Net Income/(Loss)</b>	<b>\$ 308</b>	<b>\$ 491</b>	<b>\$ 216</b>
Other Comprehensive Income/(Loss):			
Net change in pension and postretirement benefits	5	—	(5)
Net unrealized gain/(loss) on available-for-sale securities	—	(1)	3
Net non-credit-related OTTI loss on available-for-sale securities:			
Non-credit-related OTTI loss transferred from held-to-maturity securities	(4)	(28)	(2,672)
Net change in fair value of other-than-temporarily impaired securities	644	1,102	810
Reclassification of non-credit-related OTTI loss included in net income/(loss)	(3)	14	26
Total net non-credit-related OTTI loss on available-for-sale securities	637	1,088	(1,836)
Net non-credit-related OTTI loss on held-to-maturity securities:			
Non-credit-related OTTI loss	(4)	(25)	(207)
Reclassification of non-credit-related OTTI loss transferred to available-for-sale securities	—	—	157
Accretion of non-credit-related OTTI loss	7	9	266
Non-credit-related OTTI loss transferred to available-for-sale securities	4	28	2,672
Total net non-credit-related OTTI loss on held-to-maturity securities	7	12	2,888
Total other comprehensive income/(loss)	649	1,099	1,050
<b>Total Comprehensive Income/(Loss)</b>	<b>\$ 957</b>	<b>\$ 1,590</b>	<b>\$ 1,266</b>

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

**Federal Home Loan Bank of San Francisco**  
**Statements of Capital Accounts**

(In millions)	Capital Stock Class B—Putable		Retained Earnings			Accumulated Other Comprehensive Income/(Loss)	Total Capital
	Shares	Par Value	Restricted	Unrestricted	Total		
Balance, December 31, 2010	83	\$ 8,282	\$ 1,609	\$ —	\$ 1,609	\$ (2,943)	\$ 6,948
Issuance of capital stock	2	244					244
Repurchase of capital stock	(10)	(1,043)					(1,043)
Capital stock reclassified from/(to) mandatorily redeemable capital stock, net	(27)	(2,688)					(2,688)
Comprehensive income/(loss)			194	22	216	1,050	1,266
Cash dividends paid on capital stock (0.29%)				(22)	(22)		(22)
Balance, December 31, 2011	48	\$ 4,795	\$ 1,803	\$ —	\$ 1,803	\$ (1,893)	\$ 4,705
Issuance of capital stock	3	266					266
Repurchase of capital stock	(9)	(864)					(864)
Capital stock reclassified from/(to) mandatorily redeemable capital stock, net	—	(37)					(37)
Comprehensive income/(loss)			198	293	491	1,099	1,590
Cash dividends paid on capital stock (0.97%)				(47)	(47)		(47)
Balance, December 31, 2012	42	\$ 4,160	\$ 2,001	\$ 246	\$ 2,247	\$ (794)	\$ 5,613
Issuance of capital stock	5	530					530
Repurchase of capital stock	(12)	(1,226)					(1,226)
Capital stock reclassified from/(to) mandatorily redeemable capital stock, net	—	(4)					(4)
Comprehensive income/(loss)			76	232	308	649	957
Cash dividends paid on capital stock (3.99%)				(161)	(161)		(161)
Balance, December 31, 2013	35	\$ 3,460	\$ 2,077	\$ 317	\$ 2,394	\$ (145)	\$ 5,709

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

**Federal Home Loan Bank of San Francisco**  
**Statements of Cash Flows**

(In millions)	For the Years Ended December 31,		
	2013	2012	2011
<b>Cash Flows from Operating Activities:</b>			
Net Income/(Loss)	\$ 308	\$ 491	\$ 216
Adjustments to reconcile net income/(loss) to net cash provided by operating activities:			
Depreciation and amortization	(68)	(32)	(76)
Provision for/(reversal of) credit losses on mortgage loans	(1)	(1)	4
Change in net fair value adjustment on trading securities	(2)	11	7
Change in net fair value adjustment on advances and consolidated obligation bonds held under the fair value option	23	15	(25)
Change in net derivatives and hedging activities	7	42	269
Net OTTI loss, credit-related	7	44	413
Other adjustments	—	—	(3)
Net change in:			
Accrued interest receivable	21	86	59
Other assets	(8)	(10)	26
Accrued interest payable	(85)	(66)	(231)
Other liabilities	18	2	(77)
Total adjustments	(88)	91	366
Net cash provided by/(used in) operating activities	220	582	582
<b>Cash Flows from Investing Activities:</b>			
Net change in:			
Interest-bearing deposits	(128)	28	—
Securities purchased under agreements to resell	1,500	(1,500)	—
Federal funds sold	3,359	(5,491)	10,946
Premises, software, and equipment	(8)	(7)	(12)
Trading securities:			
Proceeds from maturities of long-term	236	2,548	864
Purchases of long-term	(525)	(2,666)	(1,160)
Available-for-sale securities:			
Proceeds from maturities of long-term	1,283	3,208	836
Held-to-maturity securities:			
Net (increase)/decrease in short-term	79	3,602	3,999
Proceeds from maturities of long-term	3,927	4,397	4,580
Purchases of long-term	(4,193)	(4,014)	(6,145)
Advances:			
Principal collected	529,782	361,716	255,620
Made to members	(530,789)	(337,460)	(228,146)
Mortgage loans held for portfolio:			
Principal collected	379	540	555
Proceeds from sales of foreclosed assets	4	3	—
Net cash provided by/(used in) investing activities	4,906	24,904	41,937

**Federal Home Loan Bank of San Francisco**  
**Statements of Cash Flows (continued)**

(In millions)	For the Years Ended December 31,		
	2013	2012	2011
<b>Cash Flows from Financing Activities:</b>			
Net change in:			
Deposits	273	(360)	(312)
Net (payments)/proceeds on derivative contracts with financing elements	66	48	60
Net proceeds from issuance of consolidated obligations:			
Bonds	29,195	53,478	56,156
Discount notes	107,252	49,244	56,361
Bonds transferred from another Federal Home Loan Bank	122	—	15
Payments for matured and retired consolidated obligations:			
Bonds	(45,827)	(66,189)	(93,645)
Discount notes	(88,272)	(63,180)	(56,735)
Proceeds from issuance of capital stock	530	266	244
Payments for repurchase/redemption of mandatorily redeemable capital stock	(2,276)	(1,272)	(859)
Payments for repurchase of capital stock	(1,226)	(864)	(1,043)
Cash dividends paid	(161)	(47)	(22)
Net cash provided by/(used in) financing activities	(324)	(28,876)	(39,780)
Net increase/(decrease) in cash and due from banks	4,802	(3,390)	2,739
Cash and due from banks at beginning of the period	104	3,494	755
Cash and due from banks at end of the period	\$ 4,906	\$ 104	\$ 3,494
<b>Supplemental Disclosures:</b>			
Interest paid	\$ 520	\$ 627	\$ 935
Affordable Housing Program payments	45	66	49
REFCORP payments	—	—	54
<b>Supplemental Disclosures of Noncash Investing Activities:</b>			
Transfers of mortgage loans to real estate owned	4	5	5
Transfers of other-than-temporarily impaired held-to-maturity securities to available-for-sale securities	72	140	7,940

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

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements**  
(Unaudited)

(Dollars in millions except per share amounts)

## **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 are government-sponsored enterprises (GSEs) that serve the public by enhancing the availability of credit for residential mortgages and targeted community development by providing a readily available, competitively priced 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 has a cooperative ownership structure. To access the Bank's products and services, a financial institution must be approved for membership and purchase capital stock in the Bank. The member's capital stock requirement is generally based on its use of Bank products, subject to a minimum asset-based membership requirement that is intended to reflect the value to the member of having ready access to the Bank as a reliable source of competitively priced funds. Bank capital stock is issued, transferred, redeemed, and repurchased at its par value of \$100 per share, subject to certain regulatory and statutory limits. It is not publicly traded. All shareholders may receive dividends on their capital stock, to the extent declared by the Bank's Board of Directors. Regulated financial depositories and insurance companies engaged in residential housing finance, with principal places of business located in Arizona, California, and Nevada, are eligible to apply for membership. In addition, authorized community development financial institutions are eligible to be members of the Bank. All members are required to purchase capital stock in the Bank. State and local housing authorities that meet certain statutory criteria may also borrow from the Bank. While eligible to borrow, these housing authorities are not members of the Bank, and, as such, are not required to hold capital stock.

The Bank conducts business with members in the normal course of business. See Note 22 – Transactions with Certain Members, Certain Nonmembers, and Other FHLBanks for more information.

The Federal Housing Finance Agency (Finance Agency), 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 Office of Finance is a joint office of the FHLBanks that facilitates the issuance and servicing of the debt instruments (consolidated obligations) of the FHLBanks and prepares the combined quarterly and annual financial reports of all 12 FHLBanks.

The primary source of funds for the FHLBanks is the proceeds from the sale to the public of the FHLBanks' consolidated obligations through the Office of Finance using authorized securities dealers. As provided by the Federal Home Loan Bank Act of 1932, as amended (FHLBank Act), or regulations governing the operations of the FHLBanks, all the FHLBanks have joint and several liability for all FHLBank consolidated obligations. 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.

## **Note 1 — Summary of Significant Accounting Policies**

**Use of Estimates.** The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make a number of judgments, estimates, and assumptions that may affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of income, expenses, gains, and losses during the reporting period. The most significant of these estimates include estimating the allowance for credit losses on the advances and mortgage loan portfolios; accounting for derivatives; estimating fair values of investments classified as trading and available-for-sale, derivatives and associated hedged items carried at fair value in accordance with the accounting for derivative instruments and associated hedging activities, and financial instruments carried at fair

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

value under the fair value option, and accounting for other-than-temporary impairment for investment securities; and estimating the prepayment speeds on mortgage-backed securities (MBS) and mortgage loans for the accounting of amortization of premiums and accretion of discounts on MBS and mortgage loans. Actual results could differ significantly from these estimates.

**Estimated Fair Values.** Many of the Bank's financial instruments lack an available liquid trading market as characterized by frequent exchange transactions between a willing buyer and willing seller. Therefore, the Bank uses financial models employing significant assumptions and present value calculations for the purpose of determining 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.

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 20 – Fair Value.

**Securities Purchased under Agreements to Resell.** These investments provide short-term liquidity and are carried at cost. The Bank treats securities purchased under agreements to resell as collateralized financing arrangements because they effectively represent short-term loans with investment-grade counterparties, which are classified as assets in the Statements of Condition. Securities purchased under agreements to resell are held in safekeeping in the name of the Bank by third-party custodians approved by the Bank. In accordance with the terms of these loans, if the fair value of the underlying securities decreases below the fair value required as collateral, the counterparty must place an equivalent amount of additional securities as collateral or remit an equivalent amount of cash. If an agreement to resell is deemed to be impaired, the difference between the fair value of the collateral and the amortized cost of the agreement is charged to earnings.

**Federal Funds Sold.** These investments provide short-term liquidity and are carried at cost. The Bank invests in Federal funds sold with highly rated counterparties, and such investments are only evaluated for purposes of an allowance for credit losses if the investment is not paid when due. All investments in Federal funds sold as of December 31, 2013 and 2012, were repaid according to the contractual terms.

**Investment Securities.** The Bank classifies investments as trading, available-for-sale (AFS), or held-to-maturity (HTM) at the date of acquisition. Purchases and sales of securities are recorded on a trade date basis.

The Bank classifies certain investments as trading. These securities are held for liquidity purposes and carried at fair value with changes in the fair value of these investments recorded in other income. The Bank does not participate in speculative trading practices and holds these investments indefinitely as the Bank periodically evaluates its liquidity needs.

The Bank classifies certain securities as AFS and carries these securities at their fair value. Unrealized gains and losses on these securities are recognized in accumulated other comprehensive income (AOCI).

HTM securities are carried at cost, adjusted for periodic principal repayments; amortization of premiums and accretion of discounts; and previous OTTI recognized in net income and AOCI. The Bank classifies these investments as HTM securities because the Bank has the positive intent and ability to hold these securities until maturity.

Certain changes in circumstances may cause the Bank to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Thus, the sale or transfer of an HTM security because of certain changes in circumstances, such as evidence of significant deterioration in the issuer's creditworthiness or changes in regulatory requirements, is not considered to be inconsistent with its original classification. Other events that are isolated, nonrecurring, and unusual for the Bank that could not have been reasonably anticipated may cause the Bank to sell or transfer an HTM security without

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

necessarily calling into question its intent to hold other debt securities to maturity. In addition, sales of debt securities that meet either of the following two conditions may be considered as maturities for purposes of the classification of securities: (i) the sale occurs near enough to its maturity date (or call date if exercise of the call is probable) that interest rate risk is substantially eliminated as a pricing factor and changes in market interest rates would not have a significant effect on the security's fair value, or (ii) the sale occurs after the Bank has already collected a substantial portion (at least 85%) of the principal outstanding at acquisition because of prepayments on the debt security or scheduled payments on a debt security payable in equal installments (both principal and interest) over its term.

The Bank calculates the amortization of purchased premiums and accretion of purchased discounts on investments using the level-yield method on a retrospective basis over the estimated life of the securities. This method requires a retrospective adjustment of the effective yield each time the Bank changes the estimated life as if the new estimate had been known since the original acquisition date of the securities. The Bank uses nationally recognized, market-based, third-party prepayment models to project estimated lives.

On a quarterly basis, the Bank evaluates its individual AFS and HTM investment securities in an unrealized loss position for OTTI. A security is considered impaired when its fair value is less than its amortized cost basis. For impaired debt securities, an entity is required to assess whether: (i) it has the intent to sell the debt security; (ii) it is more likely than not that it will be required to sell the debt security before its anticipated recovery of the remaining amortized cost basis of the security; or (iii) it does not expect to recover the entire amortized cost basis of the impaired debt security. If any of these conditions is met, an OTTI on the security must be recognized.

With respect to any debt security, a credit loss is defined as the amount by which the amortized cost basis exceeds the present value of the cash flows expected to be collected. If a credit loss exists but the entity does not intend to sell the debt security and it is not more likely than not that the entity will be required to sell the debt security before the anticipated recovery of its remaining amortized cost basis (the amortized cost basis less any current-period credit loss), the carrying value of the debt security is adjusted to its fair value. However, instead of recognizing the entire difference between the amortized cost basis and fair value in earnings, only the amount of the impairment representing the credit loss is recognized in earnings, while the amount of non-credit-related impairment is recognized in AOCI. The total OTTI is presented in the Statements of Income with an offset for the amount of the total OTTI that is recognized in AOCI. This presentation provides additional information about the amounts that the entity does not expect to collect related to a debt security. The credit loss on a debt security is limited to the amount of that security's unrealized losses.

For subsequent accounting of other-than-temporarily impaired securities, if the present value of cash flows expected to be collected is less than the amortized cost basis, the Bank records an additional OTTI. The amount of total OTTI for a security that was previously impaired is calculated as the difference between its amortized cost less the amount of OTTI recognized in AOCI prior to the determination of OTTI and its fair value. For an other-than-temporarily impaired security that was previously impaired and has subsequently incurred an additional OTTI related to credit loss (limited to that security's unrealized losses), this additional credit-related OTTI, up to the amount in AOCI, would be reclassified out of non-credit-related OTTI in AOCI and charged to earnings. Any credit loss in excess of the related AOCI is charged to earnings.

Subsequent related increases and decreases (if not an OTTI) in the fair value of AFS securities will be netted against the non-credit component of OTTI previously recognized in AOCI.

For securities classified as HTM, the OTTI recognized in AOCI is accreted to the carrying value of each security on a prospective basis, based on the amount and timing of future estimated cash flows (with no effect on earnings unless the security is subsequently sold or there are additional decreases in cash flows expected to be collected). For securities classified as AFS, the Bank does not accrete the OTTI recognized in AOCI to the carrying value because the subsequent measurement basis for these securities is fair value.



**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

For securities previously identified as other-than-temporarily impaired, the Bank updates its estimate of future estimated cash flows on a regular basis. If there is no additional impairment on the security, the yield of the security is adjusted on a prospective basis when there is a significant increase in the expected cash flows. This accretion is included in net interest income in the Statements of Income.

**Financial Instruments Meeting Netting Requirements.** The Bank presents certain financial instruments, including derivative instruments and securities purchased under agreements to resell, on a net basis when they have a legal right of offset and all other requirements for netting are met (collectively referred to as the netting requirements). The Bank has elected to offset its derivative asset and liability positions, as well as cash collateral received or pledged, when the netting requirements are met. The Bank did not have any offsetting liabilities related to its securities purchased under agreements to resell for the periods presented.

The net exposure for these financial instruments can change on a daily basis; therefore, there may be a delay between the time this exposure change is identified and additional collateral is requested, and the time this collateral is received or pledged. Likewise, there may be a delay for excess collateral to be returned. For derivative instruments that meet the netting requirements, any excess cash collateral received or pledged is recognized as a derivative liability or derivative asset. Additional information regarding these agreements is provided in Note 19 – Derivatives and Hedging Activities. Based on the fair value of the related collateral held, the securities purchased under agreements to resell were fully collateralized for the periods presented.

**Variable Interest Entities.** The Bank's investments in variable interest entities (VIEs) are limited to private-label residential mortgage-backed securities (PLRMBS). On an ongoing basis, the Bank performs a quarterly evaluation to determine whether it is the primary beneficiary in any VIE. The Bank evaluated its investments in VIEs as of December 31, 2013, to determine whether it is a primary beneficiary of any of these investments. The primary beneficiary is required to consolidate a VIE. The Bank determined that consolidation accounting is not required because the Bank is not the primary beneficiary of these VIEs for the periods presented. The Bank does not have the power to significantly affect the economic performance of any of these investments because it does not act as a key decision maker nor does it have the unilateral ability to replace a key decision maker. In addition, the Bank does not design, sponsor, transfer, service, or provide credit or liquidity support in any of its investments in VIEs. The Bank's maximum loss exposure for these investments is limited to the carrying value.

**Advances.** The Bank reports advances (loans to members, former members or their successors, or housing associates) either at amortized cost or at fair value when the fair value option is elected. Advances carried at amortized cost are reported net of premiums, discounts (including discounts related to the Affordable Housing Program), and hedging adjustments. The Bank amortizes premiums and accretes discounts and recognizes hedging adjustments resulting from the discontinuation of a hedging relationship to interest income using a level-yield methodology. Interest on advances is credited to income as earned. For advances carried at fair value, the Bank recognizes contractual interest in interest income.

**Advance Modifications.** In cases in which the Bank funds an advance concurrent with or within a short period of time before or after the prepayment of a previous advance to the same member, the Bank evaluates whether the subsequent advance meets the accounting criteria to qualify as a modification of an existing advance or whether it constitutes a new advance. The Bank compares the present value of the cash flows on the subsequent advance to the present value of the cash flows remaining on the previous advance. If there is at least a 10 percent difference in the present value of the cash flows or if the Bank concludes that the difference between the advances is more than minor based on a qualitative assessment of the modifications made to the previous advance's contractual terms, then the subsequent advance is accounted for as a new advance. In all other instances, the subsequent advance is accounted for as a modification.

**Prepayment Fees.** When a borrower prepays certain advances prior to the original maturity, the Bank may charge the borrower a prepayment fee. For certain advances with partial prepayment symmetry, the Bank may charge the



**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

borrower a prepayment fee or pay the borrower a prepayment credit, depending on certain circumstances, such as movements in interest rates, when the advance is prepaid.

For prepaid advances that are hedged and meet the hedge accounting requirements, the Bank terminates the hedging relationship upon prepayment and records the associated fair value gains and losses, adjusted for the prepayment fees, in interest income. If a new advance represents a modification of an original hedged advance, the fair value gains or losses on the advance and the prepayment fees are included in the carrying amount of the modified advance, and gains or losses and prepayment fees are amortized in interest income over the life of the modified advance using the level-yield method. If the modified advance is also hedged and the hedge meets the hedge accounting requirements, the modified advance is marked to fair value after the modification, and subsequent fair value changes are recorded in other income. If the prepayment represents an extinguishment of the original hedged advance, the prepayment fee and any fair value gain or loss are immediately recognized in interest income.

For prepaid advances that are not hedged or that are hedged but do not meet the hedge accounting requirements, the Bank records prepayment fees in interest income unless the Bank determines that the new advance represents a modification of the original advance. If the new advance represents a modification of the original advance, the prepayment fee on the original advance is deferred, recorded in the basis of the modified advance, and amortized over the life of the modified advance using the level-yield method. This amortization is recorded in interest income.

**Mortgage Loans Held in Portfolio.** Under the Mortgage Partnership Finance® (MPF®) Program, the Bank purchased conventional conforming fixed rate residential mortgage loans from its participating members. (“Mortgage Partnership Finance” and “MPF” are registered trademarks of the FHLBank of Chicago.) Participating members originated or purchased the mortgage loans, credit-enhanced them and sold them to the Bank, and generally retained the servicing of the loans. The Bank manages the interest rate risk, prepayment risk, and liquidity risk of each loan in its portfolio. The Bank and the participating institution (either the original participating member that sold the loans to the Bank or a successor to that member) share in the credit risk of the loans, with the Bank assuming the first loss obligation limited by the first loss account, and the participating institution assuming credit losses in excess of the first loss account, up to the amount of the credit enhancement obligation specified in the master agreement. The amount of the credit enhancement was originally calculated so that any Bank credit losses (excluding special hazard losses) in excess of the first loss account were limited to those that would be expected from an equivalent investment with a long-term credit rating of AA.

For taking on the credit enhancement obligation, the Bank pays the participating institution a credit enhancement fee, which is calculated on the remaining unpaid principal balance of the mortgage loans. Depending on the specific MPF product, all or a portion of the credit enhancement fee is paid monthly beginning with the month after each delivery of loans. The MPF Plus product also provides for a performance-based credit enhancement fee, which accrues monthly, beginning with the month after each delivery of loans, and is paid to the participating institution beginning 12 months later. The performance-based credit enhancement fee will be reduced by an amount equivalent to loan losses up to the amount of the first loss account established for each master commitment. The participating institutions obtained supplemental mortgage insurance (SMI) to cover their credit enhancement obligations under this product. If the SMI provider's claims-paying ability rating falls below a specified level, the participating institution has six months to either replace the SMI policy or assume the credit enhancement obligation and fully collateralize the obligation; otherwise the Bank may choose not to pay the participating institution its performance-based credit enhancement fee.

The Bank classifies mortgage loans as held for investment and, accordingly, reports them at their principal amount outstanding net of unamortized premiums, discounts, and unrealized gains and losses from loans initially classified as mortgage loan commitments. The Bank defers and amortizes these amounts as interest income using the level-yield method on a retrospective basis over the estimated life of the related mortgage loan. Actual prepayment experience and estimates of future principal prepayments are used in calculating the estimated life of the mortgage loans. The Bank aggregates the mortgage loans by similar characteristics (type, maturity, note rate, and acquisition date) in determining prepayment estimates. A retrospective adjustment is required each time the Bank changes the

**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

estimated amounts as if the new estimate had been known since the original acquisition date of the assets. The Bank uses nationally recognized, market-based, third-party prepayment models to project estimated lives.

The Bank records credit enhancement fees as a reduction to interest income.

**Allowance for Credit Losses.** An allowance for credit losses is a valuation allowance separately established for each identified portfolio segment, if it is probable that impairment has occurred in the Bank's portfolio as of the Statements of Condition date and the amount of loss can be reasonably estimated. To the extent necessary, an allowance for credit losses for off-balance sheet credit exposures is recorded as a liability.

**Portfolio Segments.** A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. The Bank has developed and documented a systematic methodology for determining an allowance for credit losses for each applicable portfolio segment. See Note 10 - Allowance for Credit Losses for more information.

**Allowance for Credit Losses on Credit Products.** Following the requirements of the FHLBank Act, the Bank obtains sufficient collateral for credit products to protect the Bank from credit losses. Under the FHLBank Act, collateral eligible to secure credit products includes 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 10 – Allowance for Credit Losses, the Bank may also accept secured small business, small farm, and small agribusiness loans, and securities representing a whole interest in such secured loans, as collateral from members that are community financial institutions. The Housing and Economic Recovery Act of 2008 (Housing Act) defines community financial institutions as Federal Deposit Insurance Corporation (FDIC)-insured depository institutions with average total assets over the preceding three-year period of \$1,000 or less, to be adjusted for inflation annually by the Finance Agency. The average total asset cap for 2013 was \$1,095. The Bank has never experienced any credit losses on any of its credit products. The Bank evaluates the creditworthiness of its members and nonmember borrowers on an ongoing basis.

The Bank classifies as impaired any advance with respect to which the Bank believes it is probable that all principal and interest due will not be collected according to its contractual terms. Impaired advances are valued using the present value of expected future cash flows discounted at the advance's effective interest rate, the advance's observable market price or, if collateral-dependent, the fair value of the advance's underlying collateral. When an advance is classified as impaired, the accrual of interest is discontinued and unpaid accrued interest is reversed. Advances do not return to accrual status until they are brought current with respect to both principal and interest and until the Bank believes future principal payments are no longer in doubt. No advances were classified as impaired during the periods presented.

Based on the collateral pledged as security, the Bank's credit analyses of members' financial condition, and the Bank's credit extension and collateral policies as of December 31, 2013, the Bank expects to collect all amounts due according to the contractual terms. Therefore, no allowance for losses on credit products was deemed necessary by the Bank. The Bank has never experienced any credit losses on its credit products.

**Allowance for Credit Losses on Mortgage Loans.** The Bank bases the allowance for credit losses on mortgage loans on its estimate of probable credit losses in the Bank's mortgage loan portfolio as of the date of the Statements of Condition. The Bank performs periodic reviews of its portfolio to identify the probable losses in the portfolio and to determine the likelihood of collection of the portfolio. The overall allowance is determined by an analysis that includes delinquency statistics, past performance, current performance, loan portfolio characteristics, collateral valuations, industry data, collectability of credit enhancements from members or from mortgage insurers, and prevailing economic conditions.

**Impairment Methodology on Mortgage Loans.** A mortgage loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement.

**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

Loans that are on non-accrual status and that are considered collateral-dependent are measured for impairment based on the fair value of the underlying property less estimated selling costs. Loans are considered collateral-dependent if repayment is expected to be provided solely by the sale of the underlying property, that is, there is no other available and reliable source of repayment. Collateral-dependent loans are impaired if the fair value of the underlying collateral less estimated selling costs is insufficient to recover the unpaid principal balance on the loan. Interest income on impaired loans is recognized in the same manner as interest income on non-accrual loans noted below.

The Bank places a mortgage loan on nonaccrual status when the collection of the contractual principal or interest from the participating institution 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 first as interest income and then as a reduction of principal as specified in the contractual agreement, unless the collection of the remaining principal amount due is considered doubtful. If the collection of the remaining principal amount due is considered doubtful, then cash payments received would be applied first solely to principal until the remaining principal amount due is expected to be collected and then as a recovery of any charge-off, if applicable, followed by recording interest income. A loan on non-accrual status may be restored to accrual when (1) none of its contractual principal and interest is due and unpaid, and the Bank expects repayment of the remaining contractual interest and principal, or (2) it otherwise becomes well secured and in the process of collection.

**Real Estate Owned.** Real estate owned (REO) includes assets that have been received in satisfaction of debt through foreclosures. REO is initially recorded at fair value less estimated selling costs and is subsequently carried at the lower of that amount or current fair value less estimated selling costs. The Bank recognizes a charge-off to the allowance for credit losses if the fair value of the REO less estimated selling costs is less than the recorded investment in the loan at the date of transfer from loans to REO. Any subsequent realized gains, realized or unrealized losses, and carrying costs are included in other non-interest expense in the Statements of Income. REO is recorded in "Other assets" in the Statements of Condition. At December 31, 2013, the Bank's other assets included \$3 of REO resulting from foreclosure of 27 mortgage loans held by the Bank. At December 31, 2012, the Bank's other assets included \$3 of REO resulting from foreclosure of 30 mortgage loans held by the Bank.

**Other Fees.** Letter of credit fees are recorded as other income over the term of the letter of credit.

**Derivatives.** All derivatives are recognized on the Statements of Condition at their fair value. The Bank has elected to report derivative assets and derivative liabilities net of cash collateral, including initial and variation margin, and accrued interest received from or pledged to futures commission merchants (clearing agents) or counterparties. The fair values of derivatives are netted by clearing agent or counterparty when the netting requirements have been met. If these netted amounts are positive, they are classified as an asset, and if negative, they are classified as a liability. Cash flows associated with derivatives are reflected as cash flows from operating activities in the Statements of Cash Flows unless the derivative meets the criteria to be a financing derivative.

Each derivative is designated as one of the following:

- (1) a qualifying hedge of the change in fair value of (i) a recognized asset or liability or (ii) an unrecognized firm commitment (a fair value hedge);
- (2) a qualifying hedge of (i) a forecasted transaction or (ii) 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-qualifying hedge of an asset or liability for asset-liability management purposes or of certain advances and consolidated obligation bonds for which the Bank elected the fair value option (an economic hedge); or
- (4) a non-qualifying hedge of another derivative that is offered as a product to members or used to offset other derivatives with nonmember counterparties (an intermediation hedge).

**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

If hedging relationships meet certain criteria, including but not limited to formal documentation of the hedging relationship and an expectation to be hedge effective, they are eligible for hedge accounting, and the offsetting changes in fair value of the hedged items attributable to the hedged risk may be recorded in earnings. The application of hedge accounting generally requires the Bank to evaluate the effectiveness of the hedging relationships at inception and on an ongoing basis and to calculate the changes in fair value of the derivatives and the related hedged items independently. This is known as the “long-haul” method of hedge accounting. Transactions that meet certain criteria qualify for the “short-cut” method of hedge accounting, in which an assumption can be made that the change in the fair value of a hedged item, because of changes in the benchmark rate, exactly offsets the change in the value of the related derivative. Under the shortcut method, the entire change in fair value of the interest rate swap is considered to be effective at achieving offsetting changes in fair values or cash flows of the hedged asset or liability.

Derivatives are typically executed at the same time as the hedged item, and the Bank designates the hedged item in a qualifying hedge relationship as of the trade date. In many hedging relationships, the Bank may designate the hedging relationship upon its commitment to disburse an advance or trade a consolidated obligation in which settlement occurs within the shortest period of time possible for the type of instrument based on market settlement conventions. The Bank records the changes in the fair value of the derivatives and the hedged item beginning on the trade date.

Changes in the fair value of a derivative that qualifies as a fair value hedge and is designated as a fair value hedge, along with changes in the fair value of the hedged asset or liability (hedged item) that are attributable to the hedged risk (including changes that reflect losses or gains on firm commitments), are recorded in other income as “Net gain/(loss) on derivatives and hedging activities.”

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

For both fair value and cash flow hedges, 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 other income as “Net gain/(loss) on derivatives and hedging activities.”

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. An economic hedge is defined as a derivative hedging certain advances and consolidated obligation bonds for which the Bank elected the fair value option, or hedging specific or non-specific underlying assets, liabilities, or firm commitments, that does not qualify or was not designated for fair value or cash flow hedge accounting, but is an acceptable hedging strategy under the Bank's risk management program. These economic hedging strategies also comply with Finance Agency regulatory requirements prohibiting speculative hedge transactions. An economic hedge introduces the potential for earnings variability caused by the changes in fair value of the derivatives that are recorded in the Bank's income but are not offset by corresponding changes in the value of the economically hedged assets, liabilities, or firm commitments. The derivatives used in intermediary activities do not qualify for 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. Changes in the fair value of these non-qualifying 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 these non-qualifying hedges are recorded in other income as “Net gain/(loss) on derivatives and hedging activities.” Cash flows associated with these stand-alone derivatives are reflected as cash flows from operating activities in the Statements of Cash Flows unless the derivative meets the criteria to be designated as a financing derivative.

**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

The differences between accruals of interest receivables and payables on derivatives designated as fair value or cash flow hedges are recognized as adjustments to the interest income or interest expense of the designated underlying hedged item. The differences between accruals of interest receivables and payables on intermediated derivatives for members and other economic hedges are recognized in other income as “Net gain/(loss) on derivatives and hedging activities.”

The Bank discontinues hedge accounting prospectively when: (i) 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); (ii) the derivative and/or the hedged item expires or is sold, terminated, or exercised; (iii) it is no longer probable that the forecasted transaction will occur in the originally expected period; (iv) a hedged firm commitment no longer meets the definition of a firm commitment; (v) it determines that designating the derivative as a hedging instrument is no longer appropriate; or (vi) it decides to use the derivative to offset changes in the fair value of other derivatives or instruments carried at fair value.

When hedge accounting is discontinued, the Bank either terminates the derivative or continues to carry the derivative on the Statements of Condition at its fair value, ceases to adjust the hedged asset or liability for changes in fair value, and amortizes the cumulative basis adjustment on the hedged item into earnings over the remaining life of the hedged item using a level-yield methodology.

When hedge accounting is discontinued because the Bank determines that the derivative no longer qualifies as an effective cashflow hedge of an existing hedged item, the Bank continues to carry the derivative on the Statements of Condition at its fair value and reclassifies the AOCI adjustment into earnings when earnings are affected by the existing hedged item (the original forecasted transaction).

Under limited circumstances, when the Bank discontinues cashflow hedge accounting because it is no longer probable that the forecasted transaction will occur by the end of the originally specified time period, or within 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 AOCI and is recognized in 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 the following two months, the gains and losses that were recorded in AOCI 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 continues to carry the derivative on the Statements of Condition at its fair value, removing from the Statements of Condition any asset or liability that was recorded to recognize the firm commitment and recording it as a gain or loss in current period earnings.

The Bank may be the primary obligor on consolidated obligations and may make 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: (i) the embedded derivative has economic characteristics that are not clearly and closely related to the economic characteristics of the host contract, and (ii) a separate, stand-alone 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 equivalent to an economic hedge. However, the entire contract is carried on the Statements of Condition at fair value and no portion of the contract is designated as a hedging instrument 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 period earnings (such as an investment security classified as trading, as well as hybrid financial instruments that are eligible for the fair value option), or if the Bank cannot reliably identify and measure the embedded derivative for purposes of separating the derivative from its host contract.



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Mandatorily Redeemable Capital Stock.** The Bank reclassifies the capital stock subject to redemption from capital to a liability after a member provides the Bank with a written notice of redemption; gives notice of intention to withdraw from membership; or attains nonmember status by merger or acquisition, charter termination, or other involuntary membership termination; or after a receiver or other liquidating agent for a member transfers the member's Bank capital stock to a nonmember entity, resulting in the member's shares then meeting the definition of a mandatorily redeemable financial instrument. Shares meeting this definition are reclassified to a liability at fair value. Dividends declared on shares classified as a liability are accrued at the expected dividend rate and reflected as interest expense in the Statements of Income. The repayment of these mandatorily redeemable financial instruments (by repurchase or redemption of the shares) is reflected as a financing cash outflow in the Statements of Cash Flows once settled. See Note 16 – Capital for more information.

If a member cancels its written notice of redemption or notice of withdrawal or if the Bank allows the transfer of mandatorily redeemable capital stock to a member, the Bank reclassifies mandatorily redeemable capital stock from a liability to capital. After the reclassification, dividends on the capital stock are no longer classified as interest expense.

**Premises, Software, and Equipment.** The Bank records premises, software, and equipment at cost less accumulated depreciation and amortization. The Bank's accumulated depreciation and amortization related to premises, software, and equipment totaled \$67 and \$58 at December 31, 2013 and 2012, respectively. Improvements and major renewals are capitalized; ordinary maintenance and repairs are expensed as incurred. 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. Depreciation and amortization expense was \$9 for 2013, \$10 for 2012, and \$7 for 2011. The Bank includes gains and losses on disposal of premises, software, and equipment in other income. The net realized gain on disposal of premises, software, and equipment, primarily related to the 1999 sale of the Bank's building, was \$1, \$1, and \$1 in 2013, 2012, and 2011, respectively.

The cost of computer software developed or obtained for internal use is capitalized and depreciated over future periods. At December 31, 2013 and 2012, the Bank had \$20 and \$21 in unamortized computer software costs respectively. Depreciation of computer software costs charged to expense was \$7, \$9, and \$5 in 2013, 2012, and 2011, respectively.

**Consolidated Obligations.** Consolidated obligations are recorded at amortized cost unless the Bank has elected the fair value option, in which case the consolidated obligations are carried at fair value.

**Concessions on Consolidated Obligations.** Concessions are paid to dealers in connection with the issuance of consolidated obligations for which the Bank is the primary obligor. 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. Concessions paid on consolidated obligations designated under the fair value option are expensed as incurred. Concessions paid on consolidated obligations not designated under the fair value option are deferred and amortized to expense using the level-yield method over the remaining contractual life or on a retrospective basis over the estimated life of the consolidated obligations. Unamortized concessions were \$14 and \$16 at December 31, 2013 and 2012, respectively, and are included in "Other assets." Amortization of concessions is included in consolidated obligation interest expense and totaled \$7, \$22, and \$25, in 2013, 2012, and 2011, respectively.

**Discounts and Premiums on Consolidated Obligations.** The discounts on consolidated obligation discount notes for which the Bank is the primary obligor are amortized to expense using the level-yield method over the term to maturity. The discounts and premiums on consolidated obligation bonds for which the Bank is the primary obligor are amortized to expense using the level-yield method over the remaining contractual life or on a retrospective basis over the estimated life of the consolidated obligation bonds.

**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

**Finance Agency Expenses.** The FHLBanks fund a portion of the costs of operating the Finance Agency, and each FHLBank is assessed a proportionate share of those costs. The Finance Agency allocates its expenses and working capital fund among the FHLBanks based on the ratio between each FHLBank's minimum required regulatory capital and the aggregate minimum required regulatory capital of all the FHLBanks.

**Office of Finance Expenses.** Each FHLBank is assessed a proportionate share of the cost of operating the Office of Finance, which facilitates the issuance and servicing of consolidated obligations. The Office of Finance allocates its operating and capital expenditures among the FHLBanks as follows: (1) two-thirds of the assessment is based on each FHLBank's share of total consolidated obligations outstanding, and (2) one-third of the assessment is based on an equal pro rata allocation.

**Affordable Housing Program.** As more fully discussed in Note 13 – Affordable Housing Program, the FHLBank Act requires each FHLBank to establish and fund an Affordable Housing Program (AHP). The Bank charges the required funding for the AHP to earnings and establishes a liability. The AHP funds provide subsidies to members to assist in the purchase, construction, or rehabilitation of housing for very low-, low-, and moderate-income households. Subsidies may be in the form of direct grants or below-market interest rate advances.

**Resolution Funding Corporation Assessments.** Although the FHLBanks are exempt from ordinary federal, state, and local taxation except real property taxes, they were required to make quarterly payments to the Resolution Funding Corporation (REFCORP) toward the interest on bonds issued by REFCORP through the second quarter of 2011. REFCORP was established by Congress in 1989 under 12 U.S.C. Section 1441b as a means of funding the Resolution Trust Corporation, a federal instrumentality established to provide funding for the resolution and disposition of insolvent savings institutions. Officers, employees, and agents of the Office of Finance are authorized to act for and on the behalf of REFCORP to carry out the functions of REFCORP. See Note 14 – Resolution Funding Corporation Assessments for more information.

## **Note 2 — Recently Issued and Adopted Accounting Guidance**

**Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.** On January 17, 2014, the Financial Accounting Standards Board (FASB) issued guidance clarifying when consumer mortgage loans collateralized by real estate should be reclassified to REO. Specifically, such collateralized mortgage loans should be reclassified to REO when either the creditor obtains legal title to the residential real estate property upon completion of a foreclosure or the borrower conveys all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The guidance is effective for interim and annual periods beginning on or after December 15, 2014, and may be adopted under either the modified retrospective transition method or the prospective transition method. The Bank is in the process of evaluating the effect of this guidance on the Bank's financial condition, results of operations, and cash flows, but it is not expected to be material.

**Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes.** On July 17, 2013, the FASB amended existing guidance to include the Fed Funds Effective Swap Rate (also referred to as the Overnight Index Swap Rate (OIS)) as a U.S. benchmark interest rate for hedge accounting purposes. Including OIS as an acceptable U.S. benchmark interest rate, in addition to U.S. Treasuries and London Interbank Offered Rate (LIBOR), provides a more comprehensive spectrum of interest rate resets to use as the designated benchmark interest rate risk component under the hedge accounting guidance. The amendments also remove the restriction on using different benchmark interest rates for similar hedges. The amendments apply to all entities that elect to apply hedge accounting of the benchmark interest rate and were effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption of this guidance did not affect the Bank's financial statement disclosures, financial condition, results of operations, or cash flows.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Joint and Several Liability Arrangements.** On February 28, 2013, the FASB issued guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of the guidance is fixed at the reporting date. The guidance requires an entity to measure these obligations as the sum of (1) the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and (2) any additional amount the reporting entity expects to pay on behalf of its co-obligors. In addition, the guidance requires an entity to disclose the nature and amount of the obligations as well as other information about the obligations. The guidance is effective for interim and annual periods beginning on or after December 15, 2013, and is to be applied retrospectively to obligations with joint and several liabilities existing at the beginning of an entity's fiscal year of adoption. The adoption of this guidance is not expected to affect the Bank's financial condition, results of operations, or cash flows.

**Disclosures about Offsetting Assets and Liabilities.** On December 16, 2011, the FASB and the International Accounting Standards Board issued common disclosure requirements intended to help investors and other financial statement users better assess the effect or potential effect of offsetting arrangements on a company's financial position, whether a company's financial statements are prepared on the basis of GAAP or International Financial Reporting Standards. The guidance was amended on January 31, 2013, to clarify that its scope includes only certain financial instruments that are either offset on the balance sheet or are subject to an enforceable master netting arrangement or similar agreement. The Bank is required to disclose both gross and net information about derivatives, repurchase, and security lending instruments that meet these criteria. The guidance, as amended, became effective for the Bank for interim and annual periods beginning on January 1, 2013, and was applied retrospectively for all comparative periods presented. The adoption of this guidance resulted in additional financial statement disclosures, but did not affect the Bank's financial condition, results of operations, or cash flows.

**Presentation of Comprehensive Income.** On February 5, 2013, the FASB issued guidance to improve the transparency of reporting reclassifications out of accumulated other comprehensive income/(loss) (AOCI). The guidance does not change the current requirements for reporting net income or comprehensive income in financial statements. However, it requires the Bank to provide information about the amounts reclassified out of AOCI by component. In addition, the Bank is required to present significant amounts reclassified out of AOCI, either on the face of the financial statement where net income is presented or in the footnotes. These amounts are presented based on the respective lines of net income only if the amount reclassified is required under GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under GAAP to be reclassified in their entirety to net income, the Bank is required to cross-reference to other required disclosures that provide additional detail about these other amounts. The guidance became effective for the Bank for interim and annual periods beginning on January 1, 2013, and was applied prospectively. The adoption of this guidance resulted in additional financial statement disclosures, but did not affect the Bank's financial condition, results of operations, or cash flows.

### **Recently Issued Regulatory Guidance**

**Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention.** On April 9, 2012, the Federal Housing Finance Agency (Finance Agency) issued Advisory Bulletin 2012-02, *Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention* (AB 2012-02). The guidance establishes a standard and uniform methodology for classifying loans, other real estate owned, and certain other assets (excluding investment securities) and prescribes the timing of asset charge-offs based on these classifications. The guidance is generally consistent with the *Uniform Retail Credit Classification and Account Management Policy* issued by the federal banking regulators in June 2000. AB 2012-02 was effective upon issuance. However, the Finance Agency issued additional guidance extending the effective date of the advisory bulletin. The Bank implemented the asset classification provisions as of January 1, 2014. The charge-off provisions are to be implemented no later than January 1, 2015. The adoption of the accounting guidance in AB 2012-02 is not expected to have a significant impact on the Bank's financial condition, results of operations, or cash flows.



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Note 3 — Cash and Due from Banks**

**Compensating Balances.** The Bank maintains collected cash balances with commercial banks in consideration for certain services. There are no legal restrictions under these agreements on the withdrawal of these funds. The average collected cash balances were approximately \$1 for 2013 and \$1 for 2012.

Effective July 12, 2012, the Federal Reserve eliminated its Contractual Clearing Balance Program. Prior to July 12, 2012, the Bank maintained average required balances with the Federal Reserve Bank of San Francisco for this program.

**Note 4 — Trading Securities**

The estimated fair value of trading securities as of December 31, 2013 and 2012, was as follows:

		2013		2012
Government-sponsored enterprises (GSEs) – Federal Farm Credit Bank (FFCB) bonds	\$	3,194	\$	3,175
MBS – Other U.S. obligations – Ginnie Mae		14		16
<b>Total</b>	<b>\$</b>	<b>3,208</b>	<b>\$</b>	<b>3,191</b>

**Redemption Terms.** The estimated fair value of non-mortgage-backed securities (non-MBS) by contractual maturity (based on contractual final principal payment) and of mortgage-backed securities (MBS) as of December 31, 2013 and 2012, is shown below. Expected maturities of MBS will differ from contractual maturities because borrowers generally have the right to prepay the underlying obligations without prepayment fees.

Year of Contractual Maturity		2013		2012
<b>Trading securities other than MBS:</b>				
Due in 1 year or less	\$	580	\$	234
Due after 1 year through 5 years		2,614		2,941
Subtotal		3,194		3,175
MBS – Other U.S. obligations – Ginnie Mae		14		16
<b>Total</b>	<b>\$</b>	<b>3,208</b>	<b>\$</b>	<b>3,191</b>

**Interest Rate Payment Terms.** Interest rate payment terms for trading securities at December 31, 2013 and 2012, are detailed in the following table:

		2013		2012
<b>Estimated fair value of trading securities other than MBS:</b>				
Adjustable rate	\$	3,194	\$	3,175
<b>Estimated fair value of trading MBS:</b>				
Passthrough securities – Adjustable rate		14		16
<b>Total</b>	<b>\$</b>	<b>3,208</b>	<b>\$</b>	<b>3,191</b>

The net unrealized gain/(loss) on trading securities was \$2, \$(11), and \$(7) for the years ended December 31, 2013, 2012, and 2011, respectively. These amounts represent the changes in the fair value of the securities during the reported periods.

**Note 5 — Available-for-Sale Securities**

Available-for-sale securities by major security type as of December 31, 2013 and 2012, were as follows:

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

	Amortized Cost <sup>(1)</sup>	OTTI Recognized in AOCI	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>PLRMBS:</b>					
Prime	\$ 661	\$ (11)	\$ 27	\$ —	\$ 677
Alt-A, option ARM	1,122	(74)	51	—	1,099
Alt-A, other	5,376	(239)	142	(8)	5,271
<b>Total</b>	<b>\$ 7,159</b>	<b>\$ (324)</b>	<b>\$ 220</b>	<b>\$ (8)</b>	<b>\$ 7,047</b>

**December 31, 2012**

	Amortized Cost <sup>(1)</sup>	OTTI Recognized in AOCI	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>PLRMBS:</b>					
Prime	\$ 832	\$ (46)	14	\$ —	\$ 800
Alt-A, option ARM	1,227	(219)	2	—	1,010
Alt-A, other	6,293	(539)	40	—	5,794
<b>Total</b>	<b>\$ 8,352</b>	<b>\$ (804)</b>	<b>\$ 56</b>	<b>\$ —</b>	<b>\$ 7,604</b>

(1) Amortized cost includes unpaid principal balance, unamortized premiums and discounts, and previous other-than-temporary impairments recognized in earnings.

**Redemption Terms.** Expected maturities of PLRMBS will differ from contractual maturities because borrowers generally have the right to prepay the underlying obligations without prepayment fees.

At December 31, 2013, the amortized cost of the Bank's PLRMBS classified as AFS included credit-related OTTI of \$1,312 (including interest accretion adjustments of \$40). At December 31, 2012, the amortized cost of the Bank's PLRMBS classified as AFS included credit-related OTTI of \$1,427 (including interest accretion adjustments of \$61).

**Securities Transferred.** Beginning in the first quarter of 2011, the Bank elected to transfer any PLRMBS that incurred a credit-related OTTI charge during the applicable period from the Bank's HTM portfolio to its AFS portfolio at their fair values. These transfers allow the Bank the option to divest these securities prior to maturity in view of changes in interest rates, changes in prepayment risk, or other factors, while acknowledging its intent to hold these securities for an indefinite period of time. For additional information on the transferred securities, see Note 7 – Other-Than-Temporary Impairment Analysis.

The following table summarizes the AFS securities with unrealized losses as of December 31, 2013 and 2012. The unrealized losses are aggregated by major security type and the length of time that individual securities have been in a continuous unrealized loss position. Total unrealized losses in the following table will not agree to the total gross unrealized losses in the table above. The unrealized losses in the following table also include non-credit-related OTTI losses recognized in AOCI net of subsequent unrealized gains, up to the amount of non-credit-related OTTI in AOCI. For OTTI analysis of AFS securities, see Note 7 – Other-Than-Temporary Impairment Analysis.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
<b>PLRMBS:</b>						
Prime	\$ 28	\$ —	\$ 287	\$ 11	\$ 315	\$ 11
Alt-A, option ARM	—	—	674	74	674	74
Alt-A, other	677	10	2,351	237	3,028	247
<b>Total</b>	<b>\$ 705</b>	<b>\$ 10</b>	<b>\$ 3,312</b>	<b>\$ 322</b>	<b>\$ 4,017</b>	<b>\$ 332</b>

**December 31, 2012**

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
<b>PLRMBS:</b>						
Prime	\$ —	\$ —	\$ 547	\$ 46	\$ 547	\$ 46
Alt-A, option ARM	6	—	973	219	979	219
Alt-A, other	187	1	4,208	538	4,395	539
<b>Total</b>	<b>\$ 193</b>	<b>\$ 1</b>	<b>\$ 5,728</b>	<b>\$ 803</b>	<b>\$ 5,921</b>	<b>\$ 804</b>

As indicated in the tables above, as of December 31, 2013, the Bank's investments classified as AFS had gross unrealized losses related to PLRMBS, which were primarily due to illiquidity in the MBS market, uncertainty about the future condition of the housing and mortgage markets and the economy, and market expectations of the credit performance of loan collateral underlying these securities, which caused these assets to be valued at discounts to their acquisition cost.

**Interest Rate Payment Terms.** Interest rate payment terms for AFS securities at December 31, 2013 and 2012, are shown in the following table:

	2013	2012
<b>Amortized cost of AFS PLRMBS:</b>		
Collateralized mortgage obligations:		
Fixed rate	\$ 2,450	\$ 3,055
Adjustable rate	4,709	5,297
<b>Total</b>	<b>\$ 7,159</b>	<b>\$ 8,352</b>

Certain MBS classified as fixed rate collateralized mortgage obligations have an initial fixed interest rate that subsequently converts to an adjustable interest rate on a specified date as follows:

	2013	2012
<b>Collateralized mortgage obligations:</b>		
Converts in 1 year or less	\$ 191	\$ 59
Converts after 1 year through 5 years	364	703
<b>Total</b>	<b>\$ 555</b>	<b>\$ 762</b>

**Note 6 — Held-to-Maturity Securities**

The Bank classifies the following securities as HTM because the Bank has the positive intent and ability to hold these securities to maturity:

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

	Amortized Cost <sup>(1)</sup>	OTTI Recognized in AOCI <sup>(1)</sup>	Carrying Value <sup>(1)</sup>	Gross Unrecognized Holding Gains <sup>(2)</sup>	Gross Unrecognized Holding Losses <sup>(2)</sup>	Estimated Fair Value
Certificates of deposit	\$ 1,660	\$ —	\$ 1,660	\$ —	\$ —	\$ 1,660
Housing finance agency bonds:						
California Housing Finance Agency (CalHFA) bonds	416	—	416	—	(100)	316
Subtotal	2,076	—	2,076	—	(100)	1,976
MBS:						
Other U.S. obligations – Ginnie Mae	1,575	—	1,575	3	(45)	1,533
GSEs:						
Freddie Mac	5,250	—	5,250	53	(90)	5,213
Fannie Mae	6,331	—	6,331	109	(45)	6,395
Subtotal GSEs	11,581	—	11,581	162	(135)	11,608
PLRMBS:						
Prime	1,380	—	1,380	1	(37)	1,344
Alt-A, option ARM	16	—	16	—	(2)	14
Alt-A, other	906	(27)	879	24	(26)	877
Subtotal PLRMBS	2,302	(27)	2,275	25	(65)	2,235
Total MBS	15,458	(27)	15,431	190	(245)	15,376
Total	\$ 17,534	\$ (27)	\$ 17,507	\$ 190	\$ (345)	\$ 17,352

**December 31, 2012**

	Amortized Cost <sup>(1)</sup>	OTTI Recognized in AOCI <sup>(1)</sup>	Carrying Value <sup>(1)</sup>	Gross Unrecognized Holding Gains <sup>(2)</sup>	Gross Unrecognized Holding Losses <sup>(2)</sup>	Estimated Fair Value
Certificates of deposit	\$ 1,739	\$ —	\$ 1,739	\$ —	\$ —	\$ 1,739
Housing finance agency bonds:						
CalHFA bonds	535	—	535	—	(114)	421
Subtotal	2,274	—	2,274	—	(114)	2,160
MBS:						
Other U.S. obligations – Ginnie Mae	340	—	340	8	—	348
GSEs:						
Freddie Mac	4,828	—	4,828	162	(1)	4,989
Fannie Mae	7,020	—	7,020	247	(5)	7,262
Subtotal GSEs	11,848	—	11,848	409	(6)	12,251
PLRMBS:						
Prime	1,749	—	1,749	3	(57)	1,695
Alt-A, option ARM	41	—	41	—	(7)	34
Alt-A, other	1,158	(34)	1,124	23	(51)	1,096
Subtotal PLRMBS	2,948	(34)	2,914	26	(115)	2,825
Total MBS	15,136	(34)	15,102	443	(121)	15,424
Total	\$ 17,410	\$ (34)	\$ 17,376	\$ 443	\$ (235)	\$ 17,584

- (1) Amortized cost includes unpaid principal balance, unamortized premiums and discounts, and previous OTTI recognized in earnings. The carrying value of HTM securities represents amortized cost after adjustment for non-credit-related OTTI recognized in AOCI.
- (2) Gross unrecognized holding gains/(losses) represent the difference between estimated fair value and carrying value.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

At December 31, 2013, the amortized cost of the Bank's MBS classified as HTM included premiums of \$71, discounts of \$70, and credit-related OTTI of \$6 (including interest accretion adjustments of \$5). At December 31, 2012, the amortized cost of the Bank's MBS classified as HTM included premiums of \$67, discounts of \$36, and credit-related OTTI of \$6 (including interest accretion adjustments of \$5).

**Securities Transferred.** Beginning in the first quarter of 2011, the Bank elected to transfer any PLRMBS that incurred a credit-related OTTI charge during the applicable period from the Bank's HTM portfolio to its AFS portfolio at their fair values. These transfers allow the Bank the option to divest these securities prior to maturity in view of changes in interest rates, changes in prepayment risk, or other factors, while acknowledging its intent to hold these securities for an indefinite period of time. For additional information on the transferred securities, see Note 5 – Available-for-Sale Securities and Note 7 – Other-Than-Temporary Impairment Analysis.

The following tables summarize the HTM securities with unrealized losses as of December 31, 2013 and 2012. The unrealized losses are aggregated by major security type and the length of time that individual securities have been in a continuous unrealized loss position. Total unrealized losses in the following table will not agree to the total gross unrecognized losses in the table above. The unrealized losses in the following table also include non-credit-related OTTI losses recognized in AOCI. For OTTI analysis of HTM securities, see Note 7 – Other-Than-Temporary Impairment Analysis.

**December 31, 2013**

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Housing finance agency bonds:						
CalHFA bonds	\$ —	\$ —	\$ 316	\$ 100	\$ 316	\$ 100
MBS:						
Other U.S. obligations – Ginnie Mae	1,187	45	2	—	1,189	45
GSEs:						
Freddie Mac	2,918	89	66	1	2,984	90
Fannie Mae	2,069	40	126	5	2,195	45
Subtotal GSEs	4,987	129	192	6	5,179	135
PLRMBS:						
Prime	481	5	693	32	1,174	37
Alt-A, option ARM	—	—	14	2	14	2
Alt-A, other	159	2	688	51	847	53
Subtotal PLRMBS	640	7	1,395	85	2,035	92
Total MBS	6,814	181	1,589	91	8,403	272
Total	\$ 6,814	\$ 181	\$ 1,905	\$ 191	\$ 8,719	\$ 372

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2012**

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Housing finance agency bonds:						
CalHFA bonds	\$ —	\$ —	\$ 421	\$ 114	\$ 421	\$ 114
MBS:						
Other U.S. obligations – Ginnie Mae	—	—	3	—	3	—
GSEs:						
Freddie Mac	314	1	13	—	327	1
Fannie Mae	56	1	270	4	326	5
Subtotal GSEs	370	2	283	4	653	6
PLRMBS:						
Prime	83	2	1,197	55	1,280	57
Alt-A, option ARM	—	—	34	7	34	7
Alt-A, other	—	—	1,043	85	1,043	85
Subtotal PLRMBS	83	2	2,274	147	2,357	149
Total MBS	453	4	2,560	151	3,013	155
Total	\$ 453	\$ 4	\$ 2,981	\$ 265	\$ 3,434	\$ 269

As indicated in the tables above, the Bank's investments classified as HTM had gross unrealized losses primarily related to CalHFA bonds and PLRMBS. The gross unrealized losses associated with the CalHFA bonds were mainly due to an illiquid market, credit concerns regarding the underlying mortgage collateral, and credit concerns regarding the monoline insurance providers, causing these investments to be valued at a discount to their acquisition cost. The gross unrealized losses associated with the PLRMBS were primarily due to illiquidity in the MBS market, uncertainty about the future condition of the housing and mortgage markets and the economy, and market expectations of the credit performance of the loan collateral underlying these securities, which caused these assets to be valued at discounts to their acquisition cost.

**Redemption Terms.** The amortized cost, carrying value, and estimated fair value of non-MBS securities by contractual maturity (based on contractual final principal payment) and of MBS as of December 31, 2013 and 2012, are shown below. Expected maturities of MBS will differ from contractual maturities because borrowers generally have the right to prepay the underlying obligations without prepayment fees.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

Year of Contractual Maturity	Amortized Cost <sup>(1)</sup>	Carrying Value <sup>(1)</sup>	Estimated Fair Value
<b>HTM securities other than MBS:</b>			
Due in 1 year or less	\$ 1,660	\$ 1,660	\$ 1,660
Due after 1 year through 5 years	—	—	—
Due after 5 years through 10 years	62	62	49
Due after 10 years	354	354	267
Subtotal	2,076	2,076	1,976
<b>MBS:</b>			
Other U.S. obligations – Ginnie Mae	1,575	1,575	1,533
<b>GSEs:</b>			
Freddie Mac	5,250	5,250	5,213
Fannie Mae	6,331	6,331	6,395
Subtotal GSEs	11,581	11,581	11,608
<b>PLRMBS:</b>			
Prime	1,380	1,380	1,344
Alt-A, option ARM	16	16	14
Alt-A, other	906	879	877
Subtotal PLRMBS	2,302	2,275	2,235
Total MBS	15,458	15,431	15,376
Total	\$ 17,534	\$ 17,507	\$ 17,352

**December 31, 2012**

Year of Contractual Maturity	Amortized Cost <sup>(1)</sup>	Carrying Value <sup>(1)</sup>	Estimated Fair Value
<b>HTM securities other than MBS:</b>			
Due in 1 year or less	\$ 1,739	\$ 1,739	\$ 1,739
Due after 1 year through 5 years	18	18	17
Due after 5 years through 10 years	46	46	39
Due after 10 years	471	471	365
Subtotal	2,274	2,274	2,160
<b>MBS:</b>			
Other U.S. obligations – Ginnie Mae	340	340	348
<b>GSEs:</b>			
Freddie Mac	4,828	4,828	4,989
Fannie Mae	7,020	7,020	7,262
Subtotal GSEs	11,848	11,848	12,251
<b>PLRMBS:</b>			
Prime	1,749	1,749	1,695
Alt-A, option ARM	41	41	34
Alt-A, other	1,158	1,124	1,096
Subtotal PLRMBS	2,948	2,914	2,825
Total MBS	15,136	15,102	15,424
Total	\$ 17,410	\$ 17,376	\$ 17,584

- (1) Amortized cost includes unpaid principal balance, unamortized premiums and discounts, and previous OTTI recognized in earnings. The carrying value of HTM securities represents amortized cost after adjustment for non-credit-related OTTI recognized in AOCI.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Interest Rate Payment Terms.** Interest rate payment terms for HTM securities at December 31, 2013 and 2012, are detailed in the following table:

	2013	2012
Amortized cost of HTM securities other than MBS:		
Fixed rate	\$ 1,660	\$ 1,739
Adjustable rate	416	535
Subtotal	2,076	2,274
Amortized cost of HTM MBS:		
Passthrough securities:		
Fixed rate	461	821
Adjustable rate	430	467
Collateralized mortgage obligations:		
Fixed rate	10,820	9,096
Adjustable rate	3,747	4,752
Subtotal	15,458	15,136
Total	\$ 17,534	\$ 17,410

Certain MBS classified as fixed rate passthrough securities and fixed rate collateralized mortgage obligations have an initial fixed interest rate that subsequently converts to an adjustable interest rate on a specified date as follows:

	2013	2012
Passthrough securities:		
Converts in 1 year or less	\$ 62	\$ 76
Converts after 1 year through 5 years	316	614
Converts after 5 years through 10 years	72	116
Total	\$ 450	\$ 806
Collateralized mortgage obligations:		
Converts in 1 year or less	\$ 185	\$ 26
Converts after 1 year through 5 years	133	506
Total	\$ 318	\$ 532

**Note 7 — Other-Than-Temporary Impairment Analysis**

On a quarterly basis, the Bank evaluates its individual AFS and HTM investment securities in an unrealized loss position for OTTI. As part of this evaluation, the Bank considers whether it intends to sell each debt security and whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery of the amortized cost basis. If either of these conditions is met, the Bank recognizes an OTTI charge to earnings equal to the entire difference between the security's amortized cost basis and its fair value at the statement of condition date. For securities in an unrealized loss position that meet neither of these conditions, the Bank considers whether it expects to recover the entire amortized cost basis of the security by comparing its best estimate of the present value of the cash flows expected to be collected from the security with the amortized cost basis of the security. If the Bank's best estimate of the present value of the cash flows expected to be collected is less than the amortized cost basis, the difference is considered the credit loss.

**PLRMBS.** To assess whether it expects to recover the entire amortized cost basis of its PLRMBS, the Bank performed a cash flow analysis for all of its PLRMBS as of December 31, 2013, using two third-party models. The first model projects prepayments, default rates, and loss severities on the underlying loan collateral based on



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

borrower characteristics and the particular attributes of the loans underlying the Bank's securities, in conjunction with assumptions related primarily to future changes in home prices and interest rates. A significant input to the first model is the forecast of future housing price changes for the relevant states and core-based statistical areas (CBSAs), which are based on an assessment of the regional housing markets. CBSA refers collectively to metropolitan and micropolitan statistical areas as defined by the United States Office of Management and Budget. As currently defined, a CBSA must contain at least one urban area with a population of 10,000 or more people. The FHLBanks' OTTI Governance Committee developed a short-term housing price forecast with projected changes ranging from a decrease of 5.0% to an increase of 7.0% over the 12-month period beginning October 1, 2013. For the vast majority of markets, the projected short-term housing price changes range from an increase of 1.0% to an increase of 5.0%. Thereafter, home prices were projected to recover using one of five different recovery paths. The table below presents the ranges of the annualized projected home price recovery rates at December 31, 2013.

Months	December 31, 2013
1 - 6	0.0% - 3.0%
7 - 12	1.0% - 4.0%
13 - 18	2.0% - 4.0%
19 - 30	2.0% - 5.0%
31 - 54	2.0% - 6.0%
Thereafter	2.3% - 5.6%

The month-by-month projections of future loan performance derived from the first model, which reflect projected prepayments, default rates, and loss severities, are then input into a second model that allocates the projected loan level cash flows and losses to the various security classes in each securitization structure in accordance with the structure's prescribed cash flow and loss allocation rules. When the credit enhancement for the senior securities in a securitization is derived from the presence of subordinated securities, losses are generally allocated first to the subordinated securities until their principal balance is reduced to zero. The projected cash flows are based on a number of assumptions and expectations, and the results of these models can vary significantly with changes in assumptions and expectations. The scenario of cash flows determined based on the model approach described above reflects a best-estimate scenario and includes a base case housing price forecast that reflects the expectations for near- and long-term housing price behavior.

At each quarter end, the Bank compares the present value of the cash flows expected to be collected on its PLRMBS to the amortized cost basis of the securities to determine whether a credit loss exists. For the Bank's variable rate and hybrid PLRMBS, the Bank uses the effective interest rate derived from a variable rate index (for example, one-month LIBOR) plus the contractual spread, plus or minus a fixed spread adjustment when there is an existing discount or premium on the security. As the implied forward rates of the index change over time, the effective interest rates derived from that index will also change over time. The Bank then uses the effective interest rate for the security prior to impairment for determining the present value of the future estimated cash flows. For all securities, including securities previously identified as other-than-temporarily impaired, the Bank updates its estimate of future estimated cash flows on a quarterly basis.

For all the PLRMBS in its AFS and HTM portfolios, the Bank does not intend to sell any security and it is not more likely than not that the Bank will be required to sell any security before its anticipated recovery of the remaining amortized cost basis.

For securities determined to be other-than-temporarily impaired as of December 31, 2013 (securities for which the Bank determined that it does not expect to recover the entire amortized cost basis), the following table presents a summary of the significant inputs used in measuring the amount of credit loss recognized in earnings during the year ended December 31, 2013, and the related current credit enhancement for the Bank.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

Year of Securitization	Significant Inputs for Other-Than-Temporarily Impaired PLRMBS			Current
	Prepayment Rates	Default Rates	Loss Severities	Credit Enhancement
	Weighted Average %	Weighted Average %	Weighted Average %	Weighted Average %
<b>Prime</b>				
2007	10.1	5.6	31.0	19.4
2006	10.8	18.6	42.1	—
Total Prime	10.1	5.8	31.2	19.1
<b>Alt-A, other</b>				
2007	8.8	38.9	46.0	6.9
2005	7.2	21.4	43.6	15.3
2004 and earlier	12.1	9.9	33.6	15.5
Total Alt-A, other	8.6	31.2	44.2	10.1
<b>Alt-A, option ARM</b>				
2005	5.6	19.5	36.3	30.1
Total Alt-A, option ARM	5.6	19.5	36.3	30.1
<b>Total</b>	<b>8.6</b>	<b>30.4</b>	<b>43.7</b>	<b>10.8</b>

Credit enhancement is defined as the percentage of subordinated tranches, excess spread, and over-collateralization, if any, in a security structure that will generally absorb losses before the Bank will experience a loss on the security. The calculated averages represent the dollar-weighted averages of all the PLRMBS investments in each category shown. The classification (Prime; Alt-A, option ARM; and Alt-A, other) is based on the model used to run the estimated cash flows for the CUSIP, which may not necessarily be the same as the classification at the time of origination.

For each security classified as HTM, the estimated non-credit-related OTTI is accreted prospectively, based on the amount and timing of future estimated cash flows, over the remaining life of the security as an increase in the carrying value of the security (with no effect on earnings unless the security is subsequently sold or there are additional decreases in the cash flows expected to be collected). The Bank accreted \$7 and \$9 from AOCI to increase the carrying value of the respective PLRMBS classified as HTM for the years ended December 31, 2013 and 2012, respectively. The Bank does not intend to sell these securities and it is not more likely than not that the Bank will be required to sell these securities before its anticipated recovery of the remaining amortized cost basis.

The following table presents the credit-related OTTI, which is recognized in earnings, for the years ended December 31, 2013, 2012, and 2011.

	2013	2012	2011
Balance, beginning of the year	\$ 1,397	\$ 1,362	\$ 952
Charges on securities for which OTTI was not previously recognized	—	—	16
Additional charges on securities for which OTTI was previously recognized <sup>(1)</sup>	7	44	397
Increases in cash flows expected to be collected that are recognized over the remaining life of the securities	(26)	(9)	(3)
Balance, end of the year	\$ 1,378	\$ 1,397	\$ 1,362

- (1) For the year ended December 31, 2013, “securities for which OTTI was previously recognized” represents all securities that were also other-than-temporarily impaired prior to January 1, 2013. For the year ended December 31, 2012, “securities for which OTTI was previously recognized” represents all securities that were also previously other-than-temporarily impaired prior to January 1, 2012. For the year ended December 31, 2011, “securities for which OTTI was previously recognized” represents all securities that were also previously other-than-temporarily impaired prior to January 1, 2011.

Changes in circumstances may cause the Bank to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. The sale or transfer of an HTM

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

security because of certain changes in circumstances, such as evidence of significant deterioration in the issuers' creditworthiness, is not considered to be inconsistent with its original classification. In addition, other events that are isolated, nonrecurring, or unusual for the Bank that could not have been reasonably anticipated may cause the Bank to sell or transfer an HTM security without necessarily calling into question its intent to hold other debt securities to maturity.

Beginning in the first quarter of 2011, the Bank elected to transfer any PLRMBS that incurred a credit-related OTTI charge during the applicable period from the Bank's HTM portfolio to its AFS portfolio at their fair values. The Bank recognized an OTTI credit loss on these HTM PLRMBS, which the Bank believes is evidence of a significant decline in the issuers' creditworthiness. The decline in the issuers' creditworthiness is the basis for the transfers to the AFS portfolio. These transfers allow the Bank the option to sell these securities prior to maturity in view of changes in interest rates, changes in prepayment risk, or other factors, while recognizing the Bank's intent to hold these securities for an indefinite period of time. The Bank does not intend to sell its other-than-temporarily impaired securities and it is not more likely than not that the Bank will be required to sell any security before its anticipated recovery of the remaining amortized cost basis.

The following table summarizes the PLRMBS transferred from the Bank's HTM portfolio to its AFS portfolio during the years ended December 31, 2013 and 2012. The amounts shown represent the values when the securities were transferred from the HTM portfolio to the AFS portfolio.

	2013				2012			
	Amortized Cost	OTTI Recognized in AOCI	Gross Unrecognized Holding Gains	Estimated Fair Value	Amortized Cost	OTTI Recognized in AOCI	Gross Unrecognized Holding Gains	Estimated Fair Value
Other-than-temporarily impaired PLRMBS backed by loans classified at origination as:								
Prime	\$ —	\$ —	\$ —	\$ —	\$ 22	\$ (2)	\$ —	\$ 20
Alt-A, option ARM	22	(3)	—	19	—	—	—	—
Alt-A, other	54	(1)	—	53	146	(26)	—	120
Total	\$ 76	\$ (4)	\$ —	\$ 72	\$ 168	\$ (28)	\$ —	\$ 140

The following tables present the Bank's other-than-temporarily impaired PLRMBS that incurred OTTI charges anytime during the life of the securities at December 31, 2013 and 2012, by loan collateral type:

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

	Available-for-Sale Securities			Held-to-Maturity Securities			
	Unpaid Principal Balance	Amortized Cost	Estimated Fair Value	Unpaid Principal Balance	Amortized Cost	Carrying Value	Estimated Fair Value
Other-than-temporarily impaired PLRMBS backed by loans classified at origination as:							
Prime	\$ 795	\$ 661	\$ 677	\$ —	\$ —	\$ —	\$ —
Alt-A, option ARM	1,516	1,122	1,099	—	—	—	—
Alt-A, other	6,151	5,376	5,271	150	147	120	144
<b>Total</b>	<b>\$ 8,462</b>	<b>\$ 7,159</b>	<b>\$ 7,047</b>	<b>\$ 150</b>	<b>\$ 147</b>	<b>\$ 120</b>	<b>\$ 144</b>

**December 31, 2012**

	Available-for-Sale Securities			Held-to-Maturity Securities			
	Unpaid Principal Balance	Amortized Cost	Estimated Fair Value	Unpaid Principal Balance	Amortized Cost	Carrying Value	Estimated Fair Value
Other-than-temporarily impaired PLRMBS backed by loans classified at origination as:							
Prime	\$ 976	\$ 832	\$ 800	\$ —	\$ —	\$ —	\$ —
Alt-A, option ARM	1,641	1,227	1,010	—	—	—	—
Alt-A, other	7,153	6,293	5,794	173	171	136	159
<b>Total</b>	<b>\$ 9,770</b>	<b>\$ 8,352</b>	<b>\$ 7,604</b>	<b>\$ 173</b>	<b>\$ 171</b>	<b>\$ 136</b>	<b>\$ 159</b>

For the Bank's PLRMBS that were not other-than-temporarily impaired as of December 31, 2013, the Bank has experienced net unrealized losses primarily because of illiquidity in the PLRMBS market, uncertainty about the future condition of the housing and mortgage markets and the economy, and market expectations of the credit performance of loan collateral underlying these securities, which caused these assets to be valued at discounts to their acquisition cost. The Bank does not intend to sell these securities, it is not more likely than not that the Bank will be required to sell these securities before its anticipated recovery of the remaining amortized cost basis, and the Bank expects to recover the entire amortized cost basis of these securities. As a result, the Bank determined that, as of December 31, 2013, the gross unrealized losses on these PLRMBS are temporary. These securities were included in the securities that the Bank reviewed and analyzed for OTTI as discussed above, and the analyses performed indicated that these securities were not other-than-temporarily impaired.

**All Other Available-for-Sale and Held-to-Maturity Investments.** As of December 31, 2013, the Bank's investments in housing finance agency bonds, which were issued by CalHFA, had gross unrealized losses totaling \$100. These gross unrealized losses were mainly due to an illiquid market, credit concerns regarding the underlying mortgage collateral, and credit concerns regarding the monoline insurance providers, causing these investments to be valued at a discount to their acquisition cost. The Bank independently modeled cash flows for the underlying collateral, using assumptions for default rates and loss severity that a market participant would deem reasonable, and concluded that the available credit support within the CalHFA structure more than offset the projected underlying collateral losses. The Bank determined that, as of December 31, 2013, all of the gross unrealized losses on the bonds are temporary because the underlying collateral and credit enhancements were sufficient to protect the Bank from losses. As a result, the Bank expects to recover the entire amortized cost basis of these securities.

For its agency MBS, the Bank expects to recover the entire amortized cost basis of these securities because the Bank determined that the strength of the issuers' guarantees through direct obligations or support from the U.S. government is sufficient to protect the Bank from losses. As a result, the Bank determined that, as of December 31, 2013, all of the gross unrealized losses on its agency MBS are temporary.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Note 8 — Advances**

The Bank offers a wide range of fixed and adjustable rate advance products with different maturities, interest rates, payment characteristics, and option features. Fixed rate advances generally have maturities ranging from one day to 30 years. Adjustable rate advances generally have maturities ranging from less than 30 days to 10 years, with the interest rates resetting periodically at a fixed spread to LIBOR or to another specified index.

**Redemption Terms.** The Bank had advances outstanding, excluding overdrawn demand deposit accounts, at interest rates ranging from 0.06% to 8.57% at December 31, 2013, and 0.09% to 8.57% at December 31, 2012, as summarized below.

Contractual Maturity	2013		2012	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Within 1 year	\$ 22,556	0.50%	\$ 19,565	0.61%
After 1 year through 2 years	6,838	1.48	5,957	1.47
After 2 years through 3 years	6,754	1.24	6,352	1.59
After 3 years through 4 years	3,208	1.43	5,869	1.35
After 4 years through 5 years	2,825	1.79	2,772	1.51
After 5 years	2,006	2.41	2,665	2.43
Total par value	44,187	1.00%	43,180	1.14%
Valuation adjustments for hedging activities	95		282	
Valuation adjustments under fair value option	113		288	
Total	\$ 44,395		\$ 43,750	

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 intended to make the Bank financially indifferent to the prepayment. In addition, for certain advances with partial prepayment symmetry, the Bank may charge the member a prepayment fee or pay the member a prepayment credit depending on certain circumstances, such as movements in interest rates, when the advance is prepaid. The Bank had advances with partial prepayment symmetry outstanding totaling \$6,833 at December 31, 2013, and \$6,867 at December 31, 2012. Some advances may be repaid on pertinent call dates without prepayment fees (callable advances). The Bank had callable advances outstanding totaling \$235 at December 31, 2013, and \$73 at December 31, 2012.

The Bank's advances at December 31, 2013 and 2012, included \$182 and \$197, respectively, of putable advances. At the Bank's discretion, the Bank may terminate these advances on predetermined exercise dates and offer replacement funding at prevailing market rates, subject to certain conditions. The Bank would typically exercise such termination rights when interest rates increase.

The following table summarizes advances at December 31, 2013 and 2012, by the earlier of the year of contractual maturity or next call date for callable advances and by the earlier of the year of contractual maturity or next put date for putable advances.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	Earlier of Contractual Maturity or Next Call Date		Earlier of Contractual Maturity or Next Put Date	
	2013	2012	2013	2012
Within 1 year	\$ 22,609	\$ 19,633	\$ 22,696	\$ 19,747
After 1 year through 2 years	6,843	5,952	6,838	5,915
After 2 years through 3 years	6,850	6,357	6,754	6,352
After 3 years through 4 years	3,208	5,869	3,108	5,869
After 4 years through 5 years	2,901	2,762	2,785	2,672
After 5 years	1,776	2,607	2,006	2,625
Total par value	\$ 44,187	\$ 43,180	\$ 44,187	\$ 43,180

**Credit and Concentration Risk.** The following tables present the concentration in advances to the top five borrowers and their affiliates at December 31, 2013 and 2012. The tables also present the interest income from these advances before the impact of interest rate exchange agreements associated with these advances for the years ended December 31, 2013 and 2012.

**December 31, 2013**

Name of Borrower	Advances Outstanding <sup>(1)</sup>	Percentage of Total Advances Outstanding	Interest Income from Advances <sup>(2)</sup>	Percentage of Total Interest Income from Advances
Bank of America California, N.A.	\$ 7,750	18%	\$ 15	3%
JPMorgan Chase & Co.:				
JPMorgan Bank & Trust Company, National Association	5,125	11	76	16
JPMorgan Chase Bank, National Association <sup>(3)</sup>	835	2	8	2
Subtotal JPMorgan Chase & Co.	5,960	13	84	18
First Republic Bank	5,150	12	70	15
Bank of the West	4,933	11	30	6
One West Bank, FSB	4,501	10	41	9
Subtotal	28,294	64	240	51
Others	15,893	36	234	49
Total	\$ 44,187	100%	\$ 474	100%

**December 31, 2012**

Name of Borrower	Advances Outstanding <sup>(1)</sup>	Percentage of Total Advances Outstanding	Interest Income from Advances <sup>(2)</sup>	Percentage of Total Interest Income from Advances
JPMorgan Chase & Co.:				
JPMorgan Bank & Trust Company, National Association	\$ 7,850	18%	\$ 105	15%
JPMorgan Chase Bank, National Association <sup>(3)</sup>	1,542	4	14	2
Subtotal JPMorgan Chase & Co.	9,392	22	119	17
Citibank, N.A. <sup>(3)</sup>	8,285	19	44	6
Bank of the West	2,920	7	93	14
OneWest Bank, FSB	3,651	9	55	8
First Republic Bank	3,225	7	55	8
Subtotal	27,473	64	366	53
Others	15,707	36	313	47
Total	\$ 43,180	100%	\$ 679	100%

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

- (1) Borrower advance amounts and total advance amounts are at par value, and total advance amounts will not agree to carrying value amounts shown in the Statements of Condition. The differences between the par and carrying value amounts primarily relate to unrealized gains or losses associated with hedged advances resulting from valuation adjustments related to hedging activities and under the fair value option.
- (2) Interest income amounts exclude the interest effect of interest rate exchange agreements with derivative counterparties; as a result, the total interest income amounts will not agree to the Statements of Income. The amount of interest income from advances can vary depending on the amount outstanding, terms to maturity, interest rates, and repricing characteristics.
- (3) Nonmember institution.

The Bank held a security interest in collateral from each of the top five advances borrowers and their affiliates sufficient to support their respective advances outstanding, and the Bank does not expect to incur any credit losses on these advances. As of December 31, 2013, two of the advances borrowers and their affiliates (JPMorgan Chase & Co. and Citibank, N.A.) each owned more than 10% of the Bank's outstanding capital stock, including mandatorily redeemable capital stock.

For information related to the Bank's credit risk on advances and allowance methodology for credit losses, see Note 10 – Allowance for Credit Losses.

**Interest Rate Payment Terms.** Interest rate payment terms for advances at December 31, 2013 and 2012, are detailed below:

	2013	2012
Par value of advances:		
Fixed rate:		
Due within 1 year	\$ 17,998	\$ 5,397
Due after 1 year	16,453	17,563
Total fixed rate	34,451	22,960
Adjustable rate:		
Due within 1 year	4,558	14,168
Due after 1 year	5,178	6,052
Total adjustable rate	9,736	20,220
Total par value	\$ 44,187	\$ 43,180

The Bank may use derivatives to adjust the repricing and/or options characteristics of advances to more closely match the characteristics of the Bank's funding liabilities. In general, 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 variable rate asset. This type of hedge is treated as a fair value hedge. In addition, for certain advances for which the Bank has elected the fair value option, the Bank will simultaneously execute an interest rate exchange agreement with terms that economically offset the terms of the advance. However, this type of hedge is treated as an economic hedge because these combinations generally do not meet the requirements for fair value hedge accounting treatment. For more information, see Note 19 – Derivatives and Hedging Activities and Note 20 – Fair Value.

The Bank did not have any advances with embedded features that met the requirements to separate the embedded feature from the host contract and designate the embedded feature as a stand-alone derivative at December 31, 2013 and 2012.

**Prepayment Fees, Net.** The Bank charges borrowers prepayment fees or pays borrowers prepayment credits when the principal on certain advances is paid prior to original maturity. The Bank records prepayment fees net of any associated fair value adjustments related to prepaid advances that were hedged. The net amount of prepayment fees is reflected as interest income in the Statements of Income for the years ended December 31, 2013, 2012, and 2011, as follows:



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

		2013		2012		2011
Prepayment fees received	\$	14	\$	211	\$	103
Fair value adjustments		(9)		(146)		(86)
Total prepayment fees, net	\$	5	\$	65	\$	17
Advance principal prepaid	\$	365	\$	9,858	\$	5,217

**Note 9 — Mortgage Loans Held for Portfolio**

Under the MPF Program, the Bank purchased conventional conforming fixed rate residential mortgage loans directly from its participating members from May 2002 through October 2006. Participating members originated or purchased the mortgage loans, credit-enhanced them and sold them to the Bank, and generally retained the servicing of the loans.

On October 2, 2013, the Bank announced its renewed participation in the MPF Program. In 2014, the Bank plans to begin purchasing conventional conforming fixed rate mortgage loans and FHA/VA-insured mortgage loans from members for the Bank's own portfolio under the MPF Original and MPF Government products. The Bank also plans to facilitate the purchase of fixed rate mortgage loans from members for concurrent sale to Fannie Mae under the MPF Xtra® product. ("MPF Xtra" is a registered trademark of the FHLBank of Chicago.)

The Bank plans to begin with a small number of participating members, then add other members that are active mortgage originators and servicers later in 2014 or in 2015. The Bank previously purchased conventional conforming fixed rate residential mortgage loans from participating members from May 2002 to October 2006.

The following table presents information as of December 31, 2013 and 2012, on mortgage loans, all of which are secured by one- to four-unit residential properties and single-unit second homes.

		2013		2012
Fixed rate medium-term mortgage loans	\$	238	\$	359
Fixed rate long-term mortgage loans		675		937
Subtotal		913		1,296
Unamortized premiums		10		10
Unamortized discounts		(16)		(14)
Mortgage loans held for portfolio		907		1,292
Less: Allowance for credit losses		(2)		(3)
Total mortgage loans held for portfolio, net	\$	905	\$	1,289

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

The participating member and the Bank share the risk of credit losses on conventional MPF loan products by structuring potential losses on conventional MPF loans into layers with respect to each master commitment. After any primary mortgage insurance, the Bank is obligated to incur the first layer or portion of credit losses not absorbed by the liquidation value of the real property securing the loan. Under the MPF Program, the participating member's credit enhancement protection consists of the credit enhancement amount, which may be a direct obligation of the participating member or may be a supplemental mortgage insurance policy paid for by the participating member, and may include a contingent performance-based credit enhancement fee payable to the participating member. The participating member is required to pledge collateral to secure any portion of its credit enhancement amount that is a direct obligation.



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

For taking on the credit enhancement obligation, the Bank pays the participating member or any successor a credit enhancement fee, which is calculated on the remaining unpaid principal balance of the mortgage loans. The Bank records credit enhancement fees as a reduction to interest income. The Bank reduced net interest income for credit enhancement fees totaling \$1 in 2013, \$1 in 2012, and \$1 in 2011.

**Concentration Risk.** The Bank had the following concentration in MPF loans with institutions whose outstanding total of mortgage loans sold to the Bank represented 10% or more of the Bank's total outstanding mortgage loans at December 31, 2013 and 2012.

**December 31, 2013**

Name of Institution	Mortgage Loan Balances Outstanding	Percentage of Total Mortgage Loan Balances Outstanding	Number of Mortgage Loans Outstanding	Percentage of Total Number of Mortgage Loans Outstanding
JPMorgan Chase Bank, National Association <sup>(1)</sup>	\$ 715	78%	7,355	69%
OneWest Bank, FSB	120	13	2,510	23
Subtotal	835	91	9,865	92
Others	78	9	883	8
Total	\$ 913	100%	10,748	100%

**December 31, 2012**

Name of Institution	Mortgage Loan Balances Outstanding	Percentage of Total Mortgage Loan Balances Outstanding	Number of Mortgage Loans Outstanding	Percentage of Total Number of Mortgage Loans Outstanding
JPMorgan Chase Bank, National Association <sup>(1)</sup>	\$ 1,015	79%	9,638	70%
OneWest Bank, FSB	173	13	3,064	22
Subtotal	1,188	92	12,702	92
Others	108	8	1,136	8
Total	\$ 1,296	100%	13,838	100%

(1) Nonmember institution.

For information related to the Bank's credit risk on mortgage loans and allowance methodology for credit losses, see Note 10 – Allowance for Credit Losses.

**Note 10 — Allowance for Credit Losses**

An allowance for credit losses is a valuation allowance separately established for each identified portfolio segment, if it is probable that impairment has occurred in the Bank's portfolio as of the Statements of Condition date and the amount of loss can be reasonably estimated. To the extent necessary, an allowance for credit losses for off-balance sheet credit exposures is recorded as a liability.

**Portfolio Segments.** A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. The Bank has developed and documented a systematic methodology for determining an allowance for credit losses for each of the following portfolio segments:

- advances, letters of credit, and other extensions of credit to members, collectively referred to as “credit products,”
- MPF loans held for portfolio,
- term securities purchased under agreements to resell, and
- term Federal funds sold.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Classes of Financing Receivables.** Classes of financing receivables generally are a disaggregation of a portfolio segment to the extent needed to understand the exposure to credit risk arising from these financing receivables. The Bank determined that no further disaggregation of the portfolio segments identified above is needed because the credit risk arising from these financing receivables is assessed and measured by the Bank at the portfolio segment level.

**Credit Products.** The Bank lends to member financial institutions that have a principal place of business in Arizona, California, or Nevada. Under the FHLBank Act, the Bank is required to obtain sufficient collateral for credit products to protect the Bank from credit losses. Collateral eligible to secure credit products includes certain investment securities, residential mortgage loans, cash or deposits with the Bank, and other eligible real estate-related assets. The capital stock of the Bank owned by each borrowing member is pledged as additional collateral for the member's indebtedness to the Bank. The Bank may also accept secured small business, small farm, and small agribusiness loans, and securities representing a whole interest in such secured loans, as collateral from members that are community financial institutions. The Housing Act added secured loans for community development activities as collateral that the Bank may accept from community financial institutions. In addition, the Bank has advances outstanding to former members and member successors, which are also subject to these security terms.

The Bank requires each borrowing member to execute a written Advances and Security Agreement, which describes the lending relationship between the Bank and the borrower. At December 31, 2013 and 2012, the Bank had a perfected security interest in collateral pledged by each borrowing member, or by the member's affiliate on behalf of the member, and by each nonmember borrower, with an estimated value in excess of the outstanding credit products for that borrower. Based on the financial condition of the borrower, the Bank may either (i) allow the borrower or the pledging affiliate to retain physical possession of loan collateral pledged to the Bank, provided that the borrower or the pledging affiliate agree to hold the collateral for the benefit of the Bank, or (ii) require the borrower or the pledging affiliate to deliver physical possession of loan collateral to the Bank or its custodial agent. All securities collateral is required to be delivered to the Bank's custodial agent. All loan collateral pledged to the Bank is subject to a UCC-1 financing statement.

Section 10(e) of the FHLBank Act affords any security interest granted to the Bank by a member or any affiliate of the member or any nonmember borrower 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.

The Bank classifies as impaired any advance with respect to which it is probable that all principal and interest due will not be collected according to its contractual terms. Impaired advances are valued using the present value of expected future cash flows discounted at the advance's effective interest rate, the advance's observable market price or, if collateral-dependent, the fair value of the advance's underlying collateral. When an advance is classified as impaired, the accrual of interest is discontinued and unpaid accrued interest is reversed. Advances do not return to accrual status until they are brought current with respect to both principal and interest and until the future principal payments are no longer in doubt. No advances were classified as impaired during the periods presented.

The Bank manages its credit exposure relating to credit products through an integrated approach that generally provides for a credit limit to be established for each borrower, includes an ongoing review of each borrower's financial condition, and is coupled with conservative collateral and lending policies to limit the risk of loss while taking into account borrowers' needs for a reliable funding source. At December 31, 2013 and 2012, none of the Bank's credit products were past due, on nonaccrual status, or considered impaired. There were no troubled debt restructurings related to credit products during 2013 and 2012.

Based on the collateral pledged as security for advances, the Bank's credit analyses of borrowers' financial condition, and the Bank's credit extension and collateral policies as of December 31, 2013, the Bank expects to collect all amounts due according to the contractual terms. Therefore, no allowance for losses on credit products was deemed necessary by the Bank. The Bank has never experienced any credit losses on its credit products.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

During 2013, three member institutions were placed into receivership. These institutions had no advances outstanding at the time they were placed into receivership.

From January 1, 2014, to February 28, 2014, no member institutions were placed into receivership.

**Mortgage Loans Held for Portfolio.** A mortgage loan is considered to be impaired when it is reported 90 days or more past due (nonaccrual) or when it is probable, based on current information and events, that the Bank will be unable to collect all principal and interest amounts due according to the contractual terms of the mortgage loan agreement.

Loans that are on nonaccrual status and that are considered collateral-dependent are measured for impairment based on the fair value of the underlying property less estimated selling costs. Loans are considered collateral-dependent if repayment is expected to be provided solely by the sale of the underlying property, that is, if it is considered likely that the borrower will default and there is no credit enhancement to offset losses under the master commitment, or the collectability or availability of credit enhancement is deemed to be uncertain. Collateral-dependent loans are impaired if the fair value of the underlying collateral less estimated selling costs is insufficient to recover the unpaid principal balance on the loan. Interest income on impaired loans is recognized in the same manner as interest income on nonaccrual loans, as noted below.

The Bank places a mortgage loan on nonaccrual status when the collection of the contractual principal or interest from the participating institution is reported 90 days or more past due or when the loan is in foreclosure. 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 first as interest income and then as a reduction of principal as specified in the contractual agreement, unless the collection of the remaining principal amount due is considered doubtful.

The following table presents information on delinquent mortgage loans as of December 31, 2013 and 2012.

	2013	2012
	Recorded Investment <sup>(1)</sup>	Recorded Investment <sup>(1)</sup>
30 – 59 days delinquent	\$ 14	\$ 18
60 – 89 days delinquent	7	7
90 days or more delinquent	27	32
Total past due	48	57
Total current loans	863	1,241
Total mortgage loans	\$ 911	\$ 1,298
In process of foreclosure, included above <sup>(2)</sup>	\$ 17	\$ 20
Nonaccrual loans	\$ 27	\$ 32
Loans past due 90 days or more and still accruing interest	\$ —	\$ —
Serious delinquencies as a percentage of total mortgage loans outstanding <sup>(3)</sup>	3.00%	2.45%

- (1) The recorded investment in a loan is the unpaid principal balance of the loan, adjusted for accrued interest, net deferred loan fees or costs, unamortized premiums or discounts, and direct write-downs. The recorded investment is not net of any valuation allowance.
- (2) Includes loans for which the servicer has reported a decision to foreclose or to pursue a similar alternative, such as deed-in-lieu. Loans in process of foreclosure are included in past due or current loans depending on their delinquency status.
- (3) Represents loans that are 90 days or more past due or in the process of foreclosure as a percentage of the recorded investment of total mortgage loans outstanding. The ratio increased primarily because of the decline in the recorded investment of the Bank's mortgage loans.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

*Mortgage Loans Evaluated at the Individual Master Commitment Level* – The credit risk analysis of all conventional MPF loans is performed at the individual master commitment level to determine the credit enhancements available to recover losses on MPF loans under each individual master commitment.

*Individually Evaluated Mortgage Loans* – Certain conventional mortgage loans, primarily impaired mortgage loans that are considered collateral-dependent, may be specifically identified for purposes of calculating the allowance for credit losses. The estimated credit losses on impaired collateral-dependent loans may be separately determined because sufficient information exists to make a reasonable estimate of the inherent loss on those loans on an individual loan basis. The Bank estimates the fair value of collateral using real estate broker price opinions or automated valuation models (AVMs) based on property characteristics as well as recent market sales and current listings. The resulting incurred loss, if any, is equal to the difference between the carrying value of the loan and the estimated fair value of the collateral less estimated selling costs.

*Collectively Evaluated Mortgage Loans* – The credit risk analysis of conventional loans collectively evaluated for impairment considers loan pool-specific attribute data, applies estimated loss severities, and considers the associated credit enhancements to determine the Bank's best estimate of probable incurred losses. The analysis includes estimating projected cash flows that the Bank is likely to collect based on an assessment of all available information, including prepayment speeds, default rates, and loss severity for the mortgage loans based on underlying loan-level borrower and loan characteristics; expected housing price changes; and interest rate assumptions. In performing a detailed cash flow analysis, the Bank develops its best estimate of the cash flows expected to be collected using a third-party model to project prepayments, default rates, and loss severities based on borrower characteristics and the particular attributes of the mortgage loans, in conjunction with assumptions related primarily to future changes in home prices and interest rates. The assumptions used as inputs to the model, including the forecast of future housing price changes, are consistent with assumptions used for the Bank's evaluation of its PLRMBS for OTTI.

The allowance for credit losses on the mortgage loan portfolio was as follows:

	2013	2012	2011
Balance, beginning of the year	\$ 3	\$ 6	\$ 3
Charge-offs – transferred to real estate owned (REO)	—	(2)	(1)
Provision for/(reversal of) credit losses	(1)	(1)	4
Balance, end of the year	\$ 2	\$ 3	\$ 6
Ratio of net charge-offs during the period to average loans outstanding during the year	(0.07)%	(0.08)%	(0.07)%

The allowance for credit losses and recorded investment by impairment methodology for individually and collectively evaluated impaired loans are as follows:

	2013	2012
Allowance for credit losses, end of the year		
Individually evaluated for impairment	\$ 2	\$ 3
Collectively evaluated for impairment	—	—
Total allowance for credit losses	\$ 2	\$ 3
Recorded investment, end of the year		
Individually evaluated for impairment	\$ 27	\$ 31
Collectively evaluated for impairment	884	1,267
Total recorded investment	\$ 911	\$ 1,298

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

The recorded investment, unpaid principal balance, and related allowance of impaired loans individually evaluated for impairment as of December 31, 2013 and 2012, are as follows:

	2013			2012		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance	\$ 20	\$ 20	\$ —	\$ 19	\$ 19	\$ —
With an allowance	7	7	2	12	12	3
Total	\$ 27	\$ 27	\$ 2	\$ 31	\$ 31	\$ 3

The average recorded investment on impaired loans individually evaluated for impairment is as follows:

	2013	2012
With no related allowance	\$ 19	\$ 19
With an allowance	11	16
Total	\$ 30	\$ 35

The Bank and any participating institution share in the credit risk of the loans sold by that institution as specified in a master agreement. Loans purchased under the MPF Program generally had a credit risk exposure at the time of purchase equivalent to AA-rated assets taking into consideration the credit risk sharing structure mandated by the Finance Agency's acquired member assets (AMA) regulation. The Bank holds additional risk-based capital when it determines that purchased loans do not have a credit risk exposure equivalent to AA-rated assets. The MPF Program structures potential credit losses on conventional MPF loans into layers with respect to each pool of loans purchased by the Bank under a single master commitment for the member selling the loans, as follows:

1. The first layer of protection against loss is the liquidation value of the real property securing the loan.
2. The next layer of protection comes from the primary mortgage insurance that is required for loans with a loan-to-value ratio greater than 80%, if still in place.
3. Losses that exceed the liquidation value of the real property and any primary mortgage insurance, up to an agreed-upon amount called the first loss account for each master commitment, are incurred by the Bank.
4. Losses in excess of the first loss account for each master commitment, up to an agreed-upon amount called the "credit enhancement amount," are covered by the participating institution's credit enhancement obligation at the time losses are incurred.
5. Losses in excess of the first loss account and the participating institution's remaining credit enhancement for the master commitment, if any, are incurred by the Bank.

The Bank calculates its estimated allowance for credit losses on mortgage loans acquired under its two MPF products, Original MPF and MPF Plus, as described below.

*Allowance for Credit Losses on MPF Loans* – The Bank evaluates the allowance for credit losses on MPF mortgage loans based on two components. The first component applies to each individual loan that is specifically identified as impaired. The Bank evaluates the exposure on these loans by considering the first layer of loss protection (the liquidation value of the real property securing the loan) and the availability and collectability of credit enhancements under the terms of each master commitment and records a provision for credit losses. For this component, the Bank established an allowance for credit losses for Original MPF loans totaling de minimis amounts as of December 31, 2013 and 2012, and for MPF Plus loans totaling \$2 as of December 31, 2013, and \$3 as of December 31, 2012.

The second component applies to loans that are not specifically identified as impaired and is based on the Bank's estimate of probable credit losses on those loans as of the financial statement date. The Bank evaluates the credit

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

loss exposure on a loan pool basis considering various observable data, such as delinquency statistics, past performance, current performance, loan portfolio characteristics, collateral valuations, industry data, and prevailing economic conditions. The Bank also considers the availability and collectability of credit enhancements from institutions or from mortgage insurers under the terms of each master commitment. For this component, the Bank established an allowance for credit losses for Original MPF loans totaling de minimis amounts as of December 31, 2013 and 2012, and for MPF Plus loans totaling de minimis amounts as of December 31, 2013 and 2012.

*Troubled Debt Restructurings* – Troubled debt restructuring (TDR) is considered to have occurred when a concession is granted to the debtor for economic or legal reasons related to the debtor's financial difficulties and that concession would not have been considered otherwise. An MPF loan considered a TDR is individually evaluated for impairment when determining its related allowance for credit losses. Credit loss is measured by factoring in expected cashflow shortfalls incurred as of the reporting date as well as the economic loss attributable to delaying the original contractual principal and interest due dates, if applicable.

The Bank's TDRs of MPF loans primarily involve modifying the borrower's monthly payment for a period of up to 36 months to reflect a housing expense ratio that is no more than 31% of the borrower's qualifying monthly income. The outstanding principal balance is re-amortized to reflect a principal and interest payment for a term not to exceed 40 years from the original note date and a housing expense ratio not to exceed 31%. This would result in a balloon payment at the original maturity date of the loan because the maturity date and number of remaining monthly payments are not adjusted. If the 31% ratio is still not achieved through re-amortization, the interest rate is reduced in 0.125% increments below the original note rate, to a floor rate of 3.00%, resulting in reduced principal and interest payments, for the temporary payment modification period of up to 36 months, until the 31% housing expense ratio is met.

The recorded investment of the Bank's nonperforming MPF loans classified as TDRs totaled \$0.8 as of December 31, 2013 and 2012. During 2013 and 2012, the amount of the pre- and post-modification recorded investment in TDRs that occurred during the year was equal because there were no write-offs resulting from either principal forgiveness or direct write-offs. None of the MPF loans classified as TDRs within the previous 12 months experienced a payment default.

**Term Securities Purchased Under Agreements to Resell.** Securities purchased under agreements to resell are considered collateralized financing arrangements and effectively represent short-term loans with investment-grade counterparties, which are classified as assets in the Statements of Condition. Securities purchased under agreements to resell are held in safekeeping in the name of the Bank by third-party custodians approved by the Bank. In accordance with the terms of these loans, if the market value of the underlying securities decreases below the market value required as collateral, the counterparty must place an equivalent amount of additional securities as collateral or remit an equivalent amount of cash. If an agreement to resell is deemed to be impaired, the difference between the fair value of the collateral and the amortized cost of the agreement is charged to earnings. Based upon the collateral held as security, the Bank determined that no allowance for credit losses was needed for the securities purchased under agreements to resell at December 31, 2012. The Bank did not have any term securities purchased under agreements to resell at December 31, 2013.

**Term Federal Funds Sold.** The Bank invests in Federal funds sold with highly rated counterparties, and these investments are evaluated for purposes of an allowance for credit losses if the investment is not paid when due. All investments in Federal funds sold as of December 31, 2013 and 2012, were repaid or are expected to be repaid according to the contractual terms.

#### **Note 11 — 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 nonmembers. In addition, a member that services mortgage loans may deposit in the Bank funds collected in connection with the mortgage loans, pending



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

disbursement of these funds to the owners of the mortgage loans. The Bank classifies these types of deposits as non-interest-bearing deposits.

Deposits as of December 31, 2013 and 2012, were as follows:

	2013	2012
Interest-bearing deposits:		
Demand and overnight	\$ 190	\$ 224
Term	1	2
Other	1	—
Total interest-bearing deposits	192	226
Non-interest-bearing deposits	1	1
Total	\$ 193	\$ 227

**Interest Rate Payment Terms.** Deposits classified as demand, overnight, and other pay interest based on a daily interest rate. Term deposits pay interest based on a fixed rate determined at the issuance of the deposit. Interest rate payment terms for deposits at December 31, 2013 and 2012, are detailed in the following table:

	2013		2012	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Interest-bearing deposits:				
Fixed rate	\$ 1	0.01%	\$ 2	0.03%
Adjustable rate	191	0.01	224	0.01
Total interest-bearing deposits	192	0.01	226	0.01
Non-interest-bearing deposits	1	—	1	—
Total	\$ 193	0.01%	\$ 227	0.01%

The aggregate amount of time deposits with a denomination of \$0.1 or more was \$1 at December 31, 2013, and \$2 at December 31, 2012. These time deposits were scheduled to mature within three months.

## Note 12 — Consolidated Obligations

Consolidated obligations, consisting of consolidated obligation bonds and discount notes, are jointly issued by the FHLBanks through the Office of Finance, which serves as the FHLBanks' agent. As provided by the FHLBank Act or by regulations governing the operations of the FHLBanks, all FHLBanks have joint and several liability for all FHLBank consolidated obligations. For a discussion of the joint and several liability regulation, see Note 21 – Commitments and Contingencies. In connection with each issuance of consolidated obligations, each FHLBank specifies the type, term, and amount of debt it requests to have issued on its behalf. The Office of Finance tracks the amount of debt issued on behalf of each FHLBank. In addition, the Bank separately tracks and records as a liability its specific portion of the consolidated obligations issued and is the primary obligor for that portion of the consolidated obligations issued. The Finance Agency and the U.S. Secretary of the Treasury have oversight over the issuance of FHLBank debt through the Office of Finance.

Consolidated obligation bonds are issued primarily to raise intermediate- and long-term funds for the FHLBanks. The maturity of consolidated obligation bonds generally ranges from 1 to 15 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 value when they mature.

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**Notes to Financial Statements (continued)**

The par value of the outstanding consolidated obligations of all 12 FHLBanks was \$766,837 at December 31, 2013, and \$687,902 at December 31, 2012. 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. Any assets subject to a lien or pledge for the benefit of holders of any issue of consolidated obligations are treated as if they were free from lien or pledge for the purposes of compliance with these regulations. At December 31, 2013, the Bank had qualifying assets totaling \$85,547, and the Bank's participation in consolidated obligations outstanding was \$77,401.

**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 LIBOR, the Federal funds effective rate, and others. In addition, to meet the specific needs of certain investors, fixed rate and adjustable rate consolidated obligation bonds may contain certain embedded features, such as call options and complex coupon payment terms. In general, when such consolidated obligation bonds are issued for which the Bank is the primary obligor, the Bank simultaneously enters into interest rate exchange agreements containing offsetting features to, in effect, convert the terms of the bond to the terms of a simple adjustable rate bond indexed to LIBOR.

In addition to having fixed rate or simple adjustable rate coupon payment terms, consolidated obligations may include:

- Callable bonds, which the Bank may call in whole or in part at its option on predetermined call dates according to the terms of the bond offerings;
- Step-up callable bonds, which pay interest at increasing fixed rates for specified intervals over the life of the bond and can generally be called at the Bank's option on the step-up dates according to the terms of the bond offerings;
- Step-down callable bonds, which pay interest at decreasing fixed rates for specified intervals over the life of the bond and can generally be called at the Bank's option on the step-down dates according to the terms of the bond offerings;
- Conversion bonds, which have coupon rates that convert from fixed to adjustable or from adjustable to fixed on predetermined dates according to the terms of the bond offerings.

**Redemption Terms.** The following is a summary of the Bank's participation in consolidated obligation bonds at December 31, 2013 and 2012.

Contractual Maturity	2013		2012	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Within 1 year	\$ 26,161	0.40%	\$ 40,714	1.25%
After 1 year through 2 years	7,101	0.80	9,661	0.87
After 2 years through 3 years	7,740	2.94	3,622	1.34
After 3 years through 4 years	1,963	2.50	6,406	3.45
After 4 years through 5 years	2,420	1.49	2,896	2.14
After 5 years	7,384	1.99	6,022	2.18
Total par value	52,769	1.17%	69,321	1.52%
Unamortized premiums	78		69	
Unamortized discounts	(16)		(22)	
Valuation adjustments for hedging activities	491		906	
Fair value option valuation adjustments	(115)		36	
Total	\$ 53,207		\$ 70,310	



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

The Bank's participation in consolidated obligation bonds outstanding includes callable bonds of \$13,042 at December 31, 2013, and \$8,778 at December 31, 2012. When a callable bond for which the Bank is the primary obligor is issued, the Bank may simultaneously enter 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 call option embedded in the bond (a sold callable swap). The Bank had notional amounts of interest rate exchange agreements hedging callable bonds of \$9,997 at December 31, 2013, and \$4,233 at December 31, 2012. The combined sold callable swaps and callable bonds enable the Bank to meet its funding needs at costs not otherwise directly attainable solely through the issuance of non-callable debt, while effectively converting the Bank's net payment to an adjustable rate.

The Bank's participation in consolidated obligation bonds at December 31, 2013 and 2012, was as follows:

	2013		2012	
Par value of consolidated obligation bonds:				
Non-callable	\$	39,727	\$	60,543
Callable		13,042		8,778
Total par value	\$	52,769	\$	69,321

The following is a summary of the Bank's participation in consolidated obligation bonds outstanding at December 31, 2013 and 2012, by the earlier of the year of contractual maturity or next call date.

Earlier of Contractual Maturity or Next Call Date	2013		2012	
Within 1 year	\$	36,093	\$	48,712
After 1 year through 2 years		6,046		9,271
After 2 years through 3 years		7,550		3,547
After 3 years through 4 years		1,478		6,131
After 4 years through 5 years		830		1,093
After 5 years		772		567
Total par value	\$	52,769	\$	69,321

Consolidated obligation discount notes are consolidated obligations issued to raise short-term funds. These notes are issued at less than their face value and redeemed at par value when they mature. The Bank's participation in consolidated obligation discount notes, at December 31, 2013 and 2012, all of which are due within one year, was as follows:

	2013		2012	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Par value	\$ 24,199	0.10%	\$ 5,211	0.15%
Unamortized discounts	(5)		(2)	
Total	\$ 24,194		\$ 5,209	

**Interest Rate Payment Terms.** Interest rate payment terms for consolidated obligations at December 31, 2013 and 2012, are detailed in the following table.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	2013	2012
Par value of consolidated obligations:		
Bonds:		
Fixed rate	\$ 38,489	\$ 40,823
Adjustable rate	11,218	26,918
Step-up	2,460	1,345
Step-down	340	165
Fixed rate that converts to adjustable rate	262	70
Total bonds, par	52,769	69,321
Discount notes, par	24,199	5,211
Total consolidated obligations, par	\$ 76,968	\$ 74,532

Consolidated obligation bonds are structured to meet the Bank's and/or investors' needs. Common structures include fixed rate bonds with or without call options and adjustable rate bonds with or without embedded options. In general, when bonds with these structures are issued, 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 an adjustable rate bond. The cost of this funding combination is generally lower than the cost that would be available through the issuance of an adjustable rate bond alone. These transactions generally receive fair value hedge accounting treatment. In addition, for certain consolidated obligation bonds for which the Bank has elected the fair value option, the Bank will simultaneously execute an interest rate exchange agreement with terms that economically offset the terms of the consolidated obligation bond. However, this type of hedge is treated as an economic hedge because these combinations generally do not meet the requirements for fair value hedge accounting treatment. For more information, see Note 19 – Derivatives and Hedging Activities and Note 20 – Fair Value.

The Bank did not have any bonds with embedded features that met the requirements to separate the embedded feature from the host contract and designate the embedded feature as a stand-alone derivative at December 31, 2013 and 2012. In general, the Bank has elected to account for bonds with embedded features under the fair value option, and these bonds are carried at fair value on the Statements of Condition. For more information, see Note 20 – Fair Value.

### **Note 13 — Affordable Housing Program**

The FHLBank Act requires each FHLBank to establish an Affordable Housing Program (AHP). Each FHLBank provides subsidies to members, which use the funds to assist in the purchase, construction, or rehabilitation of housing for very low-, low-, and moderate-income households. Subsidies may be in the form of direct grants or below-market interest rate advances. Annually, the FHLBanks must set aside for their AHPs, in the aggregate, the greater of \$100 or 10% of the current year's net earnings (income before interest expense related to mandatorily redeemable capital stock and the assessment for AHP, but after the assessment for REFCORP before the REFCORP obligation was fully satisfied). The exclusion of interest expense related to mandatorily redeemable capital stock is based on an advisory bulletin issued by the Finance Board. The FHLBanks fully satisfied their REFCORP obligation with their payment made on July 15, 2011. For more information, see Note 14 – Resolution Funding Corporation Assessments.

The Bank accrues its AHP assessment monthly based on its net earnings. If the Bank experienced a net loss during a quarter but still had net earnings for the year, the Bank's obligation to the AHP would be calculated based on the Bank's year-to-date net earnings. If the Bank had net earnings in subsequent quarters, it would be required to contribute additional amounts to meet its calculated annual obligation. If the Bank experienced a net loss for a full year, the amount of the AHP liability would be equal to zero, since each FHLBank's required annual AHP contribution is limited to its annual net earnings. However, if the result of the aggregate 10% calculation is less than \$100 for all 12 FHLBanks, then the FHLBank Act requires that each FHLBank contribute such prorated sums as

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

may be required to ensure that the aggregate contribution of the FHLBanks equals \$100. The proration would be made on the basis of an FHLBank's income in relation to the income of all the FHLBanks for the previous year. There was no AHP shortfall, as described above, in 2013, 2012, or 2011. If an FHLBank finds that its required AHP assessments are contributing to the financial instability of that FHLBank, it may apply to the Finance Agency for a temporary suspension of its contributions. The Bank did not make such an application in 2013, 2012, or 2011.

The Bank's total AHP assessments equaled \$52, \$60, and \$25 during 2013, 2012, and 2011, respectively. These amounts were charged to earnings each year and recognized as a liability. As subsidies are disbursed, the AHP liability is reduced. The AHP liability was as follows:

		2013		2012		2011
Balance, beginning of the year	\$	144	\$	150	\$	174
AHP assessments		52		60		25
AHP grant payments		(45)		(66)		(49)
Balance, end of the year	\$	151	\$	144	\$	150

All subsidies were distributed in the form of direct grants in 2013, 2012, and 2011.

**Note 14 — Resolution Funding Corporation Assessments**

The FHLBanks were required to make payments to REFCORP from 1990 to 2011. REFCORP was established in 1989 under 12 U.S.C. Section 1441b as a means of funding the Resolution Trust Corporation, a federal instrumentality established to provide funding for the resolution and disposition of insolvent savings institutions. Each FHLBank was required to pay 20% of income calculated in accordance with U.S. GAAP after the assessment for AHP, but before the assessment for REFCORP. The AHP and REFCORP assessments were calculated simultaneously because of their interdependence. Calculation of the AHP assessment is discussed in Note 13 – Affordable Housing Program.

On August 5, 2011, the Finance Agency certified that the FHLBanks had fully satisfied their REFCORP obligation with their payment made on July 15, 2011. During 2011, the FHLBanks entered into a Joint Capital Enhancement Agreement, as amended (Agreement), that requires each FHLBank to allocate 20% of its net income to a separate restricted retained earnings account at that FHLBank until the balance of the account equals at least 1% of that FHLBank's average balance of outstanding consolidated obligations for the previous quarter. The FHLBanks began allocating 20% of net income to their new restricted retained earnings accounts in the third quarter of 2011. Under the Agreement, these restricted retained earnings will not be available to pay dividends. For more information, see Note 16 – Capital.

Because the REFCORP obligation was fully satisfied by the FHLBanks' payment for the second quarter of 2011, the Bank did not record a REFCORP assessment for the years ended December 31, 2013 and 2012, and in each of the last two quarters of 2011. The Bank's total REFCORP assessments equaled \$17 in 2011.

Changes in the Bank's REFCORP (asset)/liability were as follows:

		2011
Balance, beginning of the year	\$	37
REFCORP assessments		17
REFCORP payments		(54)
Balance, end of the year	\$	—

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Note 15 — Accumulated Other Comprehensive Income/(Loss)**

The following table summarizes the changes in accumulated other comprehensive income/(loss) for the years ended December 31, 2013, 2012, and 2011:

	Net Unrealized Gain/(Loss) on AFS Securities	Net Non-Credit- Related OTTI Loss on AFS Securities	Net Non-Credit- Related OTTI Loss on HTM Securities	Pension and Postretirement Benefits	Total Accumulated Other Comprehensive Income/(Loss)
Balance, December 31, 2010	\$ (2)	\$ —	\$ (2,934)	\$ (7)	\$ (2,943)
Other comprehensive income/(loss) before reclassifications:					
Net change in pension and postretirement benefits				(5)	(5)
Non-credit-related OTTI loss			(207)		(207)
Non-credit-related OTTI loss transferred		(2,672)	2,672		—
Net change in fair value	3	810			813
Accretion of non-credit-related OTTI loss			266		266
Reclassification from other comprehensive income/ (loss) to net income/(loss):					
Non-credit-related OTTI to credit-related OTTI		26	157		183
Net current period other comprehensive income/(loss)	3	(1,836)	2,888	(5)	1,050
Balance, December 31, 2011	1	(1,836)	(46)	(12)	(1,893)
Other comprehensive income/(loss) before reclassifications:					
Non-credit-related OTTI loss			(25)		(25)
Non-credit-related OTTI loss transferred		(28)	28		—
Net change in fair value	(1)	1,102			1,101
Accretion of non-credit-related OTTI loss			9		9
Reclassification from other comprehensive income/ (loss) to net income/(loss):					
Non-credit-related OTTI to credit-related OTTI		14	—		14
Net current period other comprehensive income/(loss)	(1)	1,088	12	—	1,099
Balance, December 31, 2012	—	(748)	(34)	(12)	(794)
Other comprehensive income/(loss) before reclassifications:					
Net change in pension and postretirement benefits				5	5
Non-credit-related OTTI loss			(4)		(4)
Non-credit-related OTTI loss transferred		(4)	4		—
Net change in fair value		644			644
Accretion of non-credit-related OTTI loss			7		7
Reclassification from other comprehensive income/ (loss) to net income/(loss):					
Non-credit-related OTTI to credit-related OTTI		(3)	—		(3)
Net current period other comprehensive income/(loss)	—	637	7	5	649
Balance, December 31, 2013	\$ —	\$ (111)	\$ (27)	\$ (7)	\$ (145)

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

## Note 16 — Capital

**Capital Requirements.** The Bank issues only one class of capital stock, Class B stock, with a par value of one hundred dollars per share, which may be redeemed (subject to certain conditions) upon five years' notice by the member to the Bank. In addition, at its discretion, under certain conditions, the Bank may repurchase excess capital stock at any time. (See "Excess Capital Stock" below for more information.) The capital stock may be issued, redeemed, and repurchased only at its stated par value, subject to certain statutory and regulatory requirements. The Bank may only redeem or repurchase capital stock from a shareholder if, following the redemption or repurchase, the shareholder will continue to meet its minimum capital stock requirement and the Bank will continue to meet its regulatory requirements for total capital, leverage capital, and risk-based capital.

Under the Housing Act, the Director of the Finance Agency is responsible for setting the risk-based capital standards for the FHLBanks. The FHLBank Act and regulations governing the operations of the FHLBanks require that the Bank's minimum capital stock requirement for shareholders must be sufficient to enable the Bank to meet its regulatory requirements for total capital, leverage capital, and risk-based capital. The Bank must maintain: (i) total regulatory capital in an amount equal to at least 4% of its total assets, (ii) leverage capital in an amount equal to at least 5% of its total assets, and (iii) permanent capital in an amount at least equal to its risk-based capital requirement. Because the Bank issues only Class B stock, regulatory capital and permanent capital for the Bank are both composed of retained earnings and Class B stock, including mandatorily redeemable capital stock (which is classified as a liability for financial reporting purposes). Regulatory capital and permanent capital do not include AOCI. Leverage capital is defined as the sum of permanent capital, weighted by a 1.5 multiplier, plus non-permanent capital.

The Bank's permanent capital must be greater than or equal to its risk-based capital requirement, which is equal to the sum of the Bank's credit risk, market risk, and operations risk capital requirements, all of which are calculated in accordance with the rules and regulations of the Finance Agency. The Finance Agency may require an FHLBank to maintain a greater amount of permanent capital than is required by the risk-based capital requirement as defined.

As of December 31, 2013 and 2012, the Bank was in compliance with these capital rules and requirements as shown in the following table.

	2013		2012	
	Required	Actual	Required	Actual
Risk-based capital	\$ 3,912	\$ 7,925	\$ 4,073	\$ 10,750
Total regulatory capital	\$ 3,431	\$ 7,925	\$ 3,457	\$ 10,750
Total regulatory capital ratio	4.00%	9.24%	4.00%	12.44%
Leverage capital	\$ 4,289	\$ 11,888	\$ 4,321	\$ 16,125
Leverage ratio	5.00%	13.86%	5.00%	18.66%

The Bank's capital plan requires each member to own capital stock in an amount equal to the greater of its membership capital stock requirement or its activity-based capital stock requirement. The Bank may adjust these requirements from time to time within limits established in the capital plan. Any changes to the capital plan must be approved by the Bank's Board of Directors and the Finance Agency.

A member's membership capital stock requirement is 1.0% of its membership asset value. The membership capital stock requirement for a member is capped at \$25. The Bank may adjust the membership capital stock requirement for all members within a range of 0.5% to 1.5% of a member's membership asset value and may adjust the cap for all members within an authorized range of \$10 to \$50. 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

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**Notes to Financial Statements (continued)**

accepted by the Bank as eligible collateral. The membership asset factors were initially 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 activity-based capital stock requirement is 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 capital stock requirement for all members 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.

The Gramm-Leach-Bliley Act (GLB Act) established voluntary membership for all members. Any member may withdraw from membership and, subject to certain statutory and regulatory restrictions, have its capital stock redeemed after giving the required notice. Members that withdraw from membership may not reapply for membership for five years, in accordance with Finance Agency rules.

**Mandatorily Redeemable Capital Stock.** The Bank reclassifies the capital stock subject to redemption from capital to a liability after a member provides the Bank with a written notice of redemption; gives notice of intention to withdraw from membership; or attains nonmember status by merger or acquisition, charter termination, or other involuntary membership termination; or after a receiver or other liquidating agent for a member transfers the member's Bank capital stock to a nonmember entity, resulting in the member's shares then meeting the definition of a mandatorily redeemable financial instrument. Shares meeting this definition are reclassified to a liability at fair value. Dividends declared on shares classified as a liability are accrued at the expected dividend rate and reflected as interest expense in the Statements of Income. The repayment of these mandatorily redeemable financial instruments (by repurchase or redemption of the shares) is reflected as a financing cash outflow in the Statements of Cash Flows once settled.

The Bank has a cooperative ownership structure under which members, former members, and certain other nonmembers own the Bank's capital stock. Former members and certain other nonmembers are required to maintain their investment in the Bank's capital stock until their outstanding transactions are paid off or until their capital stock is redeemed following the relevant five-year redemption period for capital stock or is repurchased by the Bank, in accordance with the Bank's capital requirements. Capital stock cannot be issued, repurchased, redeemed, or transferred except between the Bank and its members (or their affiliates and successors) at the capital stock's par value of one hundred dollars per share. If a member cancels its written notice of redemption or notice of withdrawal or if the Bank allows the transfer of mandatorily redeemable capital stock to a member, the Bank reclassifies mandatorily redeemable capital stock from a liability to capital. After the reclassification, dividends on the capital stock are no longer classified as interest expense.

The Bank will not redeem or repurchase capital stock required to meet the minimum capital stock requirement until five years after the member's membership is terminated or after the Bank receives notice of the member's withdrawal, and the Bank will redeem or repurchase only the amounts that are in excess of the capital stock required to support activity (advances and mortgage loans) that may remain outstanding after the five-year redemption period has expired. The Bank will not redeem or repurchase activity-based capital stock as long as the activity remains outstanding, even after the expiration of the five-year redemption period. In both cases, the Bank will only redeem or repurchase capital stock if certain statutory and regulatory conditions are met. In accordance with the Bank's current practice, if activity-based capital stock becomes excess capital stock because an activity no longer remains outstanding, the Bank may repurchase the excess activity-based capital stock at its discretion, subject to certain statutory and regulatory conditions, on a scheduled quarterly basis.

The Bank had mandatorily redeemable capital stock totaling \$2,071 outstanding to 44 institutions at December 31, 2013, and \$4,343 outstanding to 53 institutions at December 31, 2012. The change in mandatorily redeemable capital stock for the years ended December 31, 2013, 2012, and 2011 was as follows:



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**Notes to Financial Statements (continued)**

	2013	2012	2011
Balance at the beginning of the year	\$ 4,343	\$ 5,578	\$ 3,749
Reclassified from/(to) capital during the period:			
Merger with or acquisition by nonmember institution	4	30	19
Withdrawal from membership	—	3	—
Termination of membership <sup>(1)</sup>	—	4	3,169
Acquired by/transferred to members <sup>(2)</sup>	—	—	(500)
Redemption of mandatorily redeemable capital stock	(502)	(43)	(57)
Repurchase of excess mandatorily redeemable capital stock	(1,774)	(1,229)	(802)
Balance at the end of the year	\$ 2,071	\$ 4,343	\$ 5,578

- (1) The Bank reclassified \$3,165 of capital stock to mandatorily redeemable capital stock (a liability) on June 28, 2011, as a result of the membership termination of Citibank, N.A., which became ineligible for membership in the Bank when it became a member of another FHLBank in connection with its merger with an affiliate outside of the Bank's district.
- (2) During the first quarter of 2011, the Bank allowed the transfer of excess capital stock totaling \$500, from JPMorgan Chase Bank, National Association, to JPMorgan Bank and Trust Company, National Association, to enable JPMorgan Bank and Trust Company, National Association, to satisfy its activity-based capital stock requirement. The capital stock transferred is no longer classified as mandatorily redeemable capital stock (a liability). However, the capital stock remaining with JPMorgan Chase Bank, National Association, remains classified as mandatorily redeemable capital stock (a liability).

Cash dividends on mandatorily redeemable capital stock in the amount of \$155, \$51, and \$12 were recorded as interest expense in December 31, 2013, 2012, and 2011, respectively.

The following table presents mandatorily redeemable capital stock amounts by contractual redemption period at December 31, 2013 and 2012.

Contractual Redemption Period	2013	2012
Within 1 year	\$ 571	\$ 847
After 1 year through 2 years	111	1,003
After 2 years through 3 years	1,289	194
After 3 years through 4 years	20	2,263
After 4 years through 5 years	3	36
Past contractual redemption date because of remaining activity <sup>(1)</sup>	77	—
Total	\$ 2,071	\$ 4,343

- (1) Represents mandatorily redeemable capital stock that is past the end of the contractual redemption period because of outstanding activity.

A member may cancel its notice of redemption or notice of withdrawal from membership by providing written notice to the Bank prior to the end of the relevant five-year redemption period or the membership termination date. If the Bank receives the notice of cancellation within 30 months following the notice of redemption or notice of withdrawal, the member is charged a fee equal to fifty cents multiplied by the number of shares of capital stock affected. If the Bank receives the notice of cancellation more than 30 months following the notice of redemption or notice of withdrawal (or if the Bank does not redeem the member's capital stock because following the redemption the member would fail to meet its minimum capital stock requirement), the member is charged a fee equal to one dollar multiplied by the number of shares of capital stock affected. In certain cases the Board of Directors may waive a cancellation fee for bona fide business purposes.

The Bank's capital stock is considered putable by the shareholder. There are significant statutory and regulatory restrictions on the Bank's obligation or ability to redeem outstanding capital stock, which include the following:

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Notes to Financial Statements (continued)**

- The Bank may not redeem any capital stock if, following the redemption, the Bank would fail to meet its minimum capital requirements for total capital, leverage capital, and risk-based capital. All of the Bank's capital stock immediately becomes nonredeemable if the Bank fails to meet its minimum capital requirements.
- The Bank may not be able to redeem any capital stock if either its Board of Directors or the Finance Agency determines that it has incurred or is likely to incur losses resulting in or expected to result in a charge against capital that would have any of the following effects: cause the Bank not to comply with its regulatory capital requirements, result in negative retained earnings, or otherwise create an unsafe and unsound condition at the Bank.
- In addition to being able to prohibit capital stock redemptions, the Bank's Board of Directors has a right and an obligation to call for additional capital stock purchases by its members, as a condition of continuing membership, as needed for the Bank to satisfy its statutory and regulatory capital requirements.
- If, during the period between receipt of a capital stock redemption notice and the actual redemption (a period that could last indefinitely), the Bank becomes insolvent and is either liquidated or merged with another FHLBank, the redemption value of the capital stock will be established either through the liquidation or the merger process. If the Bank is liquidated, after satisfaction of the Bank's obligations to creditors and to the extent funds are then available, each shareholder will be entitled to receive the par value of its capital stock as well as any retained earnings in an amount proportional to the shareholder's share of the total shares of capital stock, subject to any limitations that may be imposed by the Finance Agency. In the event of a merger or consolidation, the Board of Directors will determine the rights and preferences of the Bank's shareholders, subject to any terms and conditions imposed by the Finance Agency.
- The Bank may not redeem any capital stock if the principal or interest due on any consolidated obligations issued by the Office of Finance has not been paid in full.
- The Bank may not redeem any capital stock if the Bank fails to provide the Finance Agency with the quarterly certification required by section 1270.10(b)(1) of the Finance Agency rules prior to declaring or paying dividends for a quarter.
- The Bank may not redeem any capital stock if the Bank is unable to provide the required quarterly certification, projects that it will fail to comply with statutory or regulatory liquidity requirements or will be unable to fully meet all of its obligations on a timely basis, actually fails to satisfy these requirements or obligations, or negotiates to enter or enters into an agreement with another FHLBank to obtain financial assistance to meet its current obligations.

Mandatorily redeemable capital stock is considered capital for determining the Bank's compliance with its regulatory capital requirements. Based on Finance Agency interpretation, the classification of certain shares of the Bank's capital stock as mandatorily redeemable does not affect the definition of total capital for purposes of: determining the Bank's compliance with its regulatory capital requirements, calculating its mortgage-backed securities investment authority (300% of total capital), calculating its unsecured credit exposure to other GSEs (limited to 100% of total capital), or calculating its unsecured credit limits to other counterparties (various percentages of total capital depending on the rating of the counterparty).

**Excess Stock Repurchase, Retained Earnings, and Dividend Framework.** By Finance Agency regulation, dividends may be paid only out of current net earnings or previously retained earnings. As required by the Finance Agency, the Bank's Excess Stock Repurchase, Retained Earnings, and Dividend Framework is reviewed at least annually by the Bank's Board of Directors. It summarizes the Bank's capital management principles, strategy, and objectives, as well as its policies, analysis, and practices with respect to retained earnings, dividend payments, and the repurchase of excess capital stock. The Board of Directors may amend the Excess Stock Repurchase, Retained Earnings, and Dividend Framework from time to time.

The Bank's Excess Stock Repurchase, Retained Earnings, and Dividend Framework establishes amounts to be retained in restricted retained earnings, which are not made available for dividends in the current dividend period. 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



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**Notes to Financial Statements (continued)**

addition, the Bank may not pay dividends if any principal or interest due on any consolidated obligations has not been paid in full or is not expected to be paid in full by any FHLBank, or, under certain circumstances, if the Bank fails to satisfy certain liquidity requirements under applicable Finance Agency regulations.

The Bank's Risk Management Policy limits the payment of dividends based on the ratio of the Bank's estimated market value of total capital to par value of capital stock. If this ratio at the end of any quarter is less than 100% but greater than or equal to 70%, any dividend would be limited to an annualized rate no greater than the daily average of the three-month LIBOR for the applicable quarter (subject to certain conditions), and if this ratio is less than 70%, the Bank would be restricted from paying a dividend. The ratio of the Bank's estimated market value of total capital to par value of capital stock was 144.9% as of December 31, 2013.

*Retained Earnings Related to Valuation Adjustments* - In accordance with the Bank's Excess Stock Repurchase, Retained Earnings, and Dividend Framework, the Bank retains in restricted retained earnings any cumulative net gains in earnings (net of applicable assessments) resulting from gains or losses on derivatives and associated hedged items and financial instruments carried at fair value (valuation adjustments).

In general, the Bank's derivatives and hedged instruments, as well as certain assets and liabilities that are carried at fair value, are held to the maturity, call, or put date. For these financial instruments, net valuation gains or losses are primarily a matter of timing and will generally reverse through changes in future valuations and settlements of contractual interest cash flows over the remaining contractual terms to maturity, or by the exercised call or put dates. However, the Bank may have instances in which hedging relationships are terminated prior to maturity or prior to the call or put dates. Terminating the hedging relationship may result in a realized gain or loss. In addition, the Bank may have instances in which it may sell trading securities prior to maturity, which may also result in a realized gain or loss.

The purpose of retaining cumulative net gains in earnings resulting from valuation adjustments as restricted retained earnings is to provide sufficient retained earnings to offset future net losses that result from the reversal of cumulative net gains, so that potential dividend payouts in future periods are not necessarily affected by the reversals of these gains. Although restricting retained earnings in this way may preserve the Bank's ability to pay dividends, the reversal of the cumulative net gains in any given period may result in a net loss if the reversal exceeds net earnings before the impact of valuation adjustments for that period.

*Other Retained Earnings – Targeted Buildup* – In addition to any cumulative net gains resulting from valuation adjustments, the Bank holds an additional amount in restricted retained earnings intended to protect paid-in capital from the effects of an extremely adverse credit event, an extremely adverse operations risk event, a cumulative net loss related to the Bank's derivatives and associated hedged items and financial instruments carried at fair value, an extremely adverse change in the market value of the Bank's capital, a significant amount of additional credit-related OTTI on PLRMBS, or some combination of these effects, especially in periods of extremely low net income resulting from an adverse interest rate environment.

The Board of Directors has set the targeted amount of restricted retained earnings at \$1,800, and the Bank reached this target as of March 31, 2012. The Bank's retained earnings target may be changed at any time. The Board of Directors periodically reviews the applicable methodology and analysis to determine whether any adjustments are appropriate. As of December 31, 2013, the amount of restricted retained earnings in the Bank's targeted buildup account was \$1,800.

*Joint Capital Enhancement Agreement* – In 2011, the 12 FHLBanks entered into a Joint Capital Enhancement Agreement, as amended (Agreement), which is intended to enhance the capital position of each FHLBank by allocating that portion of each FHLBank's earnings historically paid to satisfy its Resolution Funding Corporation (REFCORP) obligation to a separate retained earnings account at that FHLBank.

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**Notes to Financial Statements (continued)**

On August 5, 2011, the Finance Agency certified that the FHLBanks had fully satisfied their REFCORP obligation. In accordance with the Agreement, starting in the third quarter of 2011, each FHLBank is required to allocate 20% of its net income each quarter to a separate restricted retained earnings account until the balance of the account equals at least 1% of that FHLBank's average balance of outstanding consolidated obligations for the previous quarter. Under the Agreement, these restricted retained earnings will not be available to pay dividends.

The following table summarizes the activity related to restricted retained earnings for the years ended December 31, 2013 and 2012:

	2013				2012			
	Restricted Retained Earnings Related to:				Restricted Retained Earnings Related to:			
	Valuation Adjustments	Targeted Buildup	Joint Capital Enhancement Agreement	Total	Valuation Adjustments	Targeted Buildup	Joint Capital Enhancement Agreement	Total
Balance at the beginning of the year	\$ 73	\$ 1,800	\$ 128	\$ 2,001	\$ 79	\$ 1,695	\$ 29	\$ 1,803
Transfers to/(from) restricted retained earnings	15	—	61	76	(6)	105	99	198
Balance at the end of the year	\$ 88	\$ 1,800	\$ 189	\$ 2,077	\$ 73	\$ 1,800	\$ 128	\$ 2,001

*Dividend Payments* – Finance Agency rules state that FHLBanks may declare and pay dividends only from previously retained earnings or current net earnings, and may not declare or pay dividends based on projected or anticipated earnings. There is no requirement that the Board of Directors declare and pay any dividend. A decision by the Board of Directors to declare or not declare a dividend is a discretionary matter and is subject to the requirements and restrictions of the FHLBank Act and applicable requirements under the regulations governing the operations of the FHLBanks.

The Bank currently pays dividends in cash rather than capital stock to comply with Finance Agency rules, which do not permit the Bank to pay dividends in the form of capital stock if its excess capital stock exceeds 1% of its total assets. Excess capital stock is defined as the aggregate of the capital stock held by each shareholder in excess of its minimum capital stock requirement, as established by the Bank's capital plan. As of December 31, 2013, the Bank's excess capital stock totaled \$2,446, or 2.85% of total assets.

Dividends on capital stock are recognized as cash dividends on the Statements of Capital Accounts, and dividends on mandatorily redeemable capital stock are recognized as interest expense on the Statements of Income.

The Bank paid dividends (including dividends on mandatorily redeemable capital stock) totaling \$316 at an annualized rate of 3.99% in 2013 and \$98 at an annualized rate of 0.97% in 2012.

On February 20, 2014, the Bank's Board of Directors declared a cash dividend on the capital stock outstanding during the fourth quarter of 2013 at an annualized rate of 6.67%, totaling \$98, including \$59 in dividends on capital stock and \$39 in dividends on mandatorily redeemable capital stock. The Bank recorded the dividend on February 20, 2014, the day it was declared by the Board of Directors. The Bank expects to pay the dividend on or about March 20, 2014. Dividends on mandatorily redeemable capital stock will be recognized as interest expense in the first quarter of 2014.

The Bank will continue to monitor the condition of its PLRMBS portfolio, the ratio of the estimated market value of the Bank's capital to the par value of the Bank's capital stock, its overall financial performance and retained earnings, developments in the mortgage and credit markets, and other relevant information as the basis for determining the payment of dividends in future quarters.

*Excess Capital Stock* – The Bank may repurchase some or all of a shareholder's excess capital stock, including any excess mandatorily redeemable capital stock, at the Bank's discretion, subject to certain statutory and regulatory requirements. The Bank must give the shareholder 15 days' written notice; however, the shareholder may waive this

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

notice period. The Bank may also repurchase some or all of a shareholder's excess capital stock at the shareholder's request, at the Bank's discretion, subject to certain statutory and regulatory requirements. A shareholder's excess capital stock is defined as any capital stock holdings in excess of the shareholder's minimum capital stock requirement, as established by the Bank's capital plan.

On a quarterly basis, the Bank determines whether it will repurchase excess capital stock. The Bank repurchased \$3,000 and \$2,093 in excess capital stock during 2013 and 2012, respectively.

During 2013 and 2012, the five-year redemption period for \$502 and \$43, respectively, in mandatorily redeemable capital stock expired, and the Bank redeemed the capital stock at its \$100 par value on the relevant scheduled redemption dates.

On February 20, 2014, the Bank announced that it plans to repurchase \$750 in excess capital stock on March 21, 2014. The amount of excess capital stock to be repurchased from each shareholder will be based on the total amount of capital stock (including mandatorily redeemable capital stock) outstanding to all shareholders on the repurchase date. The Bank will repurchase an equal percentage of each shareholder's total capital stock to the extent that the shareholder has sufficient excess capital stock.

The Bank will continue to monitor the condition of its PLRMBS portfolio, the ratio of the estimated market value of the Bank's capital to the par value of the Bank's capital stock, its overall financial performance and retained earnings, developments in the mortgage and credit markets, and other relevant information as the basis for determining the repurchase of excess capital stock in future quarters.

Excess capital stock totaled \$2,446 as of December 31, 2013, and \$5,452 as of December 31, 2012.

**Concentration.** The following table presents the concentration in capital stock held by institutions whose capital stock ownership represented 10% or more of the Bank's outstanding capital stock, including mandatorily redeemable capital stock, as of December 31, 2013 and 2012.

Name of Institution	2013		2012	
	Capital Stock Outstanding	Percentage of Total Capital Stock Outstanding	Capital Stock Outstanding	Percentage of Total Capital Stock Outstanding
<b>Citigroup Inc.:</b>				
Citibank, N.A. <sup>(1)</sup>	\$ 1,279	23%	\$ 2,246	26%
Banamex USA	1	—	2	—
Subtotal Citigroup Inc.	1,280	23	2,248	26
<b>JPMorgan Chase &amp; Co.:</b>				
JPMorgan Bank & Trust Company, National Association	594	11	1,044	13
JPMorgan Chase Bank, National Association <sup>(1)</sup>	77	1	695	8
Subtotal JPMorgan Chase & Co.	671	12	1,739	21
<b>Wells Fargo &amp; Company:</b>				
Wells Fargo Bank, N.A. <sup>(1)</sup>	518	9	909	11
Wells Fargo Financial National Bank	5	—	3	—
Subtotal Wells Fargo & Company	523	9	912	11
Total capital stock ownership over 10%	2,474	44	4,899	58
Others	3,057	56	3,604	42
Total	\$ 5,531	100%	\$ 8,503	100%

(1) The capital stock held by these nonmember institutions is classified as mandatorily redeemable capital stock.

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Notes to Financial Statements (continued)**

**Note 17 — Employee Retirement Plans and Incentive Compensation Plans**

***Defined Benefit Plans***

**Qualified Defined Benefit Plan.** The Bank provides retirement benefits through a Bank-sponsored Cash Balance Plan, a qualified defined benefit plan. The Cash Balance Plan is provided to all employees who have completed six months of Bank service. Under the plan, each eligible Bank employee accrues benefits annually equal to 6% of the employee's annual compensation, plus 6% interest on the benefits accrued to the employee through the prior yearend. The Cash Balance Plan is funded through a qualified trust established by the Bank.

**Non-Qualified Defined Benefit Plans.** The Bank sponsors the following non-qualified defined benefit retirement plans:

- Benefit Equalization Plan, a non-qualified retirement plan restoring benefits offered under the Cash Balance Plan that are limited by laws governing the plan. See below for further discussion of the defined contribution portion of the Benefit Equalization Plan.
- Supplemental Executive Retirement Plan (SERP), a non-qualified unfunded retirement benefit plan available to the Bank's eligible senior officers, which generally provides a service-linked supplemental cash balance annual contribution credit to SERP participants and an annual interest credit of 6% that is in addition to the contributions made to the Cash Balance Plan.
- Deferred Compensation Plan, a non-qualified retirement plan available to eligible Bank officers, which provides make-up pension benefits that would have been earned under the Cash Balance Plan had the compensation not been deferred. The make-up benefits vest according to the corresponding provisions of the Cash Balance Plan. See below for further discussion of the defined contribution portion of the Deferred Compensation Plan.

**Postretirement Health Benefit Plan.** The Bank provides a postretirement health benefit plan to employees hired before January 1, 2003. The Bank's costs are capped at 1998 health care premium amounts. As a result, changes in health care cost trend rates will have no effect on the Bank's accumulated postretirement benefit obligation or service and interest costs.

The following table summarizes the changes in the benefit obligations, plan assets, and funded status of the defined benefit Cash Balance Plan, non-qualified defined benefit plans, and postretirement health benefit plan for the years ended December 31, 2013 and 2012.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	2013			2012		
	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan
<b>Change in benefit obligation</b>						
Benefit obligation, beginning of the year	\$ 36	\$ 18	\$ 2	\$ 31	\$ 16	\$ 2
Service cost	3	2	—	3	1	—
Interest cost	1	1	—	1	1	—
Amendments	—	1	—	—	—	—
Actuarial gain/(loss)	(2)	(1)	—	1	1	—
Benefits paid	(1)	—	—	—	(1)	—
Benefit obligation, end of the year	\$ 37	\$ 21	\$ 2	\$ 36	\$ 18	\$ 2
<b>Change in plan assets</b>						
Fair value of plan assets, beginning of the year	\$ 32	\$ —	\$ —	\$ 24	\$ —	\$ —
Actual return on plan assets	5	—	—	3	—	—
Employer contributions	2	—	—	5	1	—
Benefits paid	(1)	—	—	—	(1)	—
Fair value of plan assets, end of the year	\$ 38	\$ —	\$ —	\$ 32	\$ —	\$ —
Funded status at the end of the year	\$ 1	\$ (21)	\$ (2)	\$ (4)	\$ (18)	\$ (2)

Amounts recognized in the Statements of Condition at December 31, 2013 and 2012, consist of:

	2013			2012		
	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan
Other liabilities	\$ 1	\$ (21)	\$ (2)	\$ (4)	\$ (18)	\$ (2)

Amounts recognized in AOCI at December 31, 2013 and 2012, consist of:

	2013			2012		
	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan
Net loss/(gain)	\$ 5	\$ 3	\$ (2)	\$ 10	\$ 3	\$ (1)
Prior service cost	—	1	—	—	—	—
AOCI	\$ 5	\$ 4	\$ (2)	\$ 10	\$ 3	\$ (1)

The following table presents information for pension plans with benefit obligations in excess of plan assets at December 31, 2013 and 2012.

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**Notes to Financial Statements (continued)**

	2013			2012		
	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan
Projected benefit obligation	\$ 37	\$ 21	\$ 2	\$ 36	\$ 18	\$ 2
Accumulated benefit obligation	36	20	2	34	17	2
Fair value of plan assets	38	—	—	32	—	—

Components of the net periodic benefit costs and other amounts recognized in other comprehensive income for the years ended December 31, 2013, 2012, and 2011, were as follows:

	2013			2012			2011		
	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan
Net periodic benefit cost/(income)									
Service cost	\$ 3	\$ 2	\$ —	\$ 3	\$ 1	\$ —	\$ 2	\$ 1	\$ —
Interest cost	1	1	—	1	1	—	1	1	—
Expected return on plan assets	(3)	—	—	(2)	—	—	(2)	—	—
Amortization of net loss/(gain)	1	—	—	1	—	—	—	—	—
Net periodic benefit cost	2	3	—	3	2	—	1	2	—
Other changes in plan assets and benefit obligations recognized in other comprehensive income									
Net loss/(gain)	(5)	—	(1)	(1)	—	—	4	2	(1)
Prior service cost	—	1	—	—	—	—	—	—	—
Total recognized in other comprehensive income	(5)	1	(1)	(1)	—	—	4	2	(1)
Total recognized in net periodic benefit cost and other comprehensive income	\$ (3)	\$ 4	\$ (1)	\$ 2	\$ 2	\$ —	\$ 5	\$ 4	\$ (1)

The amounts in AOCI expected to be recognized as components of net periodic benefit cost in 2014 are de minimis.

Weighted average assumptions used to determine the benefit obligations at December 31, 2013 and 2012, for the Cash Balance Plan, non-qualified defined benefit plans, and postretirement health benefit plan were as follows:

	2013			2012		
	Cash Balance Plan	Non-Qualified Defined Benefit Plans	Post-retirement Health Benefit Plan	Cash Balance Plan	Non-Qualified Defined Benefit Plans	Post-retirement Health Benefit Plan
Discount rate	4.25%	4.25%	4.75%	3.25%	3.25%	3.75%
Rate of salary increase	3.00% through 2015 4.00% thereafter	3.00% through 2015 4.00% thereafter	—	3.00% through 2015 4.00% thereafter	3.00% through 2015 4.00% thereafter	—

Weighted average assumptions used to determine the net periodic benefit costs for the years ended December 31, 2013, 2012, and 2011, for the Cash Balance Plan, non-qualified defined benefit plans, and postretirement health benefit plan were as follows:

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**Notes to Financial Statements (continued)**

	2013			2012			2011		
	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan	Cash Balance Plan	Non- Qualified Defined Benefit Plans	Post- retirement Health Benefit Plan
Discount rate	3.25%	3.25%	3.75%	4.00%	4.00%	4.25%	5.00%	5.00%	5.50%
Rate of salary increase	3.00% through 2015 4.00% thereafter	3.00% through 2015 4.00% thereafter	—	4.00	4.00	—	4.00	4.00	—
Expected return on plan assets	8.00	—	—	8.00	—	—	8.00	—	—

The Bank uses a discount rate to determine the present value of its future benefit obligations. The discount rate was determined based on the Citigroup Pension Discount Curve at the measurement date. The Citigroup Pension Discount Curve is a yield curve that reflects the market-observed yields for high-quality fixed income securities for each maturity. The projected benefit payments for each year from the plan are discounted using the spot rates on the yield curve to derive a single equivalent discount rate. The discount rate is reset annually on the measurement date.

The expected return on plan assets was determined based on: (i) the historical returns for each asset class, (ii) the expected future long-term returns for these asset classes, and (iii) the plan's target asset allocation.

The table below presents the fair values of the Cash Balance Plan's assets as of December 31, 2013 and 2012, by asset category. See Note 20 – Fair Value for further information regarding the three levels of fair value measurement.

Asset Category	2013				2012			
	Fair Value Measurement Using:			Total	Fair Value Measurement Using:			Total
	Level 1	Level 2	Level 3		Level 1	Level 2	Level 3	
Cash and cash equivalents	\$ 1	\$ —	\$ —	\$ 1	\$ 1	\$ —	\$ —	\$ 1
Equity mutual funds	24	—	—	24	18	—	—	18
Fixed income mutual funds	12	—	—	12	11	—	—	11
Real estate mutual funds	1	—	—	1	1	—	—	1
Other mutual funds	—	—	—	—	1	—	—	1
Total	\$ 38	\$ —	\$ —	\$ 38	\$ 32	\$ —	\$ —	\$ 32

The Cash Balance Plan is administered by the Bank's Retirement Committee, which establishes the plan's Statement of Investment Policy and Objectives. The Retirement Committee has adopted a strategic asset allocation based on a stable distribution of assets among major asset classes. These asset classes include domestic large-, mid-, and small-capitalization equity investments; international equity investments; and fixed income investments. The Retirement Committee has set the Cash Balance Plan's target allocation percentages for a mix range of 50% to 70% equity and 30% to 50% fixed income. The Retirement Committee reviews the performance of the Cash Balance Plan on a regular basis.

The Cash Balance Plan's weighted average asset allocation at December 31, 2013 and 2012, by asset category was as follows:



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**Notes to Financial Statements (continued)**

Asset Category	2013	2012
Cash and cash equivalents	2%	4%
Equity mutual funds	62	58
Fixed income mutual funds	32	34
Real estate mutual funds	2	2
Other mutual funds	2	2
Total	100%	100%

The Bank contributed \$2 in 2013 and expects to contribute \$2 in 2014 to the Cash Balance Plan. The Bank contributed a de minimis amount in 2013 and expects to contribute \$1 in 2014 to the non-qualified defined benefit plans and postretirement health benefit plan.

The following are the estimated future benefit payments, which reflect expected future service, as appropriate:

Year	Cash Balance Plan	Non-Qualified Defined Benefit Plans	Postretirement Health Benefit Plan
2014	\$ 2	\$ 1	\$ —
2015	3	3	—
2016	3	3	—
2017	3	2	—
2018	3	3	—
2019 – 2023	19	9	1

### ***Defined Contribution Plans***

**Retirement Savings Plan.** The Bank sponsors a qualified defined contribution retirement 401(k) savings plan, the Federal Home Loan Bank of San Francisco Savings Plan (Savings Plan). Contributions to the Savings Plan consist of elective participant contributions of up to 20% of each participant's base compensation and a Bank matching contribution of up to 6% of each participant's base compensation. The Bank contributed approximately \$2, \$2, and \$2 during the years ended December 31, 2013, 2012, and 2011, respectively.

**Benefit Equalization Plan.** The Bank sponsors a non-qualified retirement plan restoring benefits offered under the Savings Plan that have been limited by laws governing the plan. Contributions made during the years ended December 31, 2013, 2012, and 2011, were de minimis.

**Deferred Compensation Plan.** The Bank maintains a deferred compensation plan that is available to all eligible Bank officers and directors. The defined contribution portion of the plan is comprised of two components: (i) officer or director deferral of current compensation, and (ii) make-up matching contributions for officers that would have been made by the Bank under the Savings Plan had the compensation not been deferred. The make-up benefits under the Deferred Compensation Plan vest according to the corresponding provisions of the Savings Plan. The Deferred Compensation Plan liability consists of the accumulated compensation deferrals and accrued earnings on the deferrals, as well as the make-up matching contributions and any accrued earnings on the contributions. The Bank's obligation for this plan at December 31, 2013, 2012, and 2011, was \$30, \$25, and \$22, respectively.

### ***Incentive Compensation Plans***

The Bank provides incentive compensation plans for many of its employees, including senior officers. Other liabilities include \$12 and \$12 for incentive compensation at December 31, 2013 and 2012, respectively.



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**Notes to Financial Statements (continued)**

**Note 18 — Segment Information**

The Bank uses an analysis of financial performance based on the balances and adjusted net interest income of two operating segments, the advances-related business and the mortgage-related business, as well as other financial information, to review and assess financial performance and to determine the allocation of resources to these two major business segments. For purposes of segment reporting, adjusted net interest income includes interest income and expense associated with economic hedges that are recorded in “Net gain/(loss) on derivatives and hedging activities” in other income and excludes interest expense that is recorded in “Mandatorily redeemable capital stock.” Other key financial information, such as any credit-related OTTI charges on the Bank’s PLRMBS, other expenses, and assessments, is not included in the segment reporting analysis, but is incorporated into the Bank’s overall assessment of financial performance.

The advances-related business consists of advances and other credit products, related financing and hedging instruments, liquidity and other non-MBS investments associated with the Bank’s role as a liquidity provider, and capital stock. Adjusted net interest income for this segment is derived primarily from the difference, or spread, between the yield on all assets associated with the business activities in this segment and the cost of funding those activities, including 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. Adjusted net interest income for this segment is derived primarily from the difference, or spread, between the yield on the MBS 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 presents the Bank’s adjusted net interest income by operating segment and reconciles total adjusted net interest income to income before assessments for the years ended December 31, 2013, 2012, and 2011.

	Advances- Related Business	Mortgage- Related Business <sup>(1)</sup>	Adjusted Net Interest Income	Amortization of Basis Adjustments <sup>(2)</sup>	Net Interest Income/ (Expense) on Economic Hedges <sup>(3)</sup>	Interest Expense on Mandatorily Redeemable Capital Stock <sup>(4)</sup>	Net Interest Income	Other Income/ (Loss)	Other Expense	Income Before Assessments
2013	175	449	624	(48)	34	155	483	5	128	360
2012	274	512	786	(104)	(10)	51	849	(164)	134	551
2011	335	555	890	(118)	(33)	12	1,029	(645)	126	258

- (1) Does not include credit-related OTTI charges of \$7, \$44, and \$413 for the years ended December 31, 2013, 2012, and 2011, respectively.
- (2) Represents amortization of amounts deferred for adjusted net interest income purposes only, in accordance with the Bank’s Excess Stock Repurchase, Retained Earnings, and Dividend Framework.
- (3) The Bank includes interest income and interest expense associated with economic hedges in adjusted net interest income in its analysis of financial performance for its two operating segments. For financial reporting purposes, the Bank does not include these amounts in net interest income in the Statements of Income, but instead records them in other income in “Net gain/(loss) on derivatives and hedging activities.”
- (4) The Bank excludes interest expense on mandatorily redeemable capital stock from adjusted net interest income in its analysis of financial performance for its two operating segments.

The following table presents total assets by operating segment at December 31, 2013, 2012, and 2011.

	Advances- Related Business	Mortgage- Related Business	Total Assets
2013	\$ 62,297	\$ 23,477	\$ 85,774
2012	62,306	24,115	86,421
2011	88,302	25,250	113,552

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Note 19 — Derivatives and Hedging Activities**

**General.** The Bank may enter into interest rate swaps (including callable, putable, and basis swaps); swaptions; and cap, floor, corridor, and collar 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 the advances and bonds are transacted and generally have the same maturity dates as the related advances and bonds. The Bank transacts most of its derivatives with large banks and major broker-dealers. Some of these banks and broker-dealers or their affiliates buy, sell, and distribute consolidated obligations. Over-the-counter derivatives may be either transacted with a counterparty (bilateral derivatives) or cleared through a clearing agent with a derivative clearing organization (cleared derivatives). Once a derivative transaction has been accepted for clearing by a derivative clearing organization (clearinghouse), the derivative transaction is novated and the executing counterparty is replaced with the clearinghouse. The clearinghouse notifies the clearing agent of the required initial and variation margin, and the clearing agent notifies the Bank and transmits the required initial and variation margin from the Bank to the clearinghouse. The Bank is not a derivative dealer and does not trade derivatives for short-term profit.

Additional uses of interest rate exchange agreements include: (i) offsetting embedded features in assets and liabilities, (ii) hedging the anticipated issuance of debt, (iii) matching against consolidated obligation discount notes or bonds to create the equivalent of callable or non-callable fixed rate debt, (iv) modifying the repricing frequency of assets and liabilities, (v) matching against certain advances and consolidated obligations for which the Bank elected the fair value option, and (vi) exactly offsetting other derivatives executed with members (with the Bank serving as an intermediary). The Bank's use of interest rate exchange agreements results in one of the following classifications: (i) a fair value hedge of an underlying financial instrument, (ii) a cash flow hedge of an underlying financial instrument, (iii) an economic hedge of a specific asset or liability, or (iv) an intermediary transaction for members.

*Interest Rate Swaps* – An interest rate swap is an agreement between two entities to exchange cash flows in the future. The agreement sets the dates on which the cash flows will be paid and the manner in which the cash flows will be calculated. One of the simplest forms of an interest rate swap involves the promise by one party to pay cash flows equivalent to the interest on a notional principal amount at a predetermined fixed rate for a given period of time. In return for this promise, the party receives cash flows equivalent to the interest on the same notional principal amount at a variable rate for the same period of time. The variable rate received or paid by the Bank in most interest rate exchange agreements is indexed to LIBOR.

*Swaptions* – A swaption is an option on a swap that gives the buyer the right to enter into a specified interest rate swap at a certain time in the future. When used as a hedge, for example, a swaption can protect the Bank against future interest rate changes when it is planning to lend or borrow funds in the future.

*Interest Rate Caps and Floors* – In a cap agreement, additional cash flow is generated if the price or interest rate of an underlying variable rises above a certain threshold (or cap) price. In a floor agreement, additional cash flow is generated if the price or interest rate of an underlying variable falls below a certain threshold (or floor) price. Caps and floors may be used in conjunction with assets or liabilities. In general, caps and floors are designed as protection against the interest rate on a variable rate asset or liability rising above or falling below a certain level.

**Hedging Activities.** 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: (i) assets and liabilities on the balance sheet, (ii) firm commitments, or (iii) 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 attributable to the hedged risk and whether those derivatives may be expected to remain

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**Notes to Financial Statements (continued)**

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: (i) 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); (ii) the derivative and/or the hedged item expires or is sold, terminated, or exercised; (iii) it is no longer probable that the forecasted transaction will occur in the originally expected period; (iv) a hedged firm commitment no longer meets the definition of a firm commitment; (v) it determines that designating the derivative as a hedging instrument is no longer appropriate; or (vi) it decides to use the derivative to offset changes in the fair value of other derivatives or instruments carried at fair value.

*Intermediation* – As an additional service to its members, the Bank has in the past entered into offsetting interest rate exchange agreements, acting as an intermediary between offsetting derivative transactions with members and other counterparties. This intermediation allows members indirect access to the derivatives market. Derivatives in which the Bank is an intermediary may also arise when the Bank enters into derivatives to offset the economic effect of other derivatives that are no longer designated to advances, investments, or consolidated obligations. The offsetting derivatives used in intermediary activities do not receive 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.

The notional principal of the interest rate exchange agreements associated with derivatives with members and offsetting derivatives with other counterparties was \$330 at December 31, 2013, and \$430 at December 31, 2012. The Bank did not have any interest rate exchange agreements outstanding at December 31, 2013 and 2012, that were used to offset the economic effect of other derivatives that were no longer designated to advances, investments, or consolidated obligations.

*Investments* – The Bank may invest in U.S. Treasury and agency obligations, agency MBS, and the taxable portion of highly rated state or local housing finance agency obligations. In the past, the Bank has also invested in PLRMBS rated AAA at the time of acquisition. 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 risk and interest rate risk by funding investment securities with consolidated obligations that have call features or by hedging the prepayment risk with a combination of consolidated obligations and callable swaps or swaptions. The Bank may execute callable swaps and purchase swaptions in conjunction with the issuance of certain liabilities to create funding that is economically equivalent to fixed rate callable debt. Although these derivatives are economic hedges against prepayment risk and are designated to individual liabilities, they do not receive either fair value or cash flow hedge accounting treatment. Investment securities may be classified as trading, AFS, or HTM.

The Bank may also manage the risk arising from changing market prices or cash flows of investment securities classified as trading 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 trading 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 advances structures to meet members' funding needs. These advances may have maturities up to 30 years with fixed or adjustable rates and may include early termination features or options. The Bank may use derivatives to adjust the repricing and/or options characteristics of advances to more closely match the characteristics of the Bank's funding liabilities. In general, 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 variable rate asset. This type of hedge is treated as a fair value hedge.

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**Notes to Financial Statements (continued)**

In addition, for certain advances for which the Bank has elected the fair value option, the Bank will simultaneously execute an interest rate exchange agreement with terms that economically offset the terms of the advance. However, this type of hedge is treated as an economic hedge because these combinations generally do not meet the requirements for fair value hedge accounting treatment.

*Mortgage Loans* – The Bank’s investment portfolio includes fixed rate mortgage loans. The prepayment options embedded in mortgage loans can result in extensions or contractions in the expected repayment of these investments, depending on changes in estimated prepayment speeds. The Bank manages the interest rate risk and prepayment risk associated with fixed rate mortgage loans through a combination of debt issuance and derivatives. The Bank uses 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 prepaid 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 consolidated obligations to create funding that is economically equivalent to fixed rate callable bonds. 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.

*Consolidated Obligations* – Consolidated obligation bonds are structured to meet the Bank’s and/or investors’ needs. Common structures include fixed rate bonds with or without call options and adjustable rate bonds with or without embedded options. In general, when bonds with these structures are issued, 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 an adjustable rate bond. The cost of this funding combination is generally lower than the cost that would be available through the issuance of an adjustable rate bond alone. The Bank will generally elect fair value hedge accounting treatment for these hedging relationships.

In addition, for certain consolidated obligation bonds for which the Bank has elected the fair value option, the Bank will simultaneously execute an interest rate exchange agreement with terms that economically offset the terms of the consolidated obligation bond. However, this type of hedge is treated as an economic hedge because these combinations generally do not meet the requirements for fair value hedge accounting treatment.

The Bank did not have any consolidated obligations denominated in currencies other than U.S. dollars outstanding during 2013, 2012, or 2011.

*Credit Risk* – The Bank is subject to credit risk as a result of the risk of potential nonperformance by counterparties to the derivative agreements. All of the Bank’s agreements governing bilateral derivative transactions contain master netting provisions to help mitigate the credit risk exposure to each counterparty. 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 Finance Agency regulations. In addition, for bilateral derivatives, credit risk is mitigated by the master netting arrangements included in the contracts. The Bank also requires collateral agreements with collateral delivery thresholds on all bilateral derivatives. In addition, collateral related to derivative transactions with member institutions includes collateral pledged to the Bank, as evidenced by the Advances and Security Agreement, and held by the member institution for the benefit of the Bank.

For cleared derivatives, the clearinghouse is the Bank’s counterparty. The requirement that the Bank post initial and variation margin through the clearing agent, to the clearinghouse, exposes the Bank to institutional credit risk in the event that the clearing agent or the clearinghouse fails to meet its obligations. The use of cleared derivatives mitigates credit risk exposure because a central counterparty is substituted for individual counterparties and variation margin is posted daily for changes in the value of cleared derivatives through a clearing agent. The Bank has analyzed the enforceability of offsetting rights applicable to its cleared derivative transactions and determined that the exercise of those offsetting rights by a non-defaulting party under these transactions should be upheld under

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**Notes to Financial Statements (continued)**

applicable bankruptcy law and CFTC rules in the event of a clearinghouse or clearing agent insolvency and under applicable clearinghouse rules upon a non-insolvency-based event of default of the clearinghouse or clearing agent. Based on this analysis, the Bank presents a net derivative receivable or payable for all of its transactions through a particular clearing agent with a particular clearinghouse.

Based on the Bank's credit analyses and the collateral requirements, the Bank does not expect to incur any credit losses on its derivative transactions.

The notional amount of an interest rate exchange agreement serves as a factor in determining periodic interest payments or cash flows received and paid. However, the notional amount of derivatives represents neither the actual amounts exchanged nor the overall exposure of the Bank to credit risk and market risk. The risks of derivatives can be measured meaningfully on a portfolio basis by taking into account the counterparties, the types of derivatives, the items being hedged, and any offsets between the derivatives and the items being hedged.

The Bank's agreements for bilateral derivative transactions contain provisions that link the Bank's credit rating from Moody's and Standard & Poor's to various rights and obligations. Certain of these derivative agreements provide that, if the Bank's long-term debt rating falls below A3/A- (and in one agreement, below A2/A), the Bank's counterparty would have the right, but not the obligation, to terminate all of its outstanding derivative transactions with the Bank; the Bank's agreements with its clearing agents for cleared derivative transactions have similar provisions with respect to the debt rating of FHLBank System consolidated bonds. If this occurs, the Bank may choose to enter into replacement hedges, either by transferring the existing transactions to another counterparty or entering into new replacement transactions, based on prevailing market rates. In addition, the amount of collateral that the Bank is required to deliver to a counterparty under its agreements for bilateral derivative transactions depends on the Bank's credit rating. The aggregate fair value of all bilateral derivative instruments with credit-risk-related contingent features that were in a net derivative liability position (before cash collateral and related accrued interest) at December 31, 2013, was \$88, for which the Bank had posted cash collateral of \$46 in the normal course of business. If the Bank's credit rating at December 31, 2013, had been Aa/AA (the next lower rating that might require an increase in collateral to be delivered by the Bank) instead of Aaa/AA+ (the Bank's current rating), then the Bank would have been required to deliver up to \$26 of collateral (at fair value) to its derivative counterparties at December 31, 2013.

The following table summarizes the fair value of derivative instruments without the effect of netting arrangements or collateral as of December 31, 2013 and 2012. For purposes of this disclosure, the derivative values include the fair value of derivatives and related accrued interest.

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**Notes to Financial Statements (continued)**

	2013			2012		
	Notional Amount of Derivatives	Derivative Assets	Derivative Liabilities	Notional Amount of Derivatives	Derivative Assets	Derivative Liabilities
Derivatives designated as hedging instruments:						
Interest rate swaps	\$ 31,395	\$ 572	\$ 156	\$ 30,634	\$ 941	\$ 286
Total	31,395	572	156	30,634	941	286
Derivatives not designated as hedging instruments:						
Interest rate swaps	49,715	146	242	59,211	264	338
Interest rate caps, floors, corridors, and/or collars	460	2	4	571	1	6
Total	50,175	148	246	59,782	265	344
Total derivatives before netting and collateral adjustments	\$ 81,570	720	402	\$ 90,416	1,206	630
Netting adjustments by counterparty		(313)	(313)		(587)	(587)
Cash collateral and related accrued interest		(291)	(42)		(90)	(20)
Total collateral and netting adjustments <sup>(1)</sup>		(604)	(355)		(677)	(607)
Total derivative assets and total derivative liabilities		\$ 116	\$ 47		\$ 529	\$ 23

(1) Amounts include the netting of derivative assets and liabilities by counterparty, including cash collateral and related accrued interest, where the netting requirements have been met.

The following table presents the components of net gain/(loss) on derivatives and hedging activities as presented in the Statements of Income for the years ended December 31, 2013, 2012 and 2011.

	2013 Gain/(Loss)	2012 Gain/(Loss)	2011 Gain/(Loss)
Derivatives and hedged items in fair value hedging relationships – hedge ineffectiveness by derivative type:			
Interest rate swaps	\$ (2)	\$ (19)	\$ (31)
Total net gain/(loss) related to fair value hedge ineffectiveness	(2)	(19)	(31)
Derivatives not designated as hedging instruments:			
Economic hedges:			
Interest rate swaps	(8)	(73)	(192)
Interest rate caps, floors, corridors and/or collars	2	1	—
Net interest settlements	34	(10)	(33)
Total net gain/(loss) related to derivatives not designated as hedging instruments	28	(82)	(225)
Net gain/(loss) on derivatives and hedging activities	\$ 26	\$ (101)	\$ (256)

The following table presents, by type of hedged item, the gains and losses on derivatives and the related hedged items in fair value hedging relationships and the impact of those derivatives on the Bank's net interest income for the years ended December 31, 2013, 2012, and 2011.



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**Notes to Financial Statements (continued)**

Hedged Item Type	Gain/(Loss) on Derivatives	Gain/(Loss) on Hedged Item	Net Fair Value Hedge Ineffectiveness	Effect of Derivatives on Net Interest Income <sup>(1)</sup>
Year ended December 31, 2013:				
Advances	\$ 178	\$ (175)	\$ 3	\$ (126)
Consolidated obligation bonds	(373)	368	(5)	366
Total	\$ (195)	\$ 193	\$ (2)	\$ 240
Year ended December 31, 2012:				
Advances	\$ (32)	\$ 32	\$ —	\$ (143)
Consolidated obligation bonds	(259)	240	(19)	519
Total	\$ (291)	\$ 272	\$ (19)	\$ 376
Year ended December 31, 2011:				
Advances	\$ 21	\$ (19)	\$ 2	\$ (260)
Consolidated obligation bonds	(372)	339	(33)	1,092
Total	\$ (351)	\$ 320	\$ (31)	\$ 832

(1) The net interest on derivatives in fair value hedge relationships is presented in the interest income/expense line item of the respective hedged item.

The Bank may present derivative instruments, related cash collateral received or pledged, and associated accrued interest by clearing agent or by counterparty when the netting requirements have been met.

The following table presents separately the fair value of derivative assets and derivative liabilities that have met the netting requirements, including the related collateral received from or pledged to counterparties as of December 31, 2013 and 2012.

	2013		2012	
	Derivative Assets	Derivative Liabilities	Derivative Assets	Derivative Liabilities
Derivative instruments meeting netting requirements				
Gross recognized amount				
Bilateral derivatives	\$ 699	\$ 395	\$ 1,206	\$ 630
Cleared derivatives	21	7	—	—
Total gross recognized amount	720	402	1,206	630
Gross amounts of netting adjustments and cash collateral				
Bilateral derivatives	(604)	(348)	(677)	(607)
Cleared derivatives	—	(7)	—	—
Total gross amounts of netting adjustments and cash collateral	(604)	(355)	(677)	(607)
Total derivative assets and total derivative liabilities				
Bilateral derivatives	95	47	529	23
Cleared derivatives	21	—	—	—
Total derivative assets and derivative liabilities presented in the Statements of Condition	116	47	529	23
Non-cash collateral received or pledged not offset				
Can be sold or repledged - Bilateral derivatives	89	—	525	2
Net unsecured amount				
Bilateral derivatives	6	47	4	21
Cleared derivatives	21	—	—	—
Total net unsecured amount	\$ 27	\$ 47	\$ 4	\$ 21

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Note 20 — Fair Value**

The following 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 at December 31, 2013 and 2012. 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. The Bank continues to refine its valuation methodologies as markets and products develop and the pricing for certain products becomes more or less transparent. While the Bank believes that its valuation methodologies are appropriate and consistent with those of other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a materially different estimate of fair value as of the reporting date. Therefore, the fair values are not necessarily indicative of the amounts that would be realized in current market transactions, although they do reflect the Bank's judgment as to how a market participant would estimate the fair values. The fair value summary table does not represent an estimate of the overall market value of the Bank as a going concern, which would take into account future business opportunities and the net profitability of total assets and liabilities on a combined basis.

The following tables present the carrying value, the estimated fair value, and the fair value hierarchy level of the Bank's financial instruments at December 31, 2013 and 2012.

	December 31, 2013					
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3	Netting Adjustments <sup>(1)</sup>
<b>Assets</b>						
Cash and due from banks	\$ 4,906	\$ 4,906	\$ 4,906	\$ —	\$ —	\$ —
Federal funds sold	7,498	7,498	—	7,498	—	—
Trading securities	3,208	3,208	—	3,208	—	—
AFS securities	7,047	7,047	—	—	7,047	—
HTM securities	17,507	17,352	—	14,802	2,550	—
Advances	44,395	44,457	—	44,457	—	—
Mortgage loans held for portfolio, net of allowance for credit losses on mortgage loans	905	956	—	956	—	—
Accrued interest receivable	81	81	—	81	—	—
Derivative assets, net <sup>(1)</sup>	116	116	—	720	—	(604)
Other assets <sup>(3)</sup>	10	10	10	—	—	—
<b>Liabilities</b>						
Deposits	193	193	—	193	—	—
Consolidated obligations:						
Bonds	53,207	52,940	—	52,940	—	—
Discount notes	24,194	24,195	—	24,195	—	—
Total consolidated obligations	77,401	77,135	—	77,135	—	—
Mandatorily redeemable capital stock	2,071	2,071	2,071	—	—	—
Accrued interest payable	95	95	—	95	—	—
Derivative liabilities, net <sup>(1)</sup>	47	47	—	402	—	(355)
<b>Other</b>						
Standby letters of credit	12	12	—	12	—	—
Commitments to fund advances <sup>(2)</sup>	—	(1)	—	(1)	—	—



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**Notes to Financial Statements (continued)**

	December 31, 2012					
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3	Netting Adjustments <sup>(b)</sup>
<b>Assets</b>						
Cash and due from banks	\$ 104	\$ 104	\$ 104	\$ —	\$ —	\$ —
Securities purchased under agreements to resell	1,500	1,500	—	1,500	—	—
Federal funds sold	10,857	10,857	—	10,857	—	—
Trading securities	3,191	3,191	—	3,191	—	—
AFS securities	7,604	7,604	—	—	7,604	—
HTM securities	17,376	17,584	—	14,338	3,246	—
Advances	43,750	43,919	—	43,919	—	—
Mortgage loans held for portfolio, net of allowance for credit losses on mortgage loans	1,289	1,368	—	1,368	—	—
Accrued interest receivable	101	101	—	101	—	—
Derivative assets, net <sup>(1)</sup>	529	529	—	1,206	—	(677)
Other assets <sup>(3)</sup>	9	9	9	—	—	—
<b>Liabilities</b>						
Deposits	227	227	—	227	—	—
Consolidated obligations:						
Bonds	70,310	70,577	—	70,577	—	—
Discount notes	5,209	5,210	—	5,210	—	—
Total consolidated obligations	75,519	75,787	—	75,787	—	—
Mandatorily redeemable capital stock	4,343	4,343	4,343	—	—	—
Accrued interest payable	175	175	—	175	—	—
Derivative liabilities, net <sup>(1)</sup>	23	23	—	630	—	(607)
<b>Other</b>						
Standby letters of credit	13	13	—	13	—	—
Commitments to fund advances <sup>(2)</sup>	—	1	—	1	—	—
Commitments to issue consolidated obligation bonds <sup>(2)</sup>	—	5	—	5	—	—

(1) Amounts include the netting of derivative assets and liabilities by counterparty, including cash collateral and related accrued interest, where the netting requirements have been met.

(2) Estimated fair values of these commitments are presented as a net gain or (loss). For more information regarding these commitments, see Note 21 – Commitments and Contingencies.

(3) Represents publicly traded mutual funds held in a grantor trust.

**Fair Value Hierarchy.** The fair value hierarchy is used to prioritize the fair value methodologies and valuation techniques as well as the inputs to the valuation techniques used to measure fair value for assets and liabilities carried at fair value on the Statements of Condition. The inputs are evaluated and an overall level for the fair value measurement is determined. This overall level is an indication of market observability of the fair value measurement for the asset or liability. The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). An entity must disclose the level within the fair value hierarchy in which the measurements are classified for all financial assets and liabilities measured on a recurring or non-recurring basis.

The application of the fair value hierarchy to the Bank's financial assets and financial liabilities that are carried at fair value either on a recurring or non-recurring basis is as follows:

- Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in an active market that the reporting entity can access on the measurement date.
- Level 2 – Inputs other than quoted prices within Level 1 that are observable inputs for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following:

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**Notes to Financial Statements (continued)**

(1) quoted prices for similar assets or liabilities in active markets; (2) quoted prices for identical or similar assets or liabilities in markets that are not active; (3) inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates and yield curves that are observable at commonly quoted intervals, and implied volatilities); and (4) inputs that are derived principally from or corroborated by observable market data by correlation or other means.

- Level 3 – Unobservable inputs for the asset or liability.

A financial instrument's categorization within the valuation hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The following assets and liabilities, including those for which the Bank has elected the fair value option, are carried at fair value on the Statements of Condition as of December 31, 2013:

- Trading securities
- AFS securities
- Certain advances
- Derivative assets and liabilities
- Certain consolidated obligation bonds
- Certain other assets

For instruments carried at fair value, the Bank reviews the fair value hierarchy classifications on a quarterly basis. Changes in the observability of the valuation inputs may result in a reclassification of certain assets or liabilities. Such reclassifications are reported as transfers in or out as of the beginning of the quarter in which the changes occur. For the periods presented, the Bank did not have any reclassifications for transfers in or out of the fair value hierarchy levels.

**Summary of Valuation Methodologies and Primary Inputs.**

*Cash and Due from Banks* – The estimated fair value equals the carrying value.

*Federal Funds Sold and Securities Purchased Under Agreements to Resell* – The estimated fair value of overnight Federal funds sold and securities purchased under agreements to resell approximates the carrying value. The estimated fair value of term Federal funds sold and term securities purchased under agreements to resell has been determined by calculating the present value of expected cash flows for the instruments and reducing the amount for accrued interest receivable. The discount rates used in these calculations are the replacement rates for comparable instruments with similar terms.

*Investment Securities – Certificates of Deposit* – The estimated fair values of these investments are determined by calculating the present value of expected cash flows and reducing the amount for accrued interest receivable, using market-observable inputs as of the last business day of the period or using industry standard analytical models and certain actual and estimated market information. The discount rates used in these calculations are the replacement rates for comparable instruments with similar terms.

*Investment Securities – MBS* – To value its MBS, the Bank obtains prices from four designated third-party pricing vendors when available. The pricing vendors use various proprietary models to price these securities. The inputs to those models are derived from various sources including, but not limited to: benchmark yields, reported trades, dealer estimates, issuer spreads, benchmark securities, bids, offers, and other market-related data. Since many securities do not trade on a daily basis, the pricing vendors use available information as applicable, such as benchmark yield curves, benchmarking of like securities, sector groupings, and matrix pricing, to determine the prices for individual securities. Each pricing vendor has an established challenge process in place for all security valuations, which facilitates resolution of price discrepancies identified by the Bank.

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In January 2014, the Bank conducted reviews of the four pricing vendors to update and confirm its understanding of the vendors' pricing processes, methodologies, and control procedures.

The Bank's valuation technique for estimating the fair values of its MBS first requires the establishment of a "median" vendor price for each security. If four vendor prices are received, the average of the middle two prices is the median price; if three prices are received, the middle price is the median price; if two prices are received, the average of the two prices is the median price; and if one price is received, it is the median price (and also the default fair value) subject to additional validation. All vendor prices that are within a specified tolerance threshold of the median price are included in the cluster of vendor prices that are averaged to establish a default fair value. All vendor prices that are outside the threshold (outliers) are subject to further analysis including, but not limited to, comparison to prices provided by an additional third-party valuation service, prices for similar securities and/or dealer estimates, or use of internal model prices, which are deemed to be reflective of all relevant facts and circumstances that a market participant would consider. Such analysis is also applied in those limited instances where no third-party vendor price or only one third-party vendor price is available in order to arrive at an estimated fair value. If an outlier (or some other price identified in the analysis) is determined to be a better estimate of fair value, then the outlier (or the other price, as appropriate) is used as the fair value rather than the default fair value. If, instead, the analysis confirms that an outlier is (or outliers are) not representative of fair value and the default fair value is the best estimate, then the default fair value is used as the fair value.

If all vendor prices received for a security are outside the tolerance threshold level of the median price, then there is no default fair value, and the fair value is determined by an evaluation of all outlier prices (or the other prices, as appropriate) as described above.

As of December 31, 2013, four vendor prices were received for most of the Bank's MBS, and the fair value estimates for most of those securities were determined by averaging the four vendor prices. Based on the Bank's reviews of the pricing methods employed by the third-party pricing vendors and the relative lack of dispersion among the vendor prices (or, in those instances in which there were outliers or significant yield variances, the Bank's additional analyses), the Bank believes that its fair value estimates are reasonable and that the fair value measurements are classified appropriately in the fair value hierarchy. Based on limited market liquidity for PLRMBS, the fair value measurements for these securities were classified as Level 3 within the fair value hierarchy.

As an additional step, the Bank reviewed the fair value estimates of its PLRMBS as of December 31, 2013, for reasonableness using a market-implied yield test. The Bank calculated a market-implied yield for each of its PLRMBS using the estimated fair value derived from the process described above and the security's projected cash flows from the Bank's OTTI process and compared the market-implied yield to the yields for comparable securities according to dealers and other third-party sources to the extent comparable market yield data was available. This analysis did not indicate that any adjustments to the fair value estimates were necessary.

*Investment Securities – FFCB Bonds and CalHFA Bonds* – The Bank estimates the fair values of these securities using the same methodology as described above for *Investment Securities – MBS*.

*Advances* – Because quoted prices are not available for advances, the fair values are measured using model-based valuation techniques (such as calculating the present value of future cash flows and reducing the amount for accrued interest receivable).

The Bank's primary inputs for measuring the fair value of advances are market-based consolidated obligation yield curve (CO Curve) inputs obtained from the Office of Finance. The CO Curve is then adjusted to reflect the rates on replacement advances with similar terms and collateral. These spread adjustments are not market-observable and are evaluated for significance in the overall fair value measurement and the fair value hierarchy level of the advance. The Bank obtains market-observable inputs from derivative dealers for complex advances. These inputs may include volatility assumptions, which are market-based expectations of future interest rate volatility implied from current market prices for similar options (swaption volatility and volatility skew). The discount rates used in these

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calculations are the replacement advance rates for advances with similar terms. Pursuant to the Finance Agency's advances regulation, advances with an original term to 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. The Bank determined that no adjustment is required to the fair value measurement of advances for prepayment fees. In addition, the Bank did not adjust its fair value measurement of advances for creditworthiness primarily because advances were fully collateralized.

*Mortgage Loans Held for Portfolio* – The estimated fair value for mortgage loans represents modeled prices based on observable market prices for agency mortgage loan commitment rates adjusted for differences in coupon, average loan rate, seasoning, and cash flow remittance between the Bank's mortgage loans and the referenced mortgage loans. Market prices are highly dependent on the underlying prepayment assumptions. Changes in the prepayment speeds often have a material effect on the fair value estimates. These underlying prepayment assumptions are susceptible to material changes in the near term because they are made at a specific point in time.

*Accrued Interest Receivable and Payable* – The estimated fair value approximates the carrying value of accrued interest receivable and accrued interest payable.

*Derivative Assets and Liabilities* – In general, derivative instruments transacted and held by the Bank for risk management activities are traded in over-the-counter markets where quoted market prices are not readily available. These derivatives are interest rate-related. For these derivatives, the Bank measures fair value using internally developed discounted cash flow models that use market-observable inputs, such as the overnight index swap (OIS) curve; volatility assumptions, which are market-based expectations of future interest rate volatility implied from current market prices for similar options (swaption volatility and volatility skew) adjusted for counterparty credit risk, as necessary; and prepayment assumptions. Effective December 31, 2012, the Bank refined its method for estimating the fair values of its derivatives by using the OIS curve to discount the cash flows of its derivatives to determine fair value, instead of using the LIBOR swap curve, which was used in prior periods.

The Bank is subject to credit risk because of the risk of potential nonperformance by its derivative counterparties. To mitigate this risk, the Bank executes bilateral derivative transactions only with highly rated derivative dealers and major banks (derivative dealer counterparties) that meet the Bank's eligibility criteria. In addition, the Bank has entered into master netting agreements and bilateral security agreements with all active derivative dealer counterparties that provide for delivery of collateral at specified levels to limit the Bank's net unsecured credit exposure to these counterparties. Under these policies and agreements, the amount of unsecured credit exposure to an individual derivative dealer counterparty is limited to an absolute dollar credit exposure limit according to the counterparty's credit rating, as determined by rating agency long-term credit ratings of the counterparty's debt securities or deposits. The Bank executes cleared derivative transactions only with clearing agents that meet the Bank's strict eligibility requirements, and the Bank's credit exposure to the clearinghouse is secured by variation margin received from the clearinghouse. All credit exposure from derivative transactions entered into by the Bank with member counterparties that are not derivative dealers must be fully secured by eligible collateral. The Bank evaluated the potential for the fair value of the instruments to be affected by counterparty credit risk and determined that no adjustments to the overall fair value measurements were required.

The fair values of the derivative assets and liabilities include accrued interest receivable/payable and cash collateral remitted to/received from counterparties. The estimated fair values of the accrued interest receivable/payable and cash collateral approximate their carrying values because of their short-term nature. The fair values of derivatives that met the netting requirements are presented on a net basis. If these netted amounts are positive, they are classified as an asset and, if negative, they are classified as a liability.

*Deposits* – The fair value of deposits is generally equal to the carrying value of the deposits because the deposits are primarily overnight deposits or due on demand. The Bank determines the fair values of term deposits by calculating the present value of expected future cash flows from the deposits and reducing the amount for accrued interest payable. The discount rates used in these calculations are the cost of deposits with similar terms.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

*Consolidated Obligations* – Because quoted prices in active markets are not generally available for identical liabilities, the Bank measures fair values using internally developed models that use primarily market-observable inputs. The Bank’s primary inputs for measuring the fair value of consolidated obligation bonds are market-based CO Curve inputs obtained from the Office of Finance. The Office of Finance constructs the CO Curve using the Treasury yield curve as a base curve, which may be adjusted by indicative spreads obtained from market-observable sources. These market indications are generally derived from pricing indications from dealers, historical pricing relationships, and market activity for similar liabilities, such as recent GSE trades or secondary market activity. For consolidated obligation bonds with embedded options, the Bank also obtains market-observable quotes and inputs from derivative dealers. These inputs may include volatility assumptions, which are market-based expectations of future interest rate volatility implied from current market prices for similar options (swaption volatility and volatility skew).

Adjustments may be necessary to reflect the Bank’s credit quality or the credit quality of the FHLBank System when valuing consolidated obligation bonds measured at fair value. The Bank monitors its own creditworthiness and the creditworthiness of the other 11 FHLBanks and the FHLBank System to determine whether any adjustments are necessary for creditworthiness in its fair value measurement of consolidated obligation bonds. The credit ratings of the FHLBank System and any changes to the credit ratings are the basis for the Bank to determine whether the fair values of consolidated obligations have been significantly affected during the reporting period by changes in the instrument-specific credit risk.

*Mandatorily Redeemable Capital Stock* – The estimated fair value of capital stock subject to mandatory redemption is generally at par value as indicated by contemporaneous purchases, redemptions, and repurchases at par value. Fair value includes estimated dividends earned at the time of reclassification from capital to liabilities, until such amount is paid, and any subsequently declared capital stock dividend. The Bank’s capital stock can only be acquired by members at par value and redeemed or repurchased at par value, subject to statutory and regulatory requirements. The Bank’s capital stock is not traded, and no market mechanism exists for the exchange of Bank capital stock outside the cooperative ownership structure.

*Commitments* – The estimated fair value of standby letters of credit is based on the present value of fees currently charged for similar agreements and is recorded in other liabilities. The estimated fair value of off-balance sheet fixed rate commitments to fund advances and commitments to issue consolidated obligations takes into account the difference between current and committed interest rates.

**Subjectivity of Estimates Related to Fair Values of Financial Instruments.** Estimates of the fair value of financial assets and liabilities using the methodologies described above are subjective and require judgments regarding significant matters, such as the amount and timing of future cash flows, prepayment speed assumptions, expected interest rate volatility, methods to determine possible distributions of future interest rates used to value options, 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.

**Fair Value Measurements.** The tables below present the fair value of assets and liabilities, which are recorded on a recurring or nonrecurring basis at December 31, 2013 and 2012, by level within the fair value hierarchy.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

	Fair Value Measurement Using:			Netting	
	Level 1	Level 2	Level 3	Adjustments <sup>(1)</sup>	Total
Recurring fair value measurements – Assets:					
Trading securities:					
GSEs – FFCB bonds	\$ —	\$ 3,194	\$ —	\$ —	\$ 3,194
MBS:					
Other U.S. obligations – Ginnie Mae	—	14	—	—	14
Total trading securities	—	3,208	—	—	3,208
AFS securities:					
PLRMBS	—	—	7,047	—	7,047
Total AFS securities	—	—	7,047	—	7,047
Advances <sup>(2)</sup>	—	7,069	—	—	7,069
Derivative assets, net: interest rate-related	—	720	—	(604)	116
Other assets	10	—	—	—	10
Total recurring fair value measurements – Assets	\$ 10	\$ 10,997	\$ 7,047	\$ (604)	\$ 17,450
Recurring fair value measurements – Liabilities:					
Consolidated obligation bonds <sup>(3)</sup>	\$ —	\$ 10,115	\$ —	\$ —	\$ 10,115
Derivative liabilities, net: interest rate-related	—	402	—	(355)	47
Total recurring fair value measurements – Liabilities	\$ —	\$ 10,517	\$ —	\$ (355)	\$ 10,162
Nonrecurring fair value measurements – Assets:					
REO	\$ —	\$ —	\$ 2	\$ —	\$ 2

**December 31, 2012**

	Fair Value Measurement Using:			Netting	
	Level 1	Level 2	Level 3	Adjustments <sup>(1)</sup>	Total
Recurring fair value measurements – Assets:					
Trading securities:					
GSEs – FFCB bonds	\$ —	\$ 3,175	\$ —	\$ —	\$ 3,175
MBS:					
Other U.S. obligations – Ginnie Mae	—	16	—	—	16
Total trading securities	—	3,191	—	—	3,191
AFS securities:					
PLRMBS	—	—	7,604	—	7,604
Total AFS securities	—	—	7,604	—	7,604
Advances <sup>(2)</sup>	—	7,401	—	—	7,401
Derivative assets, net: interest rate-related	—	1,206	—	(677)	529
Other assets	9	—	—	—	9
Total recurring fair value measurements – Assets	\$ 9	\$ 11,798	\$ 7,604	\$ (677)	\$ 18,734
Recurring fair value measurements – Liabilities:					
Consolidated obligation bonds <sup>(3)</sup>	\$ —	\$ 27,884	\$ —	\$ —	\$ 27,884
Derivative liabilities, net: interest rate-related	—	630	—	(607)	23
Total recurring fair value measurements – Liabilities	\$ —	\$ 28,514	\$ —	\$ (607)	\$ 27,907
Nonrecurring fair value measurements – Assets:					
REO	\$ —	\$ —	\$ 2	\$ —	\$ 2

- (1) Amounts represent the netting of derivative assets and liabilities by counterparty, including cash collateral, where the netting requirements have been met.
- (2) Includes \$7,069 and \$7,390 of advances recorded under the fair value option at December 31, 2013 and 2012, respectively, and \$0 and \$11 of advances recorded at fair value at December 31, 2013 and 2012, respectively, where the exposure to overall changes in fair value was hedged in accordance with the accounting for derivative instruments and hedging activities.



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

- (3) Includes \$10,115 and \$27,884 of consolidated obligation bonds recorded under the fair value option at December 31, 2013 and 2012, respectively. There were no consolidated obligation bonds recorded at fair value at December 31, 2013 and 2012, where the exposure to overall changes in fair value was hedged in accordance with the accounting for derivative instruments and hedging activities.

The following tables present a reconciliation of the Bank's AFS PLRMBS that are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the years ended December 31, 2013 and 2012.

	2013	2012
Balance, beginning of the year	\$ 7,604	\$ 7,687
Total gain/(loss) realized and unrealized included in:		
Interest income	21	(11)
Net OTTI loss, credit-related	(7)	(44)
Unrealized gain/(loss) of other-than-temporarily impaired securities included in AOCI	644	1,102
Reclassification of non-credit-related OTTI included in net income/(loss)	(3)	14
Settlements	(1,284)	(1,284)
Transfers of HTM securities to AFS securities	72	140
Balance, end of the year	\$ 7,047	\$ 7,604
Total amount of gain/(loss) for the period included in earnings attributable to the change in unrealized gains/losses relating to assets and liabilities still held at the end of the year	\$ 15	\$ (55)

**Fair Value Option.** The fair value option provides an entity with an irrevocable option to elect fair value as an alternative measurement for selected financial assets, financial liabilities, unrecognized firm commitments, and written loan commitments not previously carried at fair value. It requires an entity to display the fair value of those assets and liabilities for which the entity has chosen to use fair value on the face of the Statements of Condition. Fair value is used for both the initial and subsequent measurement of the designated assets, liabilities, and commitments, with the changes in fair value recognized in net income. Interest income and interest expense on advances and consolidated bonds carried at fair value are recognized solely on the contractual amount of interest due or unpaid. Any transaction fees or costs are immediately recognized in non-interest income or non-interest expense.

The Bank elected the fair value option for certain financial instruments as follows:

- Adjustable rate advances with embedded options
- Callable fixed rate advances
- Putable fixed rate advances
- Putable fixed rate advances with embedded options
- Fixed rate advances with partial prepayment symmetry
- Callable or non-callable capped floater consolidated obligation bonds
- Convertible consolidated obligation bonds
- Adjustable or fixed rate range accrual consolidated obligation bonds
- Ratchet consolidated obligation bonds
- Adjustable rate advances indexed to non-LIBOR indices such as the Prime Rate, U.S. Treasury bill, and Federal funds effective rate
- Adjustable rate consolidated obligation bonds indexed to non-LIBOR indices such as the Prime Rate, U.S. Treasury bill, and Federal funds effective rate
- Step-up callable bonds, which pay interest at increasing fixed rates for specified intervals over the life of the bond and can generally be called at the Bank's option on the step-up dates
- Step-down callable bonds, which pay interest at decreasing fixed rates for specified intervals over the life of the bond and can generally be called at the Bank's option on the step-down dates

The Bank has elected the fair value option for certain financial instruments to assist in mitigating potential earnings volatility that can arise from economic hedging relationships in which the carrying value of the hedged item is not

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

adjusted for changes in fair value. The potential earnings volatility associated with using fair value only for the derivative is the Bank's primary reason for electing the fair value option for financial assets and liabilities that do not qualify for hedge accounting or that have not previously met or may be at risk for not meeting the hedge effectiveness requirements.

The following table summarizes the activity related to financial assets and liabilities for which the Bank elected the fair value option during the years ended December 31, 2013, 2012, and 2011:

	2013		2012		2011	
	Advances	Consolidated Obligation Bonds	Advances	Consolidated Obligation Bonds	Advances	Consolidated Obligation Bonds
Balance, beginning of the year	\$ 7,390	\$ 27,884	\$ 8,684	\$ 15,712	\$ 10,490	\$ 20,872
New transactions elected for fair value option	837	3,547	862	25,925	2,045	16,668
Maturities and terminations	(988)	(21,165)	(2,127)	(13,745)	(4,023)	(21,982)
Net gain/(loss) on advances and net (gain)/loss on consolidated obligation bonds held under fair value option	(169)	(146)	(22)	(7)	184	159
Change in accrued interest	(1)	(5)	(7)	(1)	(12)	(5)
Balance, end of the year	\$ 7,069	\$ 10,115	\$ 7,390	\$ 27,884	\$ 8,684	\$ 15,712

For instruments for which the fair value option has been elected, the related contractual interest income and contractual interest expense are recorded as part of net interest income on the Statements of Income. The remaining changes in fair value for instruments for which the fair value option has been elected are recorded as net gains/(losses) on financial instruments held under the fair value option in the Statements of Income. The change in fair value does not include changes in instrument-specific credit risk. For advances and consolidated obligations recorded under the fair value option, the Bank determined that no adjustments to the fair values of these instruments for instrument-specific credit risk were necessary for the years ended December 31, 2013, 2012, and 2011.

The following table presents the difference between the aggregate remaining contractual principal balance outstanding and aggregate fair value of advances and consolidated obligation bonds for which the Bank elected the fair value option at December 31, 2013 and 2012:

	At December 31, 2013			At December 31, 2012		
	Principal Balance	Fair Value	Fair Value Over/(Under) Principal Balance	Principal Balance	Fair Value	Fair Value Over/(Under) Principal Balance
Advances <sup>(1)</sup>	\$ 6,956	\$ 7,069	\$ 113	\$ 7,102	\$ 7,390	\$ 288
Consolidated obligation bonds	10,230	10,115	(115)	27,848	27,884	36

(1) At December 31, 2013 and 2012, none of these advances were 90 days or more past due or had been placed on nonaccrual status.

## Note 21 — Commitments and Contingencies

As provided by the FHLBank Act or regulations governing the operations of the FHLBanks, all FHLBanks have joint and several liability for all FHLBank consolidated obligations, which are backed only by the financial resources of the FHLBanks. The joint and several liability regulation authorizes the Finance Agency to require any FHLBank to repay all or a portion of the principal or interest on consolidated obligations for which another FHLBank is the primary obligor. The regulations provide a general framework for addressing the possibility that an FHLBank may be unable to repay the consolidated obligations for which it is the primary obligor. The Bank has never been asked or required to repay the principal or interest on any consolidated obligation on behalf of another



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

FHLBank, and as of December 31, 2013, and through the filing date of this report, does not believe that it is probable that it will be asked to do so.

The Bank determined that it was not necessary to recognize a liability for the fair value of the Bank's joint and several liability for all consolidated obligations. The joint and several obligations are mandated by the FHLBank Act or regulations governing the operations of the FHLBanks and are not the result of arms-length transactions among the FHLBanks. The FHLBanks have no control over the amount of the guarantee or the determination of how each FHLBank would perform under the joint and several obligations. Because the FHLBanks are subject to the authority of the Finance Agency as it relates to decisions involving the allocation of the joint and several liability for the FHLBanks' consolidated obligations, the FHLBanks' joint and several obligations are excluded from the initial recognition and measurement provisions. Accordingly, the Bank has not recognized a liability for its joint and several obligation related to other FHLBanks' participations in the consolidated obligations. The par value of the outstanding consolidated obligations of all 12 FHLBanks was \$766,837 at December 31, 2013, and \$687,902 at December 31, 2012. The par value of the Bank's participation in consolidated obligations was \$76,968 at December 31, 2013, and \$74,532 at December 31, 2012.

The 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 this 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.

In addition, the regulation requires that an FHLBank must provide written notice to the Finance Agency if at any time the FHLBank is unable to provide the quarterly certification; projects that it will be unable to fully meet all of its current obligations, including direct obligations, on a timely basis 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 Agency approval specifying the measures the FHLBank will undertake to make full and timely payments of all its current obligations.

Notwithstanding any other provisions in the regulation, the regulation provides that the Finance Agency 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 FHLBank that is the primary obligor, which will have a corresponding obligation to reimburse the FHLBank for the payment and associated costs, including interest.

The regulation also provides that the Finance Agency 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. The Finance Agency reserves the right to allocate the outstanding liabilities for the consolidated obligations among the FHLBanks in any other manner it may determine to ensure that the FHLBanks operate in a safe and sound manner.

Off-balance sheet commitments as of December 31, 2013 and 2012, were as follows:

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	2013			2012		
	Expire Within One Year	Expire After One Year	Total	Expire Within One Year	Expire After One Year	Total
Standby letters of credit outstanding	\$ 1,031	\$ 2,572	\$ 3,603	\$ 1,010	\$ 2,409	\$ 3,419
Commitments to fund advances <sup>(1)</sup>	4	4	8	20	1	21
Commitments to issue consolidated obligation bonds, par <sup>(2)</sup>	1,640	—	1,640	635	—	635

- (1) At December 31, 2013, none of the commitments to fund additional advances were hedged with associated interest rate swaps. At December 31, 2012, \$16 was hedged with associated interest rate swaps.
- (2) At December 31, 2013 and 2012, \$1,640 and \$500, respectively, of the unsettled consolidated obligation bonds were hedged with associated interest rate swaps.

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 a payment for a beneficiary's drawing under a letter of credit, the amount is immediately due and payable by the member to the Bank and is charged to the member's demand deposit account with the Bank. The original terms of these standby letters of credit range from 107 days to 10 years, including a final expiration in 2023. The Bank monitors the creditworthiness of members that have standby letters of credit. In addition, standby letters of credit are fully collateralized. As a result, the Bank determined that it was not necessary to record any allowance for losses on these commitments.

The value of the Bank's obligations related to standby letters of credit is recorded in other liabilities and amounted to \$12 at December 31, 2013, and \$13 at December 31, 2012. Letters of credit are fully collateralized at the time of issuance. Based on the Bank's credit analyses of members' financial condition and collateral requirements, the Bank deemed it unnecessary to record any additional liability on the letters of credit outstanding as of December 31, 2013 and 2012.

Commitments to fund advances totaled \$8 at December 31, 2013, and \$21 at December 31, 2012. Advances funded under advance commitments are fully collateralized at the time of funding (see Note 10 – Allowance for Credit Losses). Based on the Bank's credit analyses of members' financial condition and collateral requirements, the Bank deemed it unnecessary to record any additional liability on the advance commitments outstanding as of December 31, 2013 and 2012.

Commitments to issue consolidated obligations totaled \$1,640 and \$635 at December 31, 2013 and 2012.

The Bank executes over-the-counter bilateral interest rate exchange agreements with major banks and derivative entities affiliated with broker-dealers and with its members. The Bank enters into master agreements with netting provisions with all bilateral swap counterparties and into bilateral security agreements with all active derivative dealer counterparties. All member counterparty master agreements, excluding those with derivative dealers, are subject to the terms of the Bank's Advances and Security Agreement with members, and all member counterparties (except for those that are derivative dealers) must fully collateralize the Bank's net credit exposure. For cleared derivatives, the clearinghouse is the Bank's counterparty, and the Bank has clearing agreements with clearing agents that provide for delivery of initial margin to, and exchange of variation margin with, the clearinghouse. See Note 19 – Derivatives and Hedging Activities for additional information about the Bank's pledged collateral and other credit-risk-related contingent features. As of December 31, 2013, the Bank had pledged cash collateral of \$149 to counterparties and the clearing house that had market risk exposure to the Bank related to derivatives. As of December 31, 2012, the Bank had pledged total collateral of \$23, including securities with a carrying value of \$2, all of which could be sold or repledged, and cash of \$21 to counterparties that had market risk exposure to the Bank related to derivatives.

The Bank charged operating expenses for net rental and related costs of approximately \$5, \$5, and \$5 for the years ended December 31, 2013, 2012, and 2011, respectively. Future minimum rentals at December 31, 2013, were as follows:

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

Year	Future Minimum Rentals
2014	\$ 4
2015	4
2016	4
2017	4
2018	4
Thereafter	6
<b>Total</b>	<b>\$ 26</b>

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

Other commitments and contingencies are discussed in Note 1 – Summary of Significant Accounting Policies, Note 8 – Advances, Note 9 – Mortgage Loans Held for Portfolio, Note 12 – Consolidated Obligations, Note 13 – Affordable Housing Program, Note 14 – Resolution Funding Corporation Assessments, Note 16 – Capital, Note 17 – Employee Retirement Plans and Incentive Compensation Plans, and Note 19 – Derivatives and Hedging Activities.

**Note 22 — Transactions with Certain Members, Certain Nonmembers, and Other FHLBanks**

**Transactions with Members.** The Bank has a cooperative ownership structure under which current member institutions, certain former members, and certain other nonmembers own the capital stock of the Bank. Former members and certain nonmembers own the remaining capital stock and are required to maintain their investment in the Bank's capital stock until their outstanding transactions mature or are paid off or until their capital stock is redeemed following the five-year redemption period for capital stock or is repurchased by the Bank, in accordance with the Bank's capital requirements (see Note 16 – Capital for further information).

All advances are made to members, and all mortgage loans held for portfolio were purchased from members. The Bank also maintains deposit accounts for members primarily to facilitate settlement activities that are directly related to advances and mortgage loan purchases. All transactions with members and their affiliates are entered into in the normal course of business. In instances where the member has an officer or director who is a director of the Bank, transactions with the member are subject to the same eligibility and credit criteria, as well as the same conditions, as comparable transactions with all other members, in accordance with regulations governing the operations of the FHLBanks.

The Bank has investments in Federal funds sold, interest-bearing deposits, and commercial paper, and executes MBS and derivatives transactions with members or their affiliates. The Bank purchases MBS through securities brokers or dealers and executes all MBS investments without preference to the status of the counterparty or the issuer of the investment as a nonmember, member, or affiliate of a member. When the Bank executes non-MBS investments with a member, the Bank may give consideration to the member's secured credit and the Bank's advances pricing. As an additional service to its members, the Bank has in the past entered into offsetting interest rate exchange agreements, acting as an intermediary between exactly offsetting derivatives transactions with members and other counterparties. These transactions are executed at market rates.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Transactions with Certain Members and Certain Nonmembers.** The following tables set forth information at the dates and for the periods indicated with respect to transactions with: (i) members and nonmembers that held more than 10% of the outstanding shares of the Bank's capital stock, including mandatorily redeemable capital stock, at any time during the periods indicated, (ii) members that had an officer or director serving on the Bank's Board of Directors at any time during the periods indicated, and (iii) affiliates of the foregoing members and nonmembers. All transactions with members, the nonmembers described in the preceding sentence, and their respective affiliates are entered into in the normal course of business. The tables include securities transactions where certain members, nonmembers, and their affiliates (as described above) are the issuers or obligors of the securities, but do not include securities purchased, sold or issued through, or otherwise underwritten by, affiliates of certain members and nonmembers. The tables also do not include any AHP or Community Investment Cash Advance (CICA) grants. Securities purchased, sold or issued through, or otherwise underwritten by, and AHP or CICA grants provided to, the affiliates of certain members and nonmembers are in the ordinary course of the Bank's business.

	December 31, 2013	December 31, 2012
<b>Assets:</b>		
Cash and due from banks	\$ —	\$ 1
Investments <sup>(1)</sup>	1,176	3,929
Advances	11,268	20,787
Mortgage loans held for portfolio	760	1,074
Accrued interest receivable	25	32
Other assets	37	10
Derivative assets, net	257	362
<b>Total Assets</b>	<b>\$ 13,523</b>	<b>\$ 26,195</b>
<b>Liabilities:</b>		
Deposits	\$ 260	\$ 31
Mandatorily redeemable capital stock	1,356	3,850
Derivative liabilities, net	37	15
<b>Total Liabilities</b>	<b>\$ 1,653</b>	<b>\$ 3,896</b>
<b>Notional amount of derivatives</b>	<b>\$ 12,256</b>	<b>\$ 16,863</b>
Standby letters of credit	205	255

- (1) Investments consist of securities purchased under agreements to resell, Federal funds sold, AFS securities, and HTM securities issued by and/or purchased from the members or nonmembers described in this section or their affiliates.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	For the Years Ended December 31,		
	2013	2012	2011
<b>Interest Income:</b>			
Investments <sup>(1)</sup>	\$ 30	\$ 38	\$ 53
Advances <sup>(2)</sup>	134	174	185
Mortgage loans held for portfolio	44	63	82
<b>Total Interest Income</b>	<b>\$ 208</b>	<b>\$ 275</b>	<b>\$ 320</b>
<b>Interest Expense:</b>			
Mandatorily redeemable capital stock	\$ 138	\$ 45	\$ 10
Consolidated obligations <sup>(2)</sup>	(166)	(217)	(414)
<b>Total Interest Expense</b>	<b>\$ (28)</b>	<b>\$ (172)</b>	<b>\$ (404)</b>
<b>Other Income/(Loss):</b>			
Net gain/(loss) on derivatives and hedging activities	\$ (118)	\$ (159)	\$ (217)
Other income	—	1	3
<b>Total Other Income/(Loss)</b>	<b>\$ (118)</b>	<b>\$ (158)</b>	<b>\$ (214)</b>

(1) Investments consist of securities purchased under agreements to resell, Federal funds sold, AFS securities, and HTM securities issued by and/or purchased from the members or nonmembers described in this section or their affiliates.

(2) Reflects the effect of associated derivatives with the members or nonmembers described in this section or their affiliates.

The FHLBank Act requires the Bank to establish an AHP. The Bank provides subsidies to members, which use the funds to assist in the purchase, construction, or rehabilitation of housing for very low-, low-, and moderate-income households. Subsidies may be in the form of direct grants or below-market interest rate advances. Only Bank members, along with their nonmember AHP project sponsors, may submit AHP applications. All AHP subsidies are made in the normal course of business.

The FHLBank Act also requires the Bank to establish a Community Investment Program (CIP) and authorizes the Bank to offer additional CICA programs. Under these programs, the Bank provides subsidies in the form of grants and below-market interest rate advances or standby letters of credit to members for community lending and economic development projects. Only Bank members may submit applications for CICA subsidies. All CICA subsidies are made in the normal course of business.

In instances where an AHP or CICA transaction involves a member that owns more than 10% of the Bank's capital stock (or an affiliate of such a member), a member with an officer or director who is a director of the Bank, or an entity with an officer, director, or general partner who serves as a director of the Bank (and that has a direct or indirect interest in the subsidy), the transaction is subject to the same eligibility and other program criteria and requirements as all other comparable transactions and to the regulations governing the operations of the relevant program.

**Transactions with Other FHLBanks.** Transactions with other FHLBanks are identified on the face of the Bank's financial statements.

### **Note 23 — Other**

The table below discloses the categories included in other operating expense for the years ended December 31, 2013, 2012, and 2011.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	2013		2012		2011
Professional and contract services	\$	33	\$	31	\$ 27
Travel		2		2	2
Occupancy		5		5	5
Equipment		9		10	8
Other		4		4	4
Total	\$	53	\$	52	\$ 46

**Note 24 — Subsequent Events**

The Bank evaluated events subsequent to December 31, 2013, until the time of the Form 10-K filing with the Securities and Exchange Commission, and no material subsequent events were identified.

## PART I. FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

#### Federal Home Loan Bank of San Francisco Statements of Condition (Unaudited)

(In millions-except par value)	March 31, 2014	December 31, 2013
<b>Assets:</b>		
Cash and due from banks	\$ 4,541	\$ 4,906
Securities purchased under agreements to resell	500	—
Federal funds sold	6,401	7,498
Trading securities <sup>(a)</sup>	3,127	3,208
Available-for-sale (AFS) securities <sup>(a)</sup>	6,916	7,047
Held-to-maturity (HTM) securities (fair values were \$17,925 and \$17,352, respectively) <sup>(a)</sup>	17,974	17,507
Advances (includes \$6,936 and \$7,069 at fair value under the fair value option, respectively)	45,552	44,395
Mortgage loans held for portfolio, net of allowance for credit losses of \$2 and \$2, respectively	852	905
Accrued interest receivable	74	81
Premises, software, and equipment, net	25	25
Derivative assets, net	137	116
Other assets	86	86
<b>Total Assets</b>	<b>\$ 86,185</b>	<b>\$ 85,774</b>
<b>Liabilities:</b>		
Deposits	\$ 275	\$ 193
Consolidated obligations:		
Bonds (includes \$7,298 and \$10,115 at fair value under the fair value option, respectively)	53,184	53,207
Discount notes	24,863	24,194
Total consolidated obligations	78,047	77,401
Mandatorily redeemable capital stock	1,644	2,071
Accrued interest payable	148	95
Affordable Housing Program (AHP) payable	151	151
Derivative liabilities, net	38	47
Other liabilities	240	107
Total Liabilities	80,543	80,065
Commitments and Contingencies (Note 17)		
<b>Capital:</b>		
Capital stock—Class B—Putable (\$100 par value) issued and outstanding:		
33 shares and 35 shares, respectively	3,325	3,460
Unrestricted retained earnings	312	317
Restricted retained earnings	2,069	2,077
Total Retained Earnings	2,381	2,394
Accumulated other comprehensive income/(loss) (AOCI)	(64)	(145)
Total Capital	5,642	5,709
Total Liabilities and Capital	\$ 86,185	\$ 85,774

(a) At March 31, 2014, and December 31, 2013, none of these securities were pledged as collateral that may be repledged.

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

**Federal Home Loan Bank of San Francisco**  
**Statements of Income**  
(Unaudited)

(In millions)	For the Three Months Ended March 31,	
	2014	2013
<b>Interest Income:</b>		
Advances	\$ 79	\$ 89
Securities purchased under agreements to resell	—	1
Federal funds sold	3	4
Trading securities	1	2
AFS securities	71	69
HTM securities	96	101
Mortgage loans held for portfolio	11	13
<b>Total Interest Income</b>	<b>261</b>	<b>279</b>
<b>Interest Expense:</b>		
Consolidated obligations:		
Bonds	81	123
Discount notes	6	3
Mandatorily redeemable capital stock	39	26
<b>Total Interest Expense</b>	<b>126</b>	<b>152</b>
<b>Net Interest Income</b>	<b>135</b>	<b>127</b>
Provision for/(reversal of) credit losses on mortgage loans	1	—
<b>Net Interest Income After Mortgage Loan Loss Provision</b>	<b>134</b>	<b>127</b>
<b>Other Income/(Loss):</b>		
Net gain/(loss) on trading securities	—	2
Total other-than-temporary impairment (OTTI) loss	(1)	(4)
Net amount of OTTI loss reclassified to/(from) AOCI	1	1
<b>Net OTTI loss, credit-related</b>	<b>—</b>	<b>(3)</b>
Net gain/(loss) on advances and consolidated obligation bonds held under fair value option	(39)	(11)
Net gain/(loss) on derivatives and hedging activities	(10)	6
Other	1	2
<b>Total Other Income/(Loss)</b>	<b>(48)</b>	<b>(4)</b>
<b>Other Expense:</b>		
Compensation and benefits	16	16
Other operating expense	12	10
Federal Housing Finance Agency	2	2
Office of Finance	2	2
<b>Total Other Expense</b>	<b>32</b>	<b>30</b>
<b>Income/(Loss) Before Assessment</b>	<b>54</b>	<b>93</b>
AHP Assessment	9	12
<b>Net Income/(Loss)</b>	<b>\$ 45</b>	<b>\$ 81</b>

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



**Federal Home Loan Bank of San Francisco**  
**Statements of Comprehensive Income**  
(Unaudited)

(In millions)	For the Three Months Ended March 31,	
	2014	2013
<b>Net Income/(Loss)</b>	<b>\$ 45</b>	<b>\$ 81</b>
Other Comprehensive Income/(Loss):		
Net non-credit-related OTTI loss on AFS securities:		
Non-credit-related OTTI loss transferred from HTM securities	—	(3)
Net change in fair value of other-than-temporarily impaired securities	81	340
Reclassification of non-credit-related OTTI loss included in net income/(loss)	(1)	2
<b>Total net non-credit-related OTTI loss on AFS securities</b>	<b>80</b>	<b>339</b>
Net non-credit-related OTTI loss on HTM securities:		
Non-credit-related OTTI loss	—	(3)
Accretion of non-credit-related OTTI loss	1	2
Non-credit-related OTTI loss transferred to AFS securities	—	3
<b>Total net non-credit-related OTTI loss on HTM securities</b>	<b>1</b>	<b>2</b>
<b>Total other comprehensive income/(loss)</b>	<b>81</b>	<b>341</b>
<b>Total Comprehensive Income/(Loss)</b>	<b>\$ 126</b>	<b>\$ 422</b>

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

**Federal Home Loan Bank of San Francisco**  
**Statements of Capital Accounts**  
(Unaudited)

(In millions)	Capital Stock Class B—Putable		Retained Earnings			AOCI	Total Capital
	Shares	Par Value	Restricted	Unrestricted	Total		
Balance, December 31, 2012	42	\$ 4,160	\$ 2,001	\$ 246	\$ 2,247	\$ (794)	\$ 5,613
Issuance of capital stock	1	106					106
Repurchase of capital stock	(3)	(314)					(314)
Capital stock reclassified from/(to) mandatorily redeemable capital stock, net	—	(1)					(1)
Comprehensive income/(loss)			12	69	81	341	422
Cash dividends paid on capital stock (2.30%)				(25)	(25)		(25)
Balance, March 31, 2013	40	\$ 3,951	\$ 2,013	\$ 290	\$ 2,303	\$ (453)	\$ 5,801
Balance, December 31, 2013	35	\$ 3,460	\$ 2,077	\$ 317	\$ 2,394	\$ (145)	\$ 5,709
Issuance of capital stock	2	197					197
Repurchase of capital stock	(4)	(331)					(331)
Capital stock reclassified to mandatorily redeemable capital stock, net	—	(1)					(1)
Comprehensive income/(loss)			(8)	53	45	81	126
Cash dividends paid on capital stock (6.67%)				(58)	(58)		(58)
Balance, March 31, 2014	33	\$ 3,325	\$ 2,069	\$ 312	\$ 2,381	\$ (64)	\$ 5,642

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

**Federal Home Loan Bank of San Francisco**  
**Statements of Cash Flows**  
(Unaudited)

(In millions)	For the Three Months Ended March 31,	
	2014	2013
<b>Cash Flows from Operating Activities:</b>		
Net Income/(Loss)	\$ 45	\$ 81
Adjustments to reconcile net income/(loss) to net cash provided by operating activities:		
Depreciation and amortization	(20)	(15)
Provision for/(reversal of) credit losses on mortgage loans	1	—
Change in net fair value adjustment on trading securities	—	(2)
Change in net fair value adjustment on advances and consolidated obligation bonds held under the fair value option	39	11
Change in net derivatives and hedging activities	(94)	(84)
Net OTTI loss, credit-related	—	3
Net change in:		
Accrued interest receivable	7	(3)
Other assets	—	(1)
Accrued interest payable	54	67
Other liabilities	(6)	(1)
Total adjustments	(19)	(25)
Net cash provided by/(used in) operating activities	26	56
<b>Cash Flows from Investing Activities:</b>		
Net change in:		
Interest-bearing deposits	(80)	11
Securities purchased under agreements to resell	(500)	1,000
Federal funds sold	1,097	1,823
Premises, software, and equipment	(1)	(2)
Trading securities:		
Proceeds from maturities of long-term	81	1
Purchases of long-term	—	(525)
AFS securities:		
Proceeds from maturities of long-term	225	309
HTM securities:		
Net (increase)/decrease in short-term	(848)	103
Proceeds from maturities of long-term	589	1,213
Purchases of long-term	(69)	(1,189)
Advances:		
Principal collected	146,806	112,034
Made to members	(147,969)	(115,063)
Mortgage loans held for portfolio:		
Principal collected	52	113
Proceeds from sales of foreclosed assets	1	—
Net cash provided by/(used in) investing activities	(616)	(172)

**Federal Home Loan Bank of San Francisco**  
**Statements of Cash Flows (continued)**  
(Unaudited)

(In millions)	For the Three Months Ended March 31,	
	2014	2013
<b>Cash Flows from Financing Activities:</b>		
Net change in:		
Deposits	189	(25)
Net (payments)/proceeds on derivative contracts with financing elements	(1)	26
Net proceeds from issuance of consolidated obligations:		
Bonds	8,377	3,875
Discount notes	17,912	19,784
Bonds transferred from another Federal Home Loan Bank	—	122
Payments for matured and retired consolidated obligations:		
Bonds	(8,390)	(9,862)
Discount notes	(17,242)	(12,166)
Proceeds from issuance of capital stock	197	106
Payments for repurchase/redemption of mandatorily redeemable capital stock	(428)	(437)
Payments for repurchase of capital stock	(331)	(314)
Cash dividends paid	(58)	(25)
Net cash provided by/(used in) financing activities	225	1,084
Net increase/(decrease) in cash and due from banks	(365)	968
Cash and due from banks at beginning of the period	4,906	104
Cash and due from banks at end of the period	\$ 4,541	\$ 1,072
<b>Supplemental Disclosures:</b>		
Interest paid	\$ 124	\$ 118
AHP payments	9	11
<b>Supplemental Disclosures of Noncash Investing Activities:</b>		
Transfers of mortgage loans to real estate owned	1	1
Transfers of other-than-temporarily impaired HTM securities to AFS securities	—	19

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

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements**  
(Unaudited)

(Dollars in millions except per share amounts)

## **Note 1 — Summary of Significant Accounting Policies**

The information about the Federal Home Loan Bank of San Francisco (Bank) included in these unaudited financial statements reflects all adjustments that, in the opinion of the Bank, are necessary for a fair statement of results for the periods presented. These adjustments are of a normal recurring nature, unless otherwise disclosed. The results of operations in these interim statements are not necessarily indicative of the results to be expected for any subsequent period or for the entire year ending December 31, 2014. These unaudited financial statements should be read in conjunction with the Bank's Annual Report on Form 10-K for the year ended December 31, 2013 (2013 Form 10-K).

**Use of Estimates.** The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) requires management to make a number of judgments, estimates, and assumptions that may affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported amounts of income, expenses, gains, and losses during the reporting period. The most significant of these estimates include estimating the allowance for credit losses on the advances and mortgage loan portfolios; accounting for derivatives; estimating fair values of investments classified as trading and available-for-sale, derivatives and associated hedged items carried at fair value in accordance with the accounting for derivative instruments and associated hedging activities, and financial instruments carried at fair value under the fair value option, and accounting for OTTI for investment securities; and estimating the prepayment speeds on mortgage-backed securities (MBS) and mortgage loans for the accounting of amortization of premiums and accretion of discounts on MBS and mortgage loans. Actual results could differ significantly from these estimates.

**Variable Interest Entities.** The Bank's investments in variable interest entities (VIEs) are limited to private-label residential mortgage-backed securities (PLRMBS). On an ongoing basis, the Bank performs a quarterly evaluation to determine whether it is the primary beneficiary in any VIE. The Bank evaluated its investments in VIEs as of March 31, 2014, to determine whether it is a primary beneficiary of any of these investments. The primary beneficiary is required to consolidate a VIE. The Bank determined that consolidation accounting is not required because the Bank is not the primary beneficiary of these VIEs for the periods presented. The Bank does not have the power to significantly affect the economic performance of any of these investments because it does not act as a key decision maker nor does it have the unilateral ability to replace a key decision maker. In addition, the Bank does not design, sponsor, transfer, service, or provide credit or liquidity support in any of its investments in VIEs. The Bank's maximum loss exposure for these investments is limited to the carrying value.

Descriptions of the Bank's significant accounting policies are included in "Item 8. Financial Statements and Supplementary Data – Note 1 – Summary of Significant Accounting Policies" in the Bank's 2013 Form 10-K. Other changes to these policies as of March 31, 2014, are discussed in Note 2 – Recently Issued and Adopted Accounting Guidance.

## **Note 2 — Recently Issued and Adopted Accounting Guidance**

**Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.** On January 17, 2014, the Financial Accounting Standards Board (FASB) issued guidance clarifying when consumer mortgage loans collateralized by real estate should be reclassified to real estate owned (REO). Specifically, these collateralized mortgage loans should be reclassified to REO when either the creditor obtains legal title to the residential real estate property upon completion of a foreclosure or the borrower conveys all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The guidance is effective for interim and annual periods beginning on or after December 15, 2014, and may be adopted under either the modified retrospective transition method or the

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

prospective transition method. The Bank is in the process of evaluating the effect of this guidance on the Bank's financial condition, results of operations, and cash flows, but it is not expected to be material.

**Joint and Several Liability Arrangements.** On February 28, 2013, the FASB issued guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of the guidance is fixed at the reporting date. The guidance requires an entity to measure these obligations as the sum of (1) the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and (2) any additional amount the reporting entity expects to pay on behalf of its co-obligors. In addition, the guidance requires an entity to disclose the nature and amount of the obligations as well as other information about the obligations. The guidance became effective for interim and annual periods beginning on January 1, 2014, and was applied retrospectively to obligations with joint and several liabilities existing at January 1, 2014. The adoption of this guidance did not affect the Bank's financial condition, results of operations, or cash flows.

### Recently Issued Regulatory Guidance

**Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention.** On April 9, 2012, the Federal Housing Finance Agency (Finance Agency) issued Advisory Bulletin 2012-02, *Framework for Adversely Classifying Loans, Other Real Estate Owned, and Other Assets and Listing Assets for Special Mention* (AB 2012-02). The guidance establishes a standard and uniform methodology for classifying loans, other real estate owned, and certain other assets (excluding investment securities) and prescribes the timing of asset charge-offs based on these classifications. The guidance is generally consistent with the *Uniform Retail Credit Classification and Account Management Policy* issued by the federal banking regulators in June 2000. The Bank implemented the asset classification provisions as of January 1, 2014, and this adoption did not have any impact on the Bank's financial condition, results of operations, or cash flows. The charge-off provisions are to be implemented no later than January 1, 2015, and the adoption of those provisions is not expected to have a significant impact on the Bank's financial condition, results of operations, or cash flows.

### Note 3 — Trading Securities

The estimated fair value of trading securities as of March 31, 2014, and December 31, 2013, was as follows:

	March 31, 2014	December 31, 2013
Government-sponsored enterprises (GSEs) – Federal Farm Credit Bank (FFCB) bonds	\$ 3,114	\$ 3,194
MBS – Other U.S. obligations – Ginnie Mae	13	14
<b>Total</b>	<b>\$ 3,127</b>	<b>\$ 3,208</b>

**Redemption Terms.** The estimated fair value of non-mortgage-backed securities (non-MBS) by contractual maturity (based on contractual final principal payment) and of mortgage-backed securities (MBS) as of March 31, 2014, and December 31, 2013, is shown below. Expected maturities of MBS will differ from contractual maturities because borrowers generally have the right to prepay the underlying obligations without prepayment fees.

Year of Contractual Maturity	March 31, 2014	December 31, 2013
<b>Trading securities other than MBS:</b>		
Due in 1 year or less	\$ 800	\$ 580
Due after 1 year through 5 years	2,314	2,614
Subtotal	3,114	3,194
MBS – Other U.S. obligations – Ginnie Mae	13	14
<b>Total</b>	<b>\$ 3,127</b>	<b>\$ 3,208</b>

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Interest Rate Payment Terms.** Interest rate payment terms for trading securities at March 31, 2014, and December 31, 2013, are detailed in the following table:

	March 31, 2014	December 31, 2013
Estimated fair value of trading securities other than MBS:		
Adjustable rate	\$ 3,114	\$ 3,194
Estimated fair value of trading MBS:		
Passthrough securities – Adjustable rate	13	14
<b>Total</b>	<b>\$ 3,127</b>	<b>\$ 3,208</b>

The net unrealized gain/(loss) on trading securities was de minimis and \$2 for the three months ended March 31, 2014 and 2013, respectively. These amounts represent the changes in the fair value of the securities during the reported periods.

**Note 4 — Available-for-Sale Securities**

Available-for-sale (AFS) securities by major security type as of March 31, 2014, and December 31, 2013, were as follows:

**March 31, 2014**

	Amortized Cost <sup>(1)</sup>	OTTI Recognized in AOCI	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
PLRMBS:					
Prime	\$ 636	\$ (13)	\$ 35	\$ —	\$ 658
Alt-A, option ARM	1,100	(69)	63	—	1,094
Alt-A, other	5,211	(209)	166	(4)	5,164
<b>Total</b>	<b>\$ 6,947</b>	<b>\$ (291)</b>	<b>\$ 264</b>	<b>\$ (4)</b>	<b>\$ 6,916</b>

**December 31, 2013**

	Amortized Cost <sup>(1)</sup>	OTTI Recognized in AOCI	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
PLRMBS:					
Prime	\$ 661	\$ (11)	27	\$ —	\$ 677
Alt-A, option ARM	1,122	(74)	51	—	1,099
Alt-A, other	5,376	(239)	142	(8)	5,271
<b>Total</b>	<b>\$ 7,159</b>	<b>\$ (324)</b>	<b>\$ 220</b>	<b>\$ (8)</b>	<b>\$ 7,047</b>

(1) Amortized cost includes unpaid principal balance, unamortized premiums and discounts, and previous OTTI recognized in earnings.

Expected maturities of PLRMBS will differ from contractual maturities because borrowers generally have the right to prepay the underlying obligations without prepayment fees.

At March 31, 2014, the amortized cost of the Bank's PLRMBS classified as AFS included credit-related OTTI of \$1,279. At December 31, 2013, the amortized cost of the Bank's PLRMBS classified as AFS included credit-related OTTI of \$1,312.

The following table summarizes the AFS securities with unrealized losses as of March 31, 2014, and December 31, 2013. The unrealized losses are aggregated by major security type and the length of time that individual securities

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

have been in a continuous unrealized loss position. Total unrealized losses in the following table will not agree to the total gross unrealized losses in the table above. The unrealized losses in the following table also include non-credit-related OTTI losses recognized in AOCI. For OTTI analysis of AFS securities, see Note 6 – Other-Than-Temporary Impairment Analysis.

**March 31, 2014**

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
PLRMBS:						
Prime	\$ 23	\$ —	\$ 267	\$ 13	\$ 290	\$ 13
Alt-A, option ARM	—	—	642	69	642	69
Alt-A, other	454	8	2,185	205	2,639	213
Total	\$ 477	\$ 8	\$ 3,094	\$ 287	\$ 3,571	\$ 295

**December 31, 2013**

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
PLRMBS:						
Prime	\$ 28	\$ —	\$ 287	\$ 11	\$ 315	\$ 11
Alt-A, option ARM	—	—	674	74	674	74
Alt-A, other	677	10	2,351	237	3,028	247
Total	\$ 705	\$ 10	\$ 3,312	\$ 322	\$ 4,017	\$ 332

As indicated in the tables above, as of March 31, 2014, the Bank's investments classified as AFS had gross unrealized losses related to PLRMBS, which were primarily due to illiquidity in the MBS market, uncertainty about the future condition of the housing and mortgage markets and the economy, and market expectations of the credit performance of loan collateral underlying these securities, which caused these assets to be valued at discounts to their acquisition cost.

**Interest Rate Payment Terms.** Interest rate payment terms for AFS securities at March 31, 2014, and December 31, 2013, are shown in the following table:

	March 31, 2014	December 31, 2013
Amortized cost of AFS PLRMBS:		
Collateralized mortgage obligations:		
Fixed rate	\$ 2,284	\$ 2,450
Adjustable rate	4,663	4,709
Total	\$ 6,947	\$ 7,159

Certain MBS classified as fixed rate collateralized mortgage obligations have an initial fixed interest rate that subsequently converts to an adjustable interest rate on a specified date as follows:



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	March 31, 2014	December 31, 2013
Collateralized mortgage obligations:		
Converts in 1 year or less	\$ 109	\$ 191
Converts after 1 year through 5 years	343	364
Total	\$ 452	\$ 555

See Note 6 – Other-Than-Temporary Impairment Analysis for information on the transfers of securities between the AFS portfolio and the held-to-maturity (HTM) portfolio.

**Note 5 — Held-to-Maturity Securities**

The Bank classifies the following securities as HTM because the Bank has the positive intent and ability to hold these securities to maturity:

**March 31, 2014**

	Amortized Cost <sup>(1)</sup>	OTTI Recognized in AOCI <sup>(1)</sup>	Carrying Value <sup>(2)</sup>	Gross Unrecognized Holding Gains <sup>(3)</sup>	Gross Unrecognized Holding Losses <sup>(3)</sup>	Estimated Fair Value
Certificates of deposit	\$ 2,508	\$ —	\$ 2,508	\$ —	\$ —	\$ 2,508
Housing finance agency bonds:						
California Housing Finance Agency (CalHFA) bonds	380	—	380	—	(88)	292
Subtotal	2,888	—	2,888	—	(88)	2,800
MBS:						
Other U.S. obligations – Ginnie Mae	1,676	—	1,676	5	(26)	1,655
GSEs:						
Freddie Mac	5,093	—	5,093	57	(58)	5,092
Fannie Mae	6,139	—	6,139	116	(26)	6,229
Subtotal GSEs	11,232	—	11,232	173	(84)	11,321
PLRMBS:						
Prime	1,319	—	1,319	2	(31)	1,290
Alt-A, option ARM	16	—	16	—	(2)	14
Alt-A, other	869	(26)	843	24	(22)	845
Subtotal PLRMBS	2,204	(26)	2,178	26	(55)	2,149
Total MBS	15,112	(26)	15,086	204	(165)	15,125
Total	\$ 18,000	\$ (26)	\$ 17,974	\$ 204	\$ (253)	\$ 17,925

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

	Amortized Cost <sup>(1)</sup>	OTTI Recognized in AOCI <sup>(1)</sup>	Carrying Value <sup>(2)</sup>	Gross Unrecognized Holding Gains <sup>(2)</sup>	Gross Unrecognized Holding Losses <sup>(2)</sup>	Estimated Fair Value
Certificates of deposit	\$ 1,660	\$ —	\$ 1,660	\$ —	\$ —	\$ 1,660
Housing finance agency bonds:						
CalHFA bonds	416	—	416	—	(100)	316
Subtotal	2,076	—	2,076	—	(100)	1,976
MBS:						
Other U.S. obligations – Ginnie Mae	1,575	—	1,575	3	(45)	1,533
GSEs:						
Freddie Mac	5,250	—	5,250	53	(90)	5,213
Fannie Mae	6,331	—	6,331	109	(45)	6,395
Subtotal GSEs	11,581	—	11,581	162	(135)	11,608
PLRMBS:						
Prime	1,380	—	1,380	1	(37)	1,344
Alt-A, option ARM	16	—	16	—	(2)	14
Alt-A, other	906	(27)	879	24	(26)	877
Subtotal PLRMBS	2,302	(27)	2,275	25	(65)	2,235
Total MBS	15,458	(27)	15,431	190	(245)	15,376
Total	\$ 17,534	\$ (27)	\$ 17,507	\$ 190	\$ (345)	\$ 17,352

(1) Amortized cost includes unpaid principal balance, unamortized premiums and discounts, and previous OTTI recognized in earnings. The carrying value of HTM securities represents amortized cost after adjustment for non-credit-related OTTI recognized in AOCI.

(2) Gross unrecognized holding gains/(losses) represent the difference between estimated fair value and carrying value.

At March 31, 2014, the amortized cost of the Bank's MBS classified as HTM included premiums of \$65, discounts of \$65, and credit-related OTTI of \$7. At December 31, 2013, the amortized cost of the Bank's MBS classified as HTM included premiums of \$71, discounts of \$70, and credit-related OTTI of \$6.

The following tables summarize the HTM securities with unrealized losses as of March 31, 2014, and December 31, 2013. The unrealized losses are aggregated by major security type and the length of time that individual securities have been in a continuous unrealized loss position. Total unrealized losses in the following table will not agree to the total gross unrecognized losses in the table above. The unrealized losses in the following table also include non-credit-related OTTI losses recognized in AOCI. For OTTI analysis of HTM securities, see Note 6 – Other-Than-Temporary Impairment Analysis.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**March 31, 2014**

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Certificates of deposit	\$ 826	\$ —	\$ —	\$ —	\$ 826	\$ —
Housing finance agency bonds:						
CalHFA bonds	—	—	292	88	292	88
MBS:						
Other U.S. obligations – Ginnie Mae	1,109	26	2	—	1,111	26
GSEs:						
Freddie Mac	2,753	58	34	—	2,787	58
Fannie Mae	1,915	22	120	4	2,035	26
Subtotal GSEs	4,668	80	154	4	4,822	84
PLRMBS:						
Prime	375	3	667	28	1,042	31
Alt-A, option ARM	—	—	14	2	14	2
Alt-A, other	154	2	650	46	804	48
Subtotal PLRMBS	529	5	1,331	76	1,860	81
Total MBS	6,306	111	1,487	80	7,793	191
Total	\$ 7,132	\$ 111	\$ 1,779	\$ 168	\$ 8,911	\$ 279

**December 31, 2013**

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses	Estimated Fair Value	Unrealized Losses
Housing finance agency bonds:						
CalHFA bonds	\$ —	\$ —	\$ 316	\$ 100	\$ 316	\$ 100
MBS:						
Other U.S. obligations – Ginnie Mae	1,187	45	2	—	1,189	45
GSEs:						
Freddie Mac	2,918	89	66	1	2,984	90
Fannie Mae	2,069	40	126	5	2,195	45
Subtotal GSEs	4,987	129	192	6	5,179	135
PLRMBS:						
Prime	481	5	693	32	1,174	37
Alt-A, option ARM	—	—	14	2	14	2
Alt-A, other	159	2	688	51	847	53
Subtotal PLRMBS	640	7	1,395	85	2,035	92
Total MBS	6,814	181	1,589	91	8,403	272
Total	\$ 6,814	\$ 181	\$ 1,905	\$ 191	\$ 8,719	\$ 372

As indicated in the tables above, the Bank's investments classified as HTM had gross unrealized losses primarily related to CalHFA bonds and MBS. The Bank also had gross unrealized losses associated with certificates of deposit that were de minimis, which were caused by movements in interest rates and not a deterioration of the issuers' creditworthiness. The gross unrealized losses associated with the CalHFA bonds were mainly due to an illiquid market, credit concerns regarding the underlying mortgage collateral, and credit concerns regarding the monoline insurance providers, causing these investments to be valued at a discount to their acquisition cost. For its agency MBS, the Bank expects to recover the entire amortized cost basis of these securities because the Bank determined that the strength of the issuers' guarantees through direct obligations or support from the U.S. government is sufficient to protect the Bank from losses. The gross unrealized losses associated with the PLRMBS were primarily due to illiquidity in the MBS market, uncertainty about the future condition of the housing and

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

mortgage markets and the economy, and market expectations of the credit performance of the loan collateral underlying these securities, which caused these assets to be valued at discounts to their acquisition cost.

**Redemption Terms.** The amortized cost, carrying value, and estimated fair value of non-MBS securities by contractual maturity (based on contractual final principal payment) and of MBS as of March 31, 2014, and December 31, 2013, are shown below. Expected maturities of MBS will differ from contractual maturities because borrowers generally have the right to prepay the underlying obligations without prepayment fees.

**March 31, 2014**

Year of Contractual Maturity	Amortized Cost <sup>(1)</sup>	Carrying Value <sup>(2)</sup>	Estimated Fair Value
<b>HTM securities other than MBS:</b>			
Due in 1 year or less	\$ 2,508	\$ 2,508	\$ 2,508
Due after 5 years through 10 years	62	62	49
Due after 10 years	318	318	243
Subtotal	2,888	2,888	2,800
<b>MBS:</b>			
Other U.S. obligations – Ginnie Mae	1,676	1,676	1,655
<b>GSEs:</b>			
Freddie Mac	5,093	5,093	5,092
Fannie Mae	6,139	6,139	6,229
Subtotal GSEs	11,232	11,232	11,321
<b>PLRMBS:</b>			
Prime	1,319	1,319	1,290
Alt-A, option ARM	16	16	14
Alt-A, other	869	843	845
Subtotal PLRMBS	2,204	2,178	2,149
Total MBS	15,112	15,086	15,125
Total	\$ 18,000	\$ 17,974	\$ 17,925

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**December 31, 2013**

Year of Contractual Maturity	Amortized Cost <sup>(1)</sup>	Carrying Value <sup>(1)</sup>	Estimated Fair Value
<b>HTM securities other than MBS:</b>			
Due in 1 year or less	\$ 1,660	\$ 1,660	\$ 1,660
Due after 5 years through 10 years	62	62	49
Due after 10 years	354	354	267
Subtotal	2,076	2,076	1,976
<b>MBS:</b>			
Other U.S. obligations – Ginnie Mae	1,575	1,575	1,533
<b>GSEs:</b>			
Freddie Mac	5,250	5,250	5,213
Fannie Mae	6,331	6,331	6,395
Subtotal GSEs	11,581	11,581	11,608
<b>PLRMBS:</b>			
Prime	1,380	1,380	1,344
Alt-A, option ARM	16	16	14
Alt-A, other	906	879	877
Subtotal PLRMBS	2,302	2,275	2,235
<b>Total MBS</b>	<b>15,458</b>	<b>15,431</b>	<b>15,376</b>
<b>Total</b>	<b>\$ 17,534</b>	<b>\$ 17,507</b>	<b>\$ 17,352</b>

(1) Amortized cost includes unpaid principal balance, unamortized premiums and discounts, and previous OTTI recognized in earnings. The carrying value of HTM securities represents amortized cost after adjustment for non-credit-related OTTI recognized in AOCI.

**Interest Rate Payment Terms.** Interest rate payment terms for HTM securities at March 31, 2014, and December 31, 2013, are detailed in the following table:

	March 31, 2014	December 31, 2013
<b>Amortized cost of HTM securities other than MBS:</b>		
Fixed rate	\$ 2,508	\$ 1,660
Adjustable rate	380	416
Subtotal	2,888	2,076
<b>Amortized cost of HTM MBS:</b>		
<b>Passthrough securities:</b>		
Fixed rate	410	461
Adjustable rate	425	430
<b>Collateralized mortgage obligations:</b>		
Fixed rate	10,681	10,820
Adjustable rate	3,596	3,747
Subtotal	15,112	15,458
<b>Total</b>	<b>\$ 18,000</b>	<b>\$ 17,534</b>

Certain MBS classified as fixed rate passthrough securities and fixed rate collateralized mortgage obligations have an initial fixed interest rate that subsequently converts to an adjustable interest rate on a specified date as follows:

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**Notes to Financial Statements (continued)**

	March 31, 2014	December 31, 2013
Passthrough securities:		
Converts in 1 year or less	\$ 43	\$ 62
Converts after 1 year through 5 years	287	316
Converts after 5 years through 10 years	70	72
<b>Total</b>	<b>\$ 400</b>	<b>\$ 450</b>
Collateralized mortgage obligations:		
Converts in 1 year or less	\$ 203	\$ 185
Converts after 1 year through 5 years	93	133
<b>Total</b>	<b>\$ 296</b>	<b>\$ 318</b>

See Note 6 – Other-Than-Temporary Impairment Analysis for information on the transfers of securities between the AFS portfolio and the HTM portfolio.

**Note 6 — Other-Than-Temporary Impairment Analysis**

On a quarterly basis, the Bank evaluates its individual AFS and HTM investment securities in an unrealized loss position for OTTI. As part of this evaluation, the Bank considers whether it intends to sell each debt security and whether it is more likely than not that it will be required to sell the debt security before its anticipated recovery of the amortized cost basis. If either of these conditions is met, the Bank recognizes an OTTI charge to earnings equal to the entire difference between the security's amortized cost basis and its fair value at the statement of condition date. For securities in an unrealized loss position that meet neither of these conditions, the Bank considers whether it expects to recover the entire amortized cost basis of the security by comparing its best estimate of the present value of the cash flows expected to be collected from the security with the amortized cost basis of the security. If the Bank's best estimate of the present value of the cash flows expected to be collected is less than the amortized cost basis, the difference is considered the credit loss.

**PLRMBS.** To assess whether it expects to recover the entire amortized cost basis of its PLRMBS, the Bank performed a cash flow analysis for all of its PLRMBS as of March 31, 2014, using two third-party models. The first model projects prepayments, default rates, and loss severities on the underlying loan collateral based on borrower characteristics and the particular attributes of the loans underlying the Bank's securities, in conjunction with assumptions related primarily to future changes in home prices and interest rates. A significant input to the first model is the forecast of future housing price changes for the relevant states and core-based statistical areas (CBSAs), which are based on an assessment of the regional housing markets. CBSA refers collectively to metropolitan and micropolitan statistical areas as defined by the United States Office of Management and Budget. As currently defined, a CBSA must contain at least one urban area with a population of 10,000 or more people. The FHLBanks' OTTI Governance Committee developed a short-term housing price forecast with projected changes ranging from a decrease of 3.0% to an increase of 9.0% over the 12-month period beginning January 1, 2014. For the vast majority of markets, the projected short-term housing price changes range from a decrease of 1.0% to an increase of 4.0%. Thereafter, home prices were projected to recover using one of five different recovery paths. The table below presents the ranges of the annualized projected home price recovery rates at March 31, 2014.

Months	March 31, 2014
1 - 6	0.0% - 3.0%
7 - 12	1.0% - 4.0%
13 - 18	2.0% - 4.0%
19 - 30	2.0% - 5.0%
31 - 54	2.0% - 6.0%
Thereafter	2.3% - 5.6%

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**Notes to Financial Statements (continued)**

The month-by-month projections of future loan performance derived from the first model, which reflect projected prepayments, default rates, and loss severities, are then input into a second model that allocates the projected loan level cash flows and losses to the various security classes in each securitization structure in accordance with the structure's prescribed cash flow and loss allocation rules. When the credit enhancement for the senior securities in a securitization is derived from the presence of subordinated securities, losses are generally allocated first to the subordinated securities until their principal balance is reduced to zero. The projected cash flows are based on a number of assumptions and expectations, and the results of these models can vary significantly with changes in assumptions and expectations. The scenario of cash flows determined based on the model approach described above reflects a best-estimate scenario and includes a base case housing price forecast that reflects the expectations for near- and long-term housing price behavior.

At each quarter end, the Bank compares the present value of the cash flows expected to be collected on its PLRMBS to the amortized cost basis of the securities to determine whether a credit loss exists. For the Bank's variable rate and hybrid PLRMBS, the Bank uses the effective interest rate derived from a variable rate index (for example, one-month LIBOR) plus the contractual spread, plus or minus a fixed spread adjustment when there is an existing discount or premium on the security. As the implied forward rates of the index change over time, the effective interest rates derived from that index will also change over time. The Bank then uses the effective interest rate for the security prior to impairment for determining the present value of the future estimated cash flows. For all securities, including securities previously identified as other-than-temporarily impaired, the Bank updates its estimate of future estimated cash flows on a quarterly basis.

For all the PLRMBS in its AFS and HTM portfolios, the Bank does not intend to sell any security and it is not more likely than not that the Bank will be required to sell any security before its anticipated recovery of the remaining amortized cost basis.

For securities determined to be other-than-temporarily impaired as of March 31, 2014 (securities for which the Bank determined that it does not expect to recover the entire amortized cost basis), the following table presents a summary of the significant inputs used in measuring the amount of credit loss recognized in earnings in the first quarter of 2014, and the related current credit enhancement for the Bank.

**March 31, 2014**

Year of Securitization	Significant Inputs for Other-Than-Temporarily Impaired PLRMBS			Current
	Prepayment Rates	Default Rates	Loss Severities	Credit Enhancement
	Weighted Average %	Weighted Average %	Weighted Average %	Weighted Average %
Prime				
2006	12.5	17.6	41.0	—
Total Prime	12.5	17.6	41.0	—
Alt-A, other				
2007	9.9	34.4	43.2	8.4
2005	10.0	31.6	46.0	—
2004 and earlier	12.3	7.6	38.1	13.3
Total Alt-A, other	10.5	27.1	42.8	7.0
Total	10.5	27.1	42.8	6.9

Credit enhancement is defined as the percentage of subordinated tranches, excess spread, and over-collateralization, if any, in a security structure that will generally absorb losses before the Bank will experience a loss on the security. The calculated averages represent the dollar-weighted averages of all the PLRMBS investments in each category shown. The classification (Prime; Alt-A, option ARM; and Alt-A, other) is based on the model used to run the estimated cash flows for the CUSIP, which may not necessarily be the same as the classification at the time of origination.

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**Notes to Financial Statements (continued)**

For each security classified as HTM, the estimated non-credit-related OTTI is accreted prospectively, based on the amount and timing of future estimated cash flows, over the remaining life of the security as an increase in the carrying value of the security (with no effect on earnings unless the security is subsequently sold or there are additional decreases in the cash flows expected to be collected). The Bank accreted \$1 and \$2 from AOCI to increase the carrying value of the respective PLRMBS classified as HTM for the three months ended March 31, 2014 and 2013, respectively. The Bank does not intend to sell these securities and it is not more likely than not that the Bank will be required to sell these securities before its anticipated recovery of the remaining amortized cost basis.

The following table presents the credit-related OTTI, which is recognized in earnings, for the three months ended March 31, 2014 and 2013.

	Three Months Ended	
	March 31, 2014	March 31, 2013
Balance, beginning of the period	\$ 1,378	\$ 1,397
Additional charges on securities for which OTTI was previously recognized <sup>(1)</sup>	—	3
Increases in cash flows expected to be collected that are recognized over the remaining life of the securities	(16)	(2)
Balance, end of the period	\$ 1,362	\$ 1,398

- (1) For the three months ended March 31, 2014, “securities for which OTTI was previously recognized” represents all securities that were also other-than-temporarily impaired prior to January 1, 2014. For the three months ended March 31, 2013, “securities for which OTTI was previously recognized” represents all securities that were also previously other-than-temporarily impaired prior to January 1, 2013.

Changes in circumstances may cause the Bank to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. The sale or transfer of an HTM security because of certain changes in circumstances, such as evidence of significant deterioration in the issuers’ creditworthiness, is not considered to be inconsistent with its original classification. In addition, other events that are isolated, nonrecurring, or unusual for the Bank that could not have been reasonably anticipated may cause the Bank to sell or transfer an HTM security without necessarily calling into question its intent to hold other debt securities to maturity.

Beginning in the first quarter of 2011, the Bank elected to transfer any PLRMBS that incurred a credit-related OTTI loss during the applicable period from the Bank’s HTM portfolio to its AFS portfolio at their fair values. The Bank recognized an OTTI credit loss on these HTM PLRMBS, which the Bank believes is evidence of a significant decline in the issuers’ creditworthiness. The decline in the issuers’ creditworthiness is the basis for the transfers to the AFS portfolio. These transfers allow the Bank the option to sell these securities prior to maturity in view of changes in interest rates, changes in prepayment risk, or other factors, while recognizing the Bank’s intent to hold these securities for an indefinite period of time. The Bank does not intend to sell its other-than-temporarily impaired securities and it is not more likely than not that the Bank will be required to sell any security before its anticipated recovery of the remaining amortized cost basis.

The Bank did not transfer any PLRMBS from its HTM portfolio to its AFS portfolio during the three months ended March 31, 2014. The following table summarizes the PLRMBS transferred during the three months ended March 31, 2013. The amounts shown represent the values when the securities were transferred from the HTM portfolio to the AFS portfolio.



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	Three Months Ended March 31, 2013			
	Amortized Cost	OTTI Recognized in AOCI	Gross Unrecognized Holding Gains	Estimated Fair Value
Other-than-temporarily impaired PLRMBS backed by loans classified at origination as:				
Alt-A, option ARM	\$ 22	\$ (3)	\$ —	\$ 19
Total	\$ 22	\$ (3)	\$ —	\$ 19

The following tables present the Bank's AFS and HTM PLRMBS that incurred OTTI losses anytime during the life of the securities at March 31, 2014, and December 31, 2013, by loan collateral type:

**March 31, 2014**

	Available-for-Sale Securities			Held-to-Maturity Securities			
	Unpaid Principal Balance	Amortized Cost	Estimated Fair Value	Unpaid Principal Balance	Amortized Cost	Carrying Value	Estimated Fair Value
Other-than-temporarily impaired PLRMBS backed by loans classified at origination as:							
Prime	\$ 765	\$ 636	\$ 658	\$ —	\$ —	\$ —	\$ —
Alt-A, option ARM	1,486	1,100	1,094	—	—	—	—
Alt-A, other	5,968	5,211	5,164	145	142	117	140
Total	\$ 8,219	\$ 6,947	\$ 6,916	\$ 145	\$ 142	\$ 117	\$ 140

**December 31, 2013**

	Available-for-Sale Securities			Held-to-Maturity Securities			
	Unpaid Principal Balance	Amortized Cost	Estimated Fair Value	Unpaid Principal Balance	Amortized Cost	Carrying Value	Estimated Fair Value
Other-than-temporarily impaired PLRMBS backed by loans classified at origination as:							
Prime	\$ 795	\$ 661	\$ 677	\$ —	\$ —	\$ —	\$ —
Alt-A, option ARM	1,516	1,122	1,099	—	—	—	—
Alt-A, other	6,151	5,376	5,271	150	147	120	144
Total	\$ 8,462	\$ 7,159	\$ 7,047	\$ 150	\$ 147	\$ 120	\$ 144

For the Bank's PLRMBS that were not other-than-temporarily impaired as of March 31, 2014, the Bank has experienced net unrealized losses primarily because of illiquidity in the PLRMBS market, uncertainty about the future condition of the housing and mortgage markets and the economy, and market expectations of the credit performance of loan collateral underlying these securities, which caused these assets to be valued at discounts to their acquisition cost. The Bank does not intend to sell these securities, it is not more likely than not that the Bank will be required to sell these securities before its anticipated recovery of the remaining amortized cost basis, and the Bank expects to recover the entire amortized cost basis of these securities. As a result, the Bank determined that, as of March 31, 2014, the gross unrealized losses on these PLRMBS are temporary. These securities were included in the securities that the Bank reviewed and analyzed for OTTI as discussed above, and the analyses performed indicated that these securities were not other-than-temporarily impaired.

**All Other Available-for-Sale and Held-to-Maturity Investments.** As of March 31, 2014, the Bank's investments in certificates of deposit had a de minimis gross unrealized loss resulting from movements in interest rates and not a deterioration of the issuers' creditworthiness.

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As of March 31, 2014, the Bank's investments in housing finance agency bonds, which were issued by CalHFA, had gross unrealized losses totaling \$88. These gross unrealized losses were mainly due to an illiquid market, credit concerns regarding the underlying mortgage collateral, and credit concerns regarding the monoline insurance providers, causing these investments to be valued at a discount to their acquisition cost. The Bank independently modeled cash flows for the underlying collateral, using assumptions for default rates and loss severity that a market participant would deem reasonable, and concluded that the available credit support within the CalHFA structure more than offset the projected underlying collateral losses. The Bank determined that, as of March 31, 2014, all of the gross unrealized losses on the bonds are temporary because the underlying collateral and credit enhancements were sufficient to protect the Bank from losses. As a result, the Bank expects to recover the entire amortized cost basis of these securities.

For its agency MBS, the Bank expects to recover the entire amortized cost basis of these securities because the Bank determined that the strength of the issuers' guarantees through direct obligations or support from the U.S. government is sufficient to protect the Bank from losses. As a result, the Bank determined that, as of March 31, 2014, all of the gross unrealized losses on its agency MBS are temporary.

### **Note 7 — Advances**

The Bank offers a wide range of fixed and adjustable rate advance products with different maturities, interest rates, payment characteristics, and option features. Fixed rate advances generally have maturities ranging from one day to 30 years. Adjustable rate advances generally have maturities ranging from less than 30 days to 10 years, with the interest rates resetting periodically at a fixed spread to LIBOR or to another specified index.

**Redemption Terms.** The Bank had advances outstanding, excluding overdrawn demand deposit accounts, at interest rates ranging from 0.10% to 8.57% at March 31, 2014, and 0.06% to 8.57% at December 31, 2013, as summarized below.

Contractual Maturity	March 31, 2014		December 31, 2013	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Within 1 year	\$ 24,092	0.55%	\$ 22,556	0.50%
After 1 year through 2 years	6,239	1.60	6,838	1.48
After 2 years through 3 years	6,663	1.10	6,754	1.24
After 3 years through 4 years	3,854	1.38	3,208	1.43
After 4 years through 5 years	2,723	1.88	2,825	1.79
After 5 years	1,779	2.63	2,006	2.41
Total par value	45,350	1.00%	44,187	1.00%
Valuation adjustments for hedging activities	82		95	
Valuation adjustments under fair value option	120		113	
Total	\$ 45,552		\$ 44,395	

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 intended to make the Bank financially indifferent to the prepayment. In addition, for certain advances with partial prepayment symmetry, the Bank may charge the member a prepayment fee or pay the member a prepayment credit depending on certain circumstances, such as movements in interest rates, when the advance is prepaid. The Bank had advances with partial prepayment symmetry outstanding totaling \$6,702 at March 31, 2014, and \$6,833 at December 31, 2013. Some advances may be repaid on pertinent call dates without prepayment fees (callable advances). The Bank had callable advances outstanding totaling \$288 at March 31, 2014, and \$235 at December 31, 2013.

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The Bank's advances at March 31, 2014, and December 31, 2013, included \$180 and \$182, respectively, of putable advances. At the Bank's discretion, the Bank may terminate these advances on predetermined exercise dates and offer replacement funding at prevailing market rates, subject to certain conditions. The Bank would typically exercise such termination rights when interest rates increase.

The following table summarizes advances at March 31, 2014, and December 31, 2013, by the earlier of the year of contractual maturity or next call date for callable advances and by the earlier of the year of contractual maturity or next put date for putable advances.

	Earlier of Contractual Maturity or Next Call Date		Earlier of Contractual Maturity or Next Put Date	
	March 31, 2014	December 31, 2013	March 31, 2014	December 31, 2013
Within 1 year	\$ 24,175	\$ 22,609	\$ 24,231	\$ 22,696
After 1 year through 2 years	6,254	6,843	6,239	6,838
After 2 years through 3 years	6,771	6,850	6,664	6,754
After 3 years through 4 years	3,890	3,208	3,714	3,108
After 4 years through 5 years	2,765	2,901	2,723	2,785
After 5 years	1,495	1,776	1,779	2,006
Total par value	\$ 45,350	\$ 44,187	\$ 45,350	\$ 44,187

**Credit and Concentration Risk.** The following tables present the concentration in advances to the top five borrowers and their affiliates at March 31, 2014 and 2013. The tables also present the interest income from these advances before the impact of interest rate exchange agreements associated with these advances for the three months ended March 31, 2014 and 2013.

Name of Borrower	March 31, 2014		Three Months Ended March 31, 2014	
	Advances Outstanding <sup>(1)</sup>	Percentage of Total Advances Outstanding	Interest Income from Advances <sup>(2)</sup>	Percentage of Total Interest Income from Advances
Bank of America California, N.A.	\$ 10,000	22%	\$ 5	5%
JPMorgan Chase & Co.:				
JPMorgan Bank & Trust Company, National Association	5,125	11	15	13
JPMorgan Chase Bank, National Association <sup>(3)</sup>	834	2	2	2
Subtotal JPMorgan Chase & Co.	5,959	13	17	15
First Republic Bank	5,650	12	21	19
Bank of the West	4,437	10	8	7
OneWest Bank, N.A.	3,040	7	3	3
Subtotal	29,086	64	54	49
Others	16,264	36	57	51
Total	\$ 45,350	100%	\$ 111	100%

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

Name of Borrower	March 31, 2013		Three Months Ended March 31, 2013	
	Advances Outstanding <sup>(1)</sup>	Percentage of Total Advances Outstanding	Interest Income from Advances <sup>(2)</sup>	Percentage of Total Interest Income from Advances
<b>JPMorgan Chase &amp; Co.:</b>				
JPMorgan Bank & Trust Company, National Association	\$ 7,850	17%	\$ 21	17%
JPMorgan Chase Bank, National Association <sup>(3)</sup>	841	2	2	2
Subtotal JPMorgan Chase & Co.	8,691	19	23	19
Citibank, N.A. <sup>(3)</sup>	8,284	18	5	4
Bank of America California, N.A.	6,000	13	2	2
First Republic Bank	4,140	9	14	12
OneWest Bank, FSB	3,639	8	11	9
Subtotal	30,754	67	55	46
Others	15,455	33	66	54
<b>Total</b>	<b>\$ 46,209</b>	<b>100%</b>	<b>\$ 121</b>	<b>100%</b>

- (1) Borrower advance amounts and total advance amounts are at par value, and total advance amounts will not agree to carrying value amounts shown in the Statements of Condition. The differences between the par and carrying value amounts primarily relate to unrealized gains or losses associated with hedged advances resulting from valuation adjustments related to hedging activities and valuation adjustments under the fair value option.
- (2) Interest income amounts exclude the interest effect of interest rate exchange agreements with derivative counterparties; as a result, the total interest income amounts will not agree to the Statements of Income. The amount of interest income from advances can vary depending on the amount outstanding, terms to maturity, interest rates, and repricing characteristics.
- (3) Nonmember institution.

The Bank held a security interest in collateral from each of the top five advances borrowers and their affiliates sufficient to support their respective advances outstanding, and the Bank does not expect to incur any credit losses on these advances.

For information related to the Bank's credit risk on advances and allowance methodology for credit losses, see Note 9 – Allowance for Credit Losses.

**Interest Rate Payment Terms.** Interest rate payment terms for advances at March 31, 2014, and December 31, 2013, are detailed below:

	March 31, 2014	December 31, 2013
<b>Par value of advances:</b>		
Fixed rate:		
Due within 1 year	\$ 18,910	\$ 17,998
Due after 1 year	16,080	16,453
Total fixed rate	34,990	34,451
Adjustable rate:		
Due within 1 year	5,182	4,558
Due after 1 year	5,178	5,178
Total adjustable rate	10,360	9,736
Total par value	\$ 45,350	\$ 44,187

The Bank may use derivatives to adjust the repricing and/or options characteristics of advances to more closely match the characteristics of the Bank's funding liabilities. In general, 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 variable rate asset. This type of hedge is treated as a fair value hedge. In addition, for certain advances for which the Bank has elected the fair value

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**Notes to Financial Statements (continued)**

option, the Bank will simultaneously execute an interest rate exchange agreement with terms that economically offset the terms of the advance. However, this type of hedge is treated as an economic hedge because these combinations generally do not meet the requirements for fair value hedge accounting treatment. For more information, see Note 15 – Derivatives and Hedging Activities and Note 16 – Fair Value.

The Bank did not have any advances with embedded features that met the requirements to separate the embedded feature from the host contract and designate the embedded feature as a stand-alone derivative at March 31, 2014, and December 31, 2013.

**Note 8 — Mortgage Loans Held for Portfolio**

Under the Mortgage Partnership Finance® (MPF®) Program, the Bank purchased conventional conforming fixed rate residential mortgage loans directly from its participating members from May 2002 through October 2006. (“Mortgage Partnership Finance” and “MPF” are registered trademarks of the FHLBank of Chicago.) Participating members originated or purchased the mortgage loans, credit-enhanced them and sold them to the Bank, and generally retained the servicing of the loans.

The following table presents information as of March 31, 2014, and December 31, 2013, on mortgage loans, all of which are secured by one- to four-unit residential properties and single-unit second homes.

	March 31, 2014	December 31, 2013
Fixed rate medium-term mortgage loans	\$ 217	\$ 238
Fixed rate long-term mortgage loans	643	675
Subtotal	860	913
Unamortized premiums	9	10
Unamortized discounts	(15)	(16)
Mortgage loans held for portfolio	854	907
Less: Allowance for credit losses	(2)	(2)
Total mortgage loans held for portfolio, net	\$ 852	\$ 905

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

**Concentration Risk.** The Bank had the following concentration in MPF loans with institutions whose outstanding total of mortgage loans sold to the Bank represented 10% or more of the Bank’s total outstanding mortgage loans at March 31, 2014, and December 31, 2013.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**March 31, 2014**

Name of Institution	Mortgage Loan Balances Outstanding	Percentage of Total Mortgage Loan Balances Outstanding	Number of Mortgage Loans Outstanding	Percentage of Total Number of Mortgage Loans Outstanding
JPMorgan Chase Bank, National Association <sup>(1)</sup>	\$ 678	79%	7,090	69%
OneWest Bank, N.A.	110	13	2,408	23
Subtotal	788	92	9,498	92
Others	72	8	840	8
Total	\$ 860	100%	10,338	100%

**December 31, 2013**

Name of Institution	Mortgage Loan Balances Outstanding	Percentage of Total Mortgage Loan Balances Outstanding	Number of Mortgage Loans Outstanding	Percentage of Total Number of Mortgage Loans Outstanding
JPMorgan Chase Bank, National Association <sup>(1)</sup>	\$ 715	78%	7,355	69%
OneWest Bank, FSB	120	13	2,510	23
Subtotal	835	91	9,865	92
Others	78	9	883	8
Total	\$ 913	100%	10,748	100%

(1) Nonmember institution.

For information related to the Bank's credit risk on mortgage loans and allowance methodology for credit losses, see Note 9 – Allowance for Credit Losses.

**Note 9 — Allowance for Credit Losses**

The Bank has established an allowance methodology for each of its portfolio segments: credit products, mortgage loans held for portfolio, term securities purchased under agreements to resell, and term Federal funds sold. For more information on these portfolio segments, see “Item 8. Financial Statements and Supplementary Data – Note 10 – Allowance for Credit Losses” in the Bank's 2013 Form 10-K.

**Credit Products.** The Bank manages its credit exposure related to credit products through an integrated approach that generally provides for a credit limit to be established for each borrower, includes an ongoing review of each borrower's financial condition, and is coupled with conservative collateral and lending policies to limit the risk of loss while taking into account borrowers' needs for a reliable funding source. At March 31, 2014, and December 31, 2013, none of the Bank's credit products were past due, on nonaccrual status, or considered impaired. There were no troubled debt restructurings related to credit products during the three months ended March 31, 2014, or during 2013.

Based on the collateral pledged as security for advances, the Bank's credit analyses of borrowers' financial condition, and the Bank's credit extension and collateral policies as of March 31, 2014, the Bank expects to collect all amounts due according to the contractual terms. Therefore, no allowance for losses on credit products was deemed necessary by the Bank. The Bank has never experienced any credit losses on its credit products.

No member institutions were placed into receivership during the first three months of 2014, or from April 1 to April 30, 2014.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Mortgage Loans Held for Portfolio.** The following table presents information on delinquent mortgage loans as of March 31, 2014, and December 31, 2013.

	March 31, 2014	December 31, 2013
	Recorded Investment <sup>(1)</sup>	Recorded Investment <sup>(1)</sup>
30 – 59 days delinquent	\$ 14	\$ 14
60 – 89 days delinquent	5	7
90 days or more delinquent	26	27
Total past due	45	48
Total current loans	813	863
Total mortgage loans	\$ 858	\$ 911
In process of foreclosure, included above <sup>(2)</sup>	\$ 13	\$ 17
Nonaccrual loans	\$ 26	\$ 27
Serious delinquencies as a percentage of total mortgage loans outstanding <sup>(3)</sup>	3.06%	3.00%

- (1) The recorded investment in a loan is the unpaid principal balance of the loan, adjusted for accrued interest, net deferred loan fees or costs, unamortized premiums or discounts, and direct write-downs. The recorded investment is not net of any valuation allowance.
- (2) Includes loans for which the servicer has reported a decision to foreclose or to pursue a similar alternative, such as deed-in-lieu. Loans in process of foreclosure are included in past due or current loans depending on their delinquency status.
- (3) Represents loans that are 90 days or more past due or in the process of foreclosure as a percentage of the recorded investment of total mortgage loans outstanding. The ratio increased primarily because of the decline in the recorded investment of the Bank's mortgage loans.

The allowance for credit losses on the mortgage loan portfolio was as follows:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Balance, beginning of the period	\$ 2	\$ 3
Charge-offs – transferred to REO	(1)	—
Provision for/(reversal of) credit losses	1	—
Balance, end of the period	\$ 2	\$ 3
Ratio of net charge-offs during the period to average loans outstanding during the period	(0.02)%	(0.01)%

The allowance for credit losses and recorded investment by impairment methodology for individually and collectively evaluated impaired loans are as follows:

	March 31, 2014	December 31, 2013
Allowance for credit losses, end of period		
Individually evaluated for impairment	\$ 2	\$ 2
Total allowance for credit losses	\$ 2	\$ 2
Recorded investment, end of period		
Individually evaluated for impairment	\$ 26	\$ 27
Collectively evaluated for impairment	832	884
Total recorded investment	\$ 858	\$ 911

The recorded investment, unpaid principal balance, and related allowance of impaired loans individually evaluated for impairment are as follows:



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	March 31, 2014			December 31, 2013		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance	\$ 18	\$ 18	\$ —	\$ 20	\$ 20	\$ —
With an allowance	8	8	2	7	7	2
Total	\$ 26	\$ 26	\$ 2	\$ 27	\$ 27	\$ 2

The average recorded investment on impaired loans individually evaluated for impairment is as follows:

	Three Months Ended	
	March 31, 2014	March 31, 2013
With no related allowance	\$ 19	\$ 19
With an allowance	7	12
Total	\$ 26	\$ 31

The Bank and any participating financial institution share in the credit risk of the loans sold by that institution as specified in a master agreement. Loans purchased under the MPF Program generally had a credit risk exposure at the time of purchase equivalent to AA-rated assets taking into consideration the credit risk sharing structure mandated by the Finance Agency's acquired member assets (AMA) regulation. The Bank holds additional risk-based capital when it determines that purchased loans do not have a credit risk exposure equivalent to AA-rated assets. The MPF Program structures potential credit losses on conventional MPF loans into layers with respect to each pool of loans purchased by the Bank under a single master commitment for the member selling the loans, as follows:

1. The first layer of protection against loss is the liquidation value of the real property securing the loan.
2. The next layer of protection comes from the primary mortgage insurance that is required for loans with a loan-to-value ratio greater than 80%, if still in place.
3. Losses that exceed the liquidation value of the real property and any primary mortgage insurance, up to an agreed-upon amount called the first loss account for each master commitment, are incurred by the Bank.
4. Losses in excess of the first loss account for each master commitment, up to an agreed-upon amount called the credit enhancement amount, are covered by the participating institution's credit enhancement obligation at the time losses are incurred.
5. Losses in excess of the first loss account and the participating institution's remaining credit enhancement for the master commitment, if any, are incurred by the Bank.

The Bank calculates its estimated allowance for credit losses on mortgage loans acquired under its two MPF products, Original MPF and MPF Plus, as described below.

*Allowance for Credit Losses on MPF Loans* – The Bank evaluates the allowance for credit losses on MPF mortgage loans based on two components. The first component applies to each individual loan that is specifically identified as impaired. The Bank evaluates the exposure on these loans by considering the first layer of loss protection (the liquidation value of the real property securing the loan) and the availability and collectability of credit enhancements under the terms of each master commitment and records a provision for credit losses. For this component, the Bank established an allowance for credit losses for Original MPF loans totaling de minimis amounts as of March 31, 2014, and December 31, 2013, and for MPF Plus loans totaling \$2 as of March 31, 2014, and \$2 as of December 31, 2013.

The second component applies to loans that are not specifically identified as impaired and is based on the Bank's estimate of probable credit losses on those loans as of the financial statement date. The Bank evaluates the credit loss exposure on a loan pool basis considering various observable data, such as delinquency statistics, past performance, current performance, loan portfolio characteristics, collateral valuations, industry data, and prevailing



**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

economic conditions. The Bank also considers the availability and collectability of credit enhancements from institutions or from mortgage insurers under the terms of each master commitment. For this component, the Bank established an allowance for credit losses for Original MPF loans totaling de minimis amounts as of March 31, 2014, and December 31, 2013, and for MPF Plus loans totaling de minimis amounts as of March 31, 2014, and December 31, 2013.

*Troubled Debt Restructurings* – Troubled debt restructuring (TDR) is considered to have occurred when a concession is granted to the debtor for economic or legal reasons related to the debtor's financial difficulties and that concession would not have been considered otherwise. An MPF loan considered a TDR is individually evaluated for impairment when determining its related allowance for credit losses. Credit loss is measured by factoring in expected cashflow shortfalls incurred as of the reporting date as well as the economic loss attributable to delaying the original contractual principal and interest due dates, if applicable.

The Bank's TDRs of MPF loans primarily involve modifying the borrower's monthly payment for a period of up to 36 months to reflect a housing expense ratio that is no more than 31% of the borrower's qualifying monthly income. The outstanding principal balance is re-amortized to reflect a principal and interest payment for a term not to exceed 40 years from the original note date and a housing expense ratio not to exceed 31%. This would result in a balloon payment at the original maturity date of the loan because the maturity date and number of remaining monthly payments are not adjusted. If the 31% ratio is still not achieved through re-amortization, the interest rate is reduced in 0.125% increments below the original note rate, to a floor rate of 3.00%, resulting in reduced principal and interest payments, for the temporary payment modification period of up to 36 months, until the 31% housing expense ratio is met.

The recorded investment of the Bank's nonperforming MPF loans classified as TDRs totaled \$0.8 as of March 31, 2014, and \$0.8 as of December 31, 2013. During the three months ended March 31, 2014 and 2013, the amount of the pre- and post-modification recorded investment in TDRs that occurred during the year was equal because there were no write-offs resulting from either principal forgiveness or direct write-offs. None of the MPF loans classified as TDRs within the previous 12 months experienced a payment default.

**Term Securities Purchased Under Agreements to Resell.** Securities purchased under agreements to resell are considered collateralized financing arrangements and effectively represent short-term loans with investment-grade counterparties, which are classified as assets in the Statements of Condition. Securities purchased under agreements to resell are held in safekeeping in the name of the Bank by third-party custodians approved by the Bank. In accordance with the terms of these loans, if the market value of the underlying securities decreases below the market value required as collateral, the counterparty must place an equivalent amount of additional securities as collateral or remit an equivalent amount of cash. If an agreement to resell is deemed to be impaired, the difference between the fair value of the collateral and the amortized cost of the agreement is charged to earnings. The Bank did not have any term securities purchased under agreements to resell at March 31, 2014, and at December 31, 2013.

**Term Federal Funds Sold.** The Bank invests in Federal funds sold with highly rated counterparties, and these investments are evaluated for purposes of an allowance for credit losses if the investment is not paid when due. All investments in Federal funds sold as of March 31, 2014, and December 31, 2013, were repaid or are expected to be repaid according to the contractual terms.

## **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 nonmembers. In addition, a member that services mortgage loans may deposit in the Bank funds collected in connection with the mortgage loans, pending disbursement of these funds to the owners of the mortgage loans. The Bank classifies these types of deposits as non-interest-bearing deposits.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

Deposits as of March 31, 2014, and December 31, 2013, were as follows:

	March 31, 2014	December 31, 2013
Interest-bearing deposits:		
Demand and overnight	\$ 272	\$ 190
Term	1	1
Other	1	1
Total interest-bearing deposits	274	192
Non-interest-bearing deposits	1	1
Total	\$ 275	\$ 193

**Interest Rate Payment Terms.** Deposits classified as demand, overnight, and other pay interest based on a daily interest rate. Term deposits pay interest based on a fixed rate determined at the issuance of the deposit. Interest rate payment terms for deposits at March 31, 2014, and December 31, 2013, are detailed in the following table:

	March 31, 2014		December 31, 2013	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Interest-bearing deposits:				
Fixed rate	\$ 1	0.01%	\$ 1	0.01%
Adjustable rate	273	0.01	191	0.01
Total interest-bearing deposits	274	0.01	192	0.01
Non-interest-bearing deposits	1	—	1	—
Total	\$ 275	0.01%	\$ 193	0.01%

The aggregate amount of time deposits with a denomination of \$0.1 or more was \$1 at March 31, 2014, and \$1 at December 31, 2013. These time deposits were scheduled to mature within three to six months.

#### **Note 11 — Consolidated Obligations**

Consolidated obligations, consisting of consolidated obligation bonds and discount notes, are jointly issued by the FHLBanks through the Office of Finance, which serves as the FHLBanks' agent. As provided by the FHLBank Act or by regulations governing the operations of the FHLBanks, all FHLBanks have joint and several liability for all FHLBank consolidated obligations. For a discussion of the joint and several liability regulation, see "Item 8. Financial Statements and Supplementary Data – Note 21 – Commitments and Contingencies" in the Bank's 2013 Form 10-K. In connection with each issuance of consolidated obligations, each FHLBank specifies the type, term, and amount of debt it requests to have issued on its behalf. The Office of Finance tracks the amount of debt issued on behalf of each FHLBank. In addition, the Bank separately tracks and records as a liability its specific portion of the consolidated obligations issued and is the primary obligor for that portion of the consolidated obligations issued. The Finance Agency and the U.S. Secretary of the Treasury have oversight over the issuance of FHLBank debt through the Office of Finance.

**Redemption Terms.** The following is a summary of the Bank's participation in consolidated obligation bonds at March 31, 2014, and December 31, 2013.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

Contractual Maturity	March 31, 2014		December 31, 2013	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Within 1 year	\$ 25,671	0.40%	\$ 26,161	0.40%
After 1 year through 2 years	5,982	1.14	7,101	0.80
After 2 years through 3 years	8,746	2.58	7,740	2.94
After 3 years through 4 years	2,331	2.36	1,963	2.50
After 4 years through 5 years	2,740	1.51	2,420	1.49
After 5 years	7,279	1.98	7,384	1.99
Total par value	52,749	1.21%	52,769	1.17%
Unamortized premiums	77		78	
Unamortized discounts	(15)		(16)	
Valuation adjustments for hedging activities	440		491	
Fair value option valuation adjustments	(67)		(115)	
Total	\$ 53,184		\$ 53,207	

The Bank's participation in consolidated obligation bonds outstanding includes callable bonds of \$15,901 at March 31, 2014, and \$13,042 at December 31, 2013. When a callable bond for which the Bank is the primary obligor is issued, the Bank may simultaneously enter 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 call option embedded in the bond (a sold callable swap). The Bank had notional amounts of interest rate exchange agreements hedging callable bonds of \$12,121 at March 31, 2014, and \$9,997 at December 31, 2013. The combined sold callable swaps and callable bonds enable the Bank to meet its funding needs at costs not otherwise directly attainable solely through the issuance of non-callable debt, while effectively converting the Bank's net payment to an adjustable rate.

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

	March 31, 2014	December 31, 2013
Par value of consolidated obligation bonds:		
Non-callable	\$ 36,848	\$ 39,727
Callable	15,901	13,042
Total par value	\$ 52,749	\$ 52,769

The following is a summary of the Bank's participation in consolidated obligation bonds outstanding at March 31, 2014, and December 31, 2013, by the earlier of the year of contractual maturity or next call date.

Earlier of Contractual Maturity or Next Call Date	March 31, 2014	December 31, 2013
Within 1 year	\$ 36,932	\$ 36,093
After 1 year through 2 years	5,742	6,046
After 2 years through 3 years	7,012	7,550
After 3 years through 4 years	1,531	1,478
After 4 years through 5 years	720	830
After 5 years	812	772
Total par value	\$ 52,749	\$ 52,769

Consolidated obligation discount notes are consolidated obligations issued to raise short-term funds. These notes are issued at less than their face value and redeemed at par value when they mature. The Bank's participation in consolidated obligation discount notes, all of which are due within one year, was as follows:

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	March 31, 2014		December 31, 2013	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Par value	\$ 24,867	0.10%	\$ 24,199	0.10%
Unamortized discounts	(4)		(5)	
Total	\$ 24,863		\$ 24,194	

**Interest Rate Payment Terms.** Interest rate payment terms for consolidated obligations at March 31, 2014, and December 31, 2013, are detailed in the following table. For information on the general terms and types of consolidated obligations outstanding, see “Item 8. Financial Statements and Supplementary Data – Note 12 – Consolidated Obligations” in the Bank’s 2013 Form 10-K.

	March 31, 2014	December 31, 2013
Par value of consolidated obligations:		
Bonds:		
Fixed rate	\$ 41,334	\$ 38,489
Adjustable rate	7,943	11,218
Step-up	2,855	2,460
Step-down	365	340
Fixed rate that converts to adjustable rate	252	262
Total bonds, par value	52,749	52,769
Discount notes, par value	24,867	24,199
Total consolidated obligations, par value	\$ 77,616	\$ 76,968

The Bank did not have any bonds with embedded features that met the requirements to separate the embedded feature from the host contract and designate the embedded feature as a stand-alone derivative at March 31, 2014, or December 31, 2013. In general, the Bank has elected to account for bonds with embedded features under the fair value option, and these bonds are carried at fair value on the Statements of Condition. For more information, see Note 16 – Fair Value.

**Note 12 — Accumulated Other Comprehensive Income/(Loss)**

The following table summarizes the changes in AOCI for the three months ended March 31, 2014 and 2013:

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	Net Non-Credit- Related OTTI Loss on AFS Securities	Net Non-Credit- Related OTTI Loss on HTM Securities	Pension and Postretirement Benefits	Total AOCI
Balance, December 31, 2012	\$ (748)	\$ (34)	\$ (12)	\$ (794)
Other comprehensive income/(loss) before reclassifications:				
Non-credit-related OTTI loss	—	(3)		(3)
Non-credit-related OTTI loss transferred	(3)	3		—
Net change in fair value	340			340
Accretion of non-credit-related OTTI loss		2		2
Reclassification from other comprehensive income/(loss) to net income/(loss):				
Non-credit-related OTTI to credit-related OTTI	2	—		2
Net current period other comprehensive income/(loss)	339	2	—	341
Balance, March 31, 2013	\$ (409)	\$ (32)	\$ (12)	\$ (453)
Balance, December 31, 2013	\$ (111)	\$ (27)	\$ (7)	\$ (145)
Other comprehensive income/(loss) before reclassifications:				
Net change in fair value	81			81
Accretion of non-credit-related OTTI loss		1		1
Reclassification from other comprehensive income/(loss) to net income/(loss):				
Non-credit-related OTTI to credit-related OTTI	(1)	—		(1)
Net current period other comprehensive income/(loss)	80	1	—	81
Balance, March 31, 2014	\$ (31)	\$ (26)	\$ (7)	\$ (64)

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

### Note 13 — Capital

**Capital Requirements.** Under the Housing Act, the Director of the Finance Agency is responsible for setting the risk-based capital standards for the FHLBanks. The FHLBank Act and regulations governing the operations of the FHLBanks require that the Bank’s minimum capital stock requirement for shareholders must be sufficient to enable the Bank to meet its regulatory requirements for total capital, leverage capital, and risk-based capital. The Bank must maintain: (i) total regulatory capital in an amount equal to at least 4% of its total assets, (ii) leverage capital in an amount equal to at least 5% of its total assets, and (iii) permanent capital in an amount that is greater than or equal to its risk-based capital requirement. Because the Bank issues only Class B stock, regulatory capital and permanent capital for the Bank are both composed of retained earnings and Class B stock, including mandatorily redeemable capital stock (which is classified as a liability for financial reporting purposes). Regulatory capital and permanent capital do not include AOCI. Leverage capital is defined as the sum of permanent capital, weighted by a 1.5 multiplier, plus non-permanent capital.

The risk-based capital requirement is equal to the sum of the Bank’s credit risk, market risk, and operations risk capital requirements, all of which are calculated in accordance with the rules and regulations of the Finance Agency. The Finance Agency may require an FHLBank to maintain a greater amount of permanent capital than is required by the risk-based capital requirement as defined.

As of March 31, 2014, and December 31, 2013, the Bank was in compliance with these capital rules and requirements as shown in the following table.

	March 31, 2014		December 31, 2013	
	Required	Actual	Required	Actual
Risk-based capital	\$ 3,735	\$ 7,350	\$ 3,912	\$ 7,925
Total regulatory capital	\$ 3,447	\$ 7,350	\$ 3,431	\$ 7,925
Total regulatory capital ratio	4.00%	8.53%	4.00%	9.24%
Leverage capital	\$ 4,309	\$ 11,024	\$ 4,289	\$ 11,888
Leverage ratio	5.00%	12.79%	5.00%	13.86%

**Mandatorily Redeemable Capital Stock.** The Bank had mandatorily redeemable capital stock totaling \$1,644 outstanding to 43 institutions at March 31, 2014, and \$2,071 outstanding to 44 institutions at December 31, 2013. The change in mandatorily redeemable capital stock for the three months ended March 31, 2014 and 2013, was as follows:

	Three Months Ended	
	March 31, 2014	March 31, 2013
Balance at the beginning of the period	\$ 2,071	\$ 4,343
Reclassified from/(to) capital during the period:		
Merger with or acquisition by nonmember institution	—	1
Acquired by/transferred to members	1	—
Redemption of mandatorily redeemable capital stock	(9)	(1)
Repurchase of excess mandatorily redeemable capital stock	(419)	(436)
Balance at the end of the period	\$ 1,644	\$ 3,907

Cash dividends on mandatorily redeemable capital stock in the amount of \$39 and \$26 were recorded as interest expense for the three months ended March 31, 2014 and 2013, respectively.

The Bank’s mandatorily redeemable capital stock is discussed more fully in “Item 8. Financial Statements and Supplementary Data – Note 16 – Capital” in the Bank’s 2013 Form 10-K.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

The following table presents mandatorily redeemable capital stock amounts by contractual redemption period at March 31, 2014, and December 31, 2013.

Contractual Redemption Period	March 31, 2014	December 31, 2013
Within 1 year	\$ 452	\$ 571
After 1 year through 2 years	84	111
After 2 years through 3 years	1,016	1,289
After 3 years through 4 years	16	20
After 4 years through 5 years	3	3
Past contractual redemption date because of remaining activity <sup>(1)</sup>	73	77
<b>Total</b>	<b>\$ 1,644</b>	<b>\$ 2,071</b>

(1) Represents mandatorily redeemable capital stock that is past the end of the contractual redemption period because of outstanding activity.

**Excess Stock Repurchase, Retained Earnings, and Dividend Framework.** The Bank's Excess Stock Repurchase, Retained Earnings, and Dividend Framework summarizes the Bank's capital risk management principles, strategy, and objectives, as well as its policies, analysis, and practices with respect to retained earnings, dividend payments, and the repurchase of excess capital stock. 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 may not pay dividends if any principal or interest due on any consolidated obligations has not been paid in full or is not expected to be paid in full by any FHLBank, or, under certain circumstances, if the Bank fails to satisfy certain liquidity requirements under applicable Finance Agency regulations.

The Bank's Risk Management Policy limits the payment of dividends if the ratio of the Bank's estimated market value of total capital to par value of capital stock falls below certain levels. If this ratio at the end of any quarter is less than 100% but greater than or equal to 70%, any dividend would be limited to an annualized rate no greater than the daily average of the three-month LIBOR for the applicable quarter (subject to certain conditions), and if this ratio is less than 70%, the Bank would be restricted from paying a dividend. The ratio of the Bank's estimated market value of total capital to par value of capital stock was 151% as of March 31, 2014.

*Retained Earnings* - The Bank's Excess Stock Repurchase, Retained Earnings, and Dividend Framework establishes amounts to be retained in restricted retained earnings, which are not made available in the current dividend period.

The following table summarizes the activity related to restricted retained earnings for the three months ended March 31, 2014 and 2013:

	Three Months Ended							
	March 31, 2014				March 31, 2013			
	Restricted Retained Earnings Related to:				Restricted Retained Earnings Related to:			
	Valuation Adjustments	Targeted Buildup	Joint Capital Enhancement Agreement	Total	Valuation Adjustments	Targeted Buildup	Joint Capital Enhancement Agreement	Total
Balance at the beginning of the period	\$ 88	\$ 1,800	\$ 189	\$ 2,077	\$ 73	\$ 1,800	\$ 128	\$ 2,001
Transfers to/(from) restricted retained earnings	(17)	—	9	(8)	(4)	—	16	12
Balance at the end of the period	\$ 71	\$ 1,800	\$ 198	\$ 2,069	\$ 69	\$ 1,800	\$ 144	\$ 2,013

For more information on these three categories of restricted retained earnings and the Bank's Retained Earnings and Dividend Policy, see "Item 8. Financial Statements and Supplementary Data – Note 16 – Capital" in the Bank's 2013 Form 10-K.



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

*Dividend Payments* – Finance Agency rules state that FHLBanks may declare and pay dividends only from previously retained earnings or current net earnings, and may not declare or pay dividends based on projected or anticipated earnings. There is no requirement that the Board of Directors declare and pay any dividend. A decision by the Board of Directors to declare or not declare a dividend is a discretionary matter and is subject to the requirements and restrictions of the FHLBank Act and applicable requirements under the regulations governing the operations of the FHLBanks.

The Bank currently pays dividends in cash rather than capital stock to comply with Finance Agency rules, which do not permit the Bank to pay dividends in the form of capital stock if its excess capital stock exceeds 1% of its total assets. Excess capital stock is defined as the aggregate of the capital stock held by each shareholder in excess of its minimum capital stock requirement, as established by the Bank's capital plan. As of March 31, 2014, the Bank's excess capital stock totaled \$1,850, or 2.15% of total assets.

Dividends on capital stock are recognized as cash dividends on the Statements of Capital Accounts, and dividends on mandatorily redeemable capital stock are recognized as interest expense on the Statements of Income.

In the first quarter of 2014, the Bank paid dividends at an annualized rate of 6.67%, totaling \$97, including \$58 in dividends on capital stock and \$39 in dividends on mandatorily redeemable capital stock. In the first quarter of 2013, the Bank paid dividends at an annualized rate of 2.30%, totaling \$51, including \$25 in dividends on capital stock and \$26 in dividends on mandatorily redeemable capital stock.

On April 28, 2014, the Bank's Board of Directors declared a cash dividend on the capital stock outstanding during the first quarter of 2014 at an annualized rate of 6.80%, totaling \$93, including \$59 in dividends on capital stock and \$34 in dividends on mandatorily redeemable capital stock. The Bank recorded the dividend on April 28, 2014, the day it was declared by the Board of Directors. The Bank expects to pay the dividend on or about May 15, 2014. Dividends on mandatorily redeemable capital stock will be recognized as interest expense in the second quarter of 2014.

The Bank will continue to monitor the condition of its PLRMBS portfolio, the ratio of the estimated market value of the Bank's capital to the par value of the Bank's capital stock, its overall financial performance and retained earnings, developments in the mortgage and credit markets, and other relevant information as the basis for determining the payment of dividends in future quarters.

*Excess Capital Stock* – The Bank may repurchase some or all of a shareholder's excess capital stock, including any excess mandatorily redeemable capital stock, at the Bank's discretion, subject to certain statutory and regulatory requirements. The Bank must give the shareholder 15 days' written notice; however, the shareholder may waive this notice period. The Bank may also repurchase some or all of a shareholder's excess capital stock at the shareholder's request, at the Bank's discretion, subject to certain statutory and regulatory requirements. A shareholder's excess capital stock is defined as any capital stock holdings in excess of the shareholder's minimum capital stock requirement, as established by the Bank's capital plan.

On a quarterly basis, the Bank determines whether it will repurchase excess capital stock. The Bank repurchased \$750 in excess capital stock in the first quarter of 2014 and 2013, respectively.

During the first quarter of 2014, the five-year redemption period for \$9 in mandatorily redeemable capital stock expired, and the Bank redeemed the capital stock at its \$100 par value on the relevant scheduled redemption date.

On April 28, 2014, the Bank announced that it plans to repurchase \$750 in excess capital stock on May 16, 2014. The amount of excess capital stock to be repurchased from each shareholder will be based on the total amount of capital stock (including mandatorily redeemable capital stock) outstanding to all shareholders on the repurchase



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date. The Bank will repurchase an equal percentage of each shareholder's total capital stock to the extent that the shareholder has sufficient excess capital stock.

The Bank will continue to monitor the condition of its PLRMBS portfolio, the ratio of the estimated market value of the Bank's capital to the par value of the Bank's capital stock, its overall financial performance and retained earnings, developments in the mortgage and credit markets, and other relevant information as the basis for determining the repurchase of excess capital stock in future quarters.

Excess capital stock totaled \$1,850 as of March 31, 2014, and \$2,446 as of December 31, 2013.

For more information on excess capital stock, see "Item 8. Financial Statements and Supplementary Data – Note 16 – Capital" in the Bank's 2013 Form 10-K.

**Concentration.** The following table presents the concentration in capital stock held by institutions whose capital stock ownership represented 10% or more of the Bank's outstanding capital stock, including mandatorily redeemable capital stock, as of March 31, 2014, and December 31, 2013.

Name of Institution	March 31, 2014		December 31, 2013	
	Capital Stock Outstanding	Percentage of Total Capital Stock Outstanding	Capital Stock Outstanding	Percentage of Total Capital Stock Outstanding
<b>Citigroup Inc.:</b>				
Citibank, N.A. <sup>(1)</sup>	\$ 1,010	20%	\$ 1,279	23%
Banamex USA	1	—	1	—
Subtotal Citigroup Inc.	1,011	20	1,280	23
<b>JPMorgan Chase &amp; Co.:</b>				
JPMorgan Bank & Trust Company, National Association	469	9	594	11
JPMorgan Chase Bank, National Association <sup>(1)</sup>	73	1	77	1
Subtotal JPMorgan Chase & Co.	542	10	671	12
<b>Total capital stock ownership over 10%</b>	<b>1,553</b>	<b>30</b>	<b>1,951</b>	<b>35</b>
<b>Others</b>	<b>3,416</b>	<b>70</b>	<b>3,580</b>	<b>65</b>
<b>Total</b>	<b>\$ 4,969</b>	<b>100%</b>	<b>\$ 5,531</b>	<b>100%</b>

(1) The capital stock held by these nonmember institutions is classified as mandatorily redeemable capital stock.

#### **Note 14 — Segment Information**

The Bank uses an analysis of financial performance based on the balances and adjusted net interest income of two operating segments, the advances-related business and the mortgage-related business, as well as other financial information, to review and assess financial performance and to determine the allocation of resources to these two major business segments. For purposes of segment reporting, adjusted net interest income includes income and expense associated with cash flow settlements from economic hedges that are recorded in "Net gain/(loss) on derivatives and hedging activities" in other income and excludes interest expense that is recorded in "Mandatorily redeemable capital stock." Other key financial information, such as any credit-related OTTI losses on the Bank's PLRMBS, other expenses, and assessments, is not included in the segment reporting analysis, but is incorporated into the Bank's overall assessment of financial performance.

For more information on these operating segments, see "Item 8. Financial Statements and Supplementary Data – Note 18 – Segment Information" in the Bank's 2013 Form 10-K.

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The following table presents the Bank's adjusted net interest income by operating segment and reconciles total adjusted net interest income to income before the AHP assessment for the three months ended March 31, 2014 and 2013.

	Advances- Related Business	Mortgage- Related Business <sup>(1)</sup>	Adjusted Net Interest Income	Amortization of Basis Adjustments <sup>(2)</sup>	Income/ (Expense) on Economic Hedges <sup>(3)</sup>	Interest Expense on Mandatorily Redeemable Capital Stock <sup>(4)</sup>	Net Interest Income	Other Income/ (Loss)	Other Expense	Income Before AHP Assessment
Three months ended										
March 31, 2014	\$ 39	\$ 110	\$ 149	\$ (2)	\$ (22)	\$ 39	\$ 134	\$ (48)	\$ 32	\$ 54
March 31, 2013	43	113	156	(18)	21	26	127	(4)	30	93

- (1) Does not include credit-related OTTI losses of a de minimis amount and \$3 for the three months ended March 31, 2014 and 2013, respectively.
- (2) Represents amortization of amounts deferred for adjusted net interest income purposes only, in accordance with the Bank's Excess Stock Repurchase, Retained Earnings, and Dividend Framework.
- (3) The Bank includes income and expense associated with cash flow settlements from economic hedges in adjusted net interest income in its analysis of financial performance for its two operating segments. For financial reporting purposes, the Bank does not include these amounts in net interest income in the Statements of Income, but instead records them in other income in "Net gain/(loss) on derivatives and hedging activities."
- (4) The Bank excludes interest expense on mandatorily redeemable capital stock from adjusted net interest income in its analysis of financial performance for its two operating segments.

The following table presents total assets by operating segment at March 31, 2014, and December 31, 2013.

	Advances- Related Business	Mortgage- Related Business	Total Assets
March 31, 2014	\$ 63,241	\$ 22,944	\$ 86,185
December 31, 2013	62,297	23,477	85,774

## Note 15 — Derivatives and Hedging Activities

**General.** The Bank may enter into interest rate swaps (including callable, puttable, and basis swaps); swaptions; and cap, floor, corridor, and collar 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 the advances and bonds are transacted and generally have the same maturity dates as the related advances and bonds. The Bank transacts most of its derivatives with large banks and major broker-dealers. Some of these banks and broker-dealers or their affiliates buy, sell, and distribute consolidated obligations. Over-the-counter derivatives may be either transacted with a counterparty (bilateral derivatives) or cleared after execution through a clearing agent with a derivative clearing organization (cleared derivatives). Once a derivative transaction has been accepted for clearing by a derivative clearing organization (clearinghouse), the derivative transaction is novated and the executing counterparty is replaced with the clearinghouse. The clearinghouse notifies the clearing agent of the required initial and variation margin, and the clearing agent notifies the Bank and transmits the required initial and variation margin from the Bank to the clearinghouse. The Bank is not a derivative dealer and does not trade derivatives for short-term profit.

Additional uses of interest rate exchange agreements include: (i) offsetting embedded features in assets and liabilities, (ii) hedging anticipated issuance of debt, (iii) matching against consolidated obligation discount notes or bonds to create the equivalent of callable or non-callable fixed rate debt, (iv) modifying the repricing frequency of assets and liabilities, (v) matching against certain advances and consolidated obligations for which the Bank elected the fair value option, and (vi) exactly offsetting other derivatives that may be executed with members (with the Bank serving as an intermediary) or cleared at a derivative clearing organization. The Bank's use of interest rate exchange

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agreements results in one of the following classifications: (i) a fair value hedge of an underlying financial instrument, (ii) an economic hedge of a specific asset or liability, or (iii) an intermediary transaction for members.

*Interest Rate Swaps* – An interest rate swap is an agreement between two entities to exchange cash flows in the future. The agreement sets the dates on which the cash flows will be paid and the manner in which the cash flows will be calculated. One of the simplest forms of an interest rate swap involves the promise by one party to pay cash flows equivalent to the interest on a notional principal amount at a predetermined fixed rate for a given period of time. In return for this promise, the party receives cash flows equivalent to the interest on the same notional principal amount at a variable rate for the same period of time. The variable rate received or paid by the Bank in most interest rate exchange agreements is indexed to LIBOR.

*Swaptions* – A swaption is an option on a swap that gives the buyer the right to enter into a specified interest rate swap at a certain time in the future. When used as a hedge, for example, a swaption can protect the Bank against future interest rate changes when it is planning to lend or borrow funds in the future.

*Interest Rate Caps and Floors* – In a cap agreement, additional cash flow is generated if the price or interest rate of an underlying variable rises above a certain threshold (or cap) price. In a floor agreement, additional cash flow is generated if the price or interest rate of an underlying variable falls below a certain threshold (or floor) price. Caps and floors may be used in conjunction with assets or liabilities. In general, caps and floors are designed as protection against the interest rate on a variable rate asset or liability rising above or falling below a certain level.

**Hedging Activities.** 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: (i) assets and liabilities on the balance sheet, (ii) firm commitments, or (iii) 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 attributable to the hedged risk 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: (i) 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); (ii) the derivative and/or the hedged item expires or is sold, terminated, or exercised; (iii) it is no longer probable that the forecasted transaction will occur in the originally expected period; (iv) a hedged firm commitment no longer meets the definition of a firm commitment; (v) it determines that designating the derivative as a hedging instrument is no longer appropriate; or (vi) it decides to use the derivative to offset changes in the fair value of other derivatives or instruments carried at fair value.

*Intermediation* – As an additional service to its members, the Bank has in the past entered into offsetting interest rate exchange agreements, acting as an intermediary between offsetting derivative transactions with members and other counterparties. This intermediation allows members indirect access to the derivatives market. Derivatives in which the Bank is an intermediary may also arise when the Bank enters into derivatives to offset the economic effect of other derivatives that are no longer designated to advances, investments, or consolidated obligations. The offsetting derivatives used in intermediary activities do not receive 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.

The notional principal of the interest rate exchange agreements associated with derivatives with members and offsetting derivatives with other counterparties was \$330 at March 31, 2014, and \$330 at December 31, 2013. The Bank did not have any interest rate exchange agreements outstanding at March 31, 2014, or December 31, 2013, that

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were used to offset the economic effect of other derivatives that were no longer designated to advances, investments, or consolidated obligations.

*Investments* – The Bank may invest in U.S. Treasury and agency obligations, agency MBS, and the taxable portion of highly rated state or local housing finance agency obligations. In the past, the Bank has also invested in PLRMBS rated AAA at the time of acquisition. 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 risk and interest rate risk by funding investment securities with consolidated obligations that have call features or by hedging the prepayment risk with a combination of consolidated obligations and callable swaps or swaptions. The Bank may execute callable swaps and purchase swaptions in conjunction with the issuance of certain liabilities to create funding that is economically equivalent to fixed rate callable debt. Although these derivatives are economic hedges against prepayment risk and are designated to individual liabilities, they do not receive either fair value or cash flow hedge accounting treatment. Investment securities may be classified as trading, AFS, or HTM.

The Bank may also manage the risk arising from changing market prices or cash flows of investment securities classified as trading 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 trading 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 advances structures to meet members' funding needs. These advances may have maturities up to 30 years with fixed or adjustable rates and may include early termination features or options. The Bank may use derivatives to adjust the repricing and/or options characteristics of advances to more closely match the characteristics of the Bank's funding liabilities. In general, 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 variable rate asset. This type of hedge is treated as a fair value hedge.

In addition, for certain advances for which the Bank has elected the fair value option, the Bank will simultaneously execute an interest rate exchange agreement with terms that economically offset the terms of the advance. However, this type of hedge is treated as an economic hedge because these combinations generally do not meet the requirements for fair value hedge accounting treatment.

*Mortgage Loans* – The Bank's investment portfolio includes fixed rate mortgage loans. The prepayment options embedded in mortgage loans can result in extensions or contractions in the expected repayment of these investments, depending on changes in estimated prepayment speeds. The Bank manages the interest rate risk and prepayment risk associated with fixed rate mortgage loans through a combination of debt issuance and derivatives. The Bank uses 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 prepaid 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 consolidated obligations to create funding that is economically equivalent to fixed rate callable bonds. 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.

*Consolidated Obligations* – Consolidated obligation bonds are structured to meet the Bank's and/or investors' needs. Common structures include fixed rate bonds with or without call options and adjustable rate bonds with or without embedded options. In general, when bonds with these structures are issued, 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 an adjustable rate bond. The cost of this funding combination is generally lower than the cost that

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would be available through the issuance of an adjustable rate bond alone. The Bank will generally elect fair value hedge accounting treatment for these hedging relationships.

In addition, for certain consolidated obligation bonds for which the Bank has elected the fair value option, the Bank will simultaneously execute an interest rate exchange agreement with terms that economically offset the terms of the consolidated obligation bond. However, this type of hedge is treated as an economic hedge because these combinations generally do not meet the requirements for fair value hedge accounting treatment.

The Bank did not have any consolidated obligations denominated in currencies other than U.S. dollars outstanding during the three months ended March 31, 2014, or the year ended December 31, 2013.

*Credit Risk* – The Bank is subject to credit risk as a result of the risk of potential nonperformance by counterparties to the derivative agreements. All of the Bank's agreements governing bilateral derivative transactions contain master netting provisions to help mitigate the credit risk exposure to each counterparty. 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 Finance Agency regulations. The Bank also requires collateral agreements with collateral delivery thresholds on all bilateral derivatives. In addition, collateral related to derivative transactions with member institutions includes collateral pledged to the Bank, as evidenced by the Advances and Security Agreement, and held by the member institution for the benefit of the Bank.

For cleared derivatives, the clearinghouse is the Bank's counterparty. The requirement that the Bank post initial and variation margin through the clearing agent, to the clearinghouse, exposes the Bank to institutional credit risk in the event that the clearing agent or the clearinghouse fails to meet its obligations. The use of cleared derivatives, however, mitigates the Bank's overall credit risk exposure because a central counterparty is substituted for individual counterparties and variation margin is posted daily for changes in the value of cleared derivatives through a clearing agent. The Bank has analyzed the enforceability of offsetting rights applicable to its cleared derivative transactions and determined that the exercise of those offsetting rights by a non-defaulting party under these transactions should be upheld under applicable bankruptcy law and CFTC rules in the event of a clearinghouse or clearing agent insolvency and under applicable clearinghouse rules upon a non-insolvency-based event of default of the clearinghouse or clearing agent. Based on this analysis, the Bank presents a net derivative receivable or payable for all of its transactions through a particular clearing agent with a particular clearinghouse.

Based on the Bank's credit analyses and the collateral requirements, the Bank does not expect to incur any credit losses on its derivative transactions.

The notional amount of an interest rate exchange agreement serves as a factor in determining periodic interest payments or cash flows received and paid. However, the notional amount of derivatives represents neither the actual amounts exchanged nor the overall exposure of the Bank to credit risk and market risk. The risks of derivatives can be measured meaningfully on a portfolio basis by taking into account the counterparties, the types of derivatives, the items being hedged, and any offsets between the derivatives and the items being hedged.

The Bank's agreements for bilateral derivative transactions contain provisions that link the Bank's credit rating from Moody's and Standard & Poor's to various rights and obligations. Certain of these derivative agreements provide that, if the Bank's long-term debt rating falls below A3/A- (and in one agreement, below A2/A), the Bank's counterparty would have the right, but not the obligation, to terminate all of its outstanding derivative transactions with the Bank; the Bank's agreements with its clearing agents for cleared derivative transactions have similar provisions with respect to the debt rating of FHLBank System consolidated bonds. If this occurs, the Bank may choose to enter into replacement hedges, either by transferring the existing transactions to another counterparty or entering into new replacement transactions, based on prevailing market rates. In addition, the amount of collateral that the Bank is required to deliver to a counterparty under its agreements for bilateral derivative transactions depends on the Bank's credit rating. The aggregate fair value of all bilateral derivative instruments with credit-risk-related contingent features that were in a net derivative liability position (before cash collateral and related accrued



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interest) at March 31, 2014, was \$70, for which the Bank had posted cash collateral of \$34 in the normal course of business. If the Bank's credit rating at March 31, 2014, had been Aa/AA (the next lower rating that might require an increase in collateral to be delivered by the Bank) instead of Aaa/AA+ (the Bank's current rating), then the Bank would have been required to deliver up to \$21 of collateral (at fair value) to its derivative counterparties at March 31, 2014.

The following table summarizes the fair value of derivative instruments without the effect of netting arrangements or collateral as of March 31, 2014, and December 31, 2013. For purposes of this disclosure, the derivative values include the fair value of derivatives and related accrued interest.

	March 31, 2014			December 31, 2013		
	Notional Amount of Derivatives	Derivative Assets	Derivative Liabilities	Notional Amount of Derivatives	Derivative Assets	Derivative Liabilities
Derivatives designated as hedging instruments:						
Interest rate swaps	\$ 37,042	\$ 568	\$ 139	\$ 31,395	\$ 572	\$ 156
Total	37,042	568	139	31,395	572	156
Derivatives not designated as hedging instruments:						
Interest rate swaps	39,494	121	195	49,715	146	242
Interest rate caps, floors, corridors, and/or collars	2,586	24	4	460	2	4
Total	42,080	145	199	50,175	148	246
Total derivatives before netting and collateral adjustments	\$ 79,122	713	338	\$ 81,570	720	402
Netting adjustments by counterparty		(267)	(267)		(313)	(313)
Cash collateral and related accrued interest		(309)	(33)		(291)	(42)
Total collateral and netting adjustments <sup>(1)</sup>		(576)	(300)		(604)	(355)
Total derivative assets and total derivative liabilities		\$ 137	\$ 38		\$ 116	\$ 47

(1) Amounts include the netting of derivative assets and liabilities by counterparty, including cash collateral and related accrued interest, where the netting requirements have been met.

The following table presents the components of net gain/(loss) on derivatives and hedging activities as presented in the Statements of Income for the three months ended March 31, 2014 and 2013.

	Three Months Ended	
	March 31, 2014	March 31, 2013
	Gain/(Loss)	Gain/(Loss)
Derivatives and hedged items in fair value hedging relationships – hedge ineffectiveness by derivative type:		
Interest rate swaps	\$ (2)	\$ (2)
Total net gain/(loss) related to fair value hedge ineffectiveness	(2)	(2)
Derivatives not designated as hedging instruments:		
Economic hedges:		
Interest rate swaps	15	(13)
Interest rate caps, floors, corridors and/or collars	(1)	—
Net cash flow settlements	(22)	21
Total net gain/(loss) related to derivatives not designated as hedging instruments	(8)	8
Net gain/(loss) on derivatives and hedging activities	\$ (10)	\$ 6

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The following table presents, by type of hedged item, the gains and losses on derivatives and the related hedged items in fair value hedging relationships and the impact of those derivatives on the Bank's net interest income for the three months ended March 31, 2014 and 2013.

Hedged Item Type	Three Months Ended							
	March 31, 2014				March 31, 2013			
	Gain/(Loss) on Derivatives	Gain/(Loss) on Hedged Item	Net Fair Value Hedge Ineffectiveness	Effect of Derivatives on Net Interest Income <sup>(1)</sup>	Gain/(Loss) on Derivatives	Gain/(Loss) on Hedged Item	Net Fair Value Hedge Ineffectiveness	Effect of Derivatives on Net Interest Income <sup>(1)</sup>
Advances	\$ 10	\$ (10)	\$ —	\$ (32)	\$ 37	\$ (37)	\$ —	\$ (30)
Consolidated obligation bonds	(51)	49	(2)	65	(114)	112	(2)	113
<b>Total</b>	<b>\$ (41)</b>	<b>\$ 39</b>	<b>\$ (2)</b>	<b>\$ 33</b>	<b>\$ (77)</b>	<b>\$ 75</b>	<b>\$ (2)</b>	<b>\$ 83</b>

(1) The net interest on derivatives in fair value hedge relationships is presented in the interest income/expense line item of the respective hedged item.

The Bank may present derivative instruments, related cash collateral received or pledged, and associated accrued interest by clearing agent or by counterparty when the netting requirements have been met.

The following table presents separately the fair value of derivative assets and derivative liabilities that have met the netting requirements, including the related collateral received from or pledged to counterparties as of March 31, 2014, and December 31, 2013.

	March 31, 2014		December 31, 2013	
	Derivative Assets	Derivative Liabilities	Derivative Assets	Derivative Liabilities
Derivative instruments meeting netting requirements				
Gross recognized amount				
Bilateral derivatives	\$ 697	\$ 331	\$ 699	\$ 395
Cleared derivatives	16	7	21	7
Total gross recognized amount	713	338	720	402
Gross amounts of netting adjustments and cash collateral				
Bilateral derivatives	(598)	(293)	(604)	(348)
Cleared derivatives	22	(7)	—	(7)
Total gross amount of netting adjustments and cash collateral	(576)	(300)	(604)	(355)
Total derivative assets and total derivative liabilities				
Bilateral derivatives	99	38	95	47
Cleared derivatives	38	—	21	—
Total derivative assets and derivative liabilities presented in the Statements of Condition	137	38	116	47
Non-cash collateral received or pledged not offset				
Can be sold or repledged - Bilateral derivatives	93	—	89	—
Net unsecured amount				
Bilateral derivatives	6	38	6	47
Cleared derivatives	38	—	21	—
Total net unsecured amount	\$ 44	\$ 38	\$ 27	\$ 47

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**Note 16 — Fair Value**

The following 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 at March 31, 2014, and December 31, 2013. 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 cannot be precisely quantified or verified and may change as economic and market factors and evaluation of those factors change. The Bank continues to refine its valuation methodologies as markets and products develop and the pricing for certain products becomes more or less transparent. While the Bank believes that its valuation methodologies are appropriate and consistent with those of other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a materially different estimate of fair value as of the reporting date. Therefore, the fair values are not necessarily indicative of the amounts that would be realized in current market transactions, although they do reflect the Bank's judgment as to how a market participant would estimate the fair values. The fair value summary table does not represent an estimate of the overall market value of the Bank as a going concern, which would take into account future business opportunities and the net profitability of total assets and liabilities on a combined basis.

The following tables present the carrying value, the estimated fair value, and the fair value hierarchy level of the Bank's financial instruments at March 31, 2014, and December 31, 2013.

	March 31, 2014					
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3	Netting Adjustments <sup>(b)</sup>
<b>Assets</b>						
Cash and due from banks	\$ 4,541	\$ 4,541	\$ 4,541	\$ —	\$ —	\$ —
Securities purchased under agreements to resell	500	500	—	500	—	—
Federal funds sold	6,401	6,401	—	6,401	—	—
Trading securities	3,127	3,127	—	3,127	—	—
AFS securities	6,916	6,916	—	—	6,916	—
HTM securities	17,974	17,925	—	15,483	2,442	—
Advances	45,552	45,640	—	45,640	—	—
Mortgage loans held for portfolio, net of allowance for credit losses on mortgage loans	852	905	—	905	—	—
Accrued interest receivable	74	74	—	74	—	—
Derivative assets, net <sup>(1)</sup>	137	137	—	713	—	(576)
Other assets <sup>(2)</sup>	11	11	11	—	—	—
<b>Liabilities</b>						
Deposits	275	275	—	275	—	—
Consolidated obligations:						
Bonds	53,184	53,049	—	53,049	—	—
Discount notes	24,863	24,865	—	24,865	—	—
Total consolidated obligations	78,047	77,914	—	77,914	—	—
Mandatorily redeemable capital stock	1,644	1,644	1,644	—	—	—
Accrued interest payable	148	148	—	148	—	—
Derivative liabilities, net <sup>(1)</sup>	38	38	—	338	—	(300)
<b>Other</b>						
Standby letters of credit	12	12	—	12	—	—
Commitments to issue consolidated obligation bonds <sup>(3)</sup>	—	2	—	2	—	—



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	December 31, 2013					
	Carrying Value	Estimated Fair Value	Level 1	Level 2	Level 3	Netting Adjustments <sup>(b)</sup>
<b>Assets</b>						
Cash and due from banks	\$ 4,906	\$ 4,906	\$ 4,906	\$ —	\$ —	\$ —
Federal funds sold	7,498	7,498	—	7,498	—	—
Trading securities	3,208	3,208	—	3,208	—	—
AFS securities	7,047	7,047	—	—	7,047	—
HTM securities	17,507	17,352	—	14,802	2,550	—
Advances	44,395	44,457	—	44,457	—	—
Mortgage loans held for portfolio, net of allowance for credit losses on mortgage loans	905	956	—	956	—	—
Accrued interest receivable	81	81	—	81	—	—
Derivative assets, net <sup>(1)</sup>	116	116	—	720	—	(604)
Other assets <sup>(2)</sup>	10	10	10	—	—	—
<b>Liabilities</b>						
Deposits	193	193	—	193	—	—
Consolidated obligations:						
Bonds	53,207	52,940	—	52,940	—	—
Discount notes	24,194	24,195	—	24,195	—	—
Total consolidated obligations	77,401	77,135	—	77,135	—	—
Mandatorily redeemable capital stock	2,071	2,071	2,071	—	—	—
Accrued interest payable	95	95	—	95	—	—
Derivative liabilities, net <sup>(1)</sup>	47	47	—	402	—	(355)
<b>Other</b>						
Standby letters of credit	12	12	—	12	—	—
Commitments to fund advances <sup>(3)</sup>	—	(1)	—	(1)	—	—

(1) Amounts include the netting of derivative assets and liabilities by counterparty, including cash collateral and related accrued interest, where the netting requirements have been met.

(2) Represents publicly traded mutual funds held in a grantor trust.

(3) Estimated fair values of these commitments are presented as a net gain or (loss). For more information regarding these commitments, see Note 17 – Commitments and Contingencies.

**Fair Value Hierarchy.** The fair value hierarchy is used to prioritize the fair value methodologies and valuation techniques as well as the inputs to the valuation techniques used to measure fair value for assets and liabilities carried at fair value on the Statements of Condition. The inputs are evaluated and an overall level for the fair value measurement is determined. This overall level is an indication of market observability of the fair value measurement for the asset or liability. The fair value hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). An entity must disclose the level within the fair value hierarchy in which the measurements are classified for all financial assets and liabilities measured on a recurring or non-recurring basis.

The application of the fair value hierarchy to the Bank's financial assets and financial liabilities that are carried at fair value either on a recurring or non-recurring basis is as follows:

- Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in an active market that the reporting entity can access on the measurement date.
- Level 2 – Inputs other than quoted prices within Level 1 that are observable inputs for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include the following: (1) quoted prices for similar assets or liabilities in active markets; (2) quoted prices for identical or similar

**Federal Home Loan Bank of San Francisco  
Notes to Financial Statements (continued)**

assets or liabilities in markets that are not active; (3) inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates and yield curves that are observable at commonly quoted intervals, and implied volatilities); and (4) inputs that are derived principally from or corroborated by observable market data by correlation or other means.

- Level 3 – Unobservable inputs for the asset or liability.

A financial instrument's categorization within the valuation hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The following assets and liabilities, including those for which the Bank has elected the fair value option, are carried at fair value on the Statements of Condition as of March 31, 2014:

- Trading securities
- AFS securities
- Certain advances
- Derivative assets and liabilities
- Certain consolidated obligation bonds
- Certain other assets

For instruments carried at fair value, the Bank reviews the fair value hierarchy classifications on a quarterly basis. Changes in the observability of the valuation inputs may result in a reclassification of certain assets or liabilities. Such reclassifications are reported as transfers in or out as of the beginning of the quarter in which the changes occur. For the periods presented, the Bank did not have any reclassifications for transfers in or out of the fair value hierarchy levels.

#### **Summary of Valuation Methodologies and Primary Inputs.**

*Cash and Due from Banks* – The estimated fair value equals the carrying value.

*Federal Funds Sold and Securities Purchased Under Agreements to Resell* – The estimated fair value of overnight Federal funds sold and securities purchased under agreements to resell approximates the carrying value. The estimated fair value of term Federal funds sold and term securities purchased under agreements to resell has been determined by calculating the present value of expected cash flows for the instruments and reducing the amount for accrued interest receivable. The discount rates used in these calculations are the replacement rates for comparable instruments with similar terms.

*Investment Securities – Certificates of Deposit* – The estimated fair values of these investments are determined by calculating the present value of expected cash flows and reducing the amount for accrued interest receivable, using market-observable inputs as of the last business day of the period or using industry standard analytical models and certain actual and estimated market information. The discount rates used in these calculations are the replacement rates for comparable instruments with similar terms.

*Investment Securities – MBS* – To value its MBS, the Bank obtains prices from four designated third-party pricing vendors when available. The pricing vendors use various proprietary models to price these securities. The inputs to those models are derived from various sources including, but not limited to: benchmark yields, reported trades, dealer estimates, issuer spreads, benchmark securities, bids, offers, and other market-related data. Since many securities do not trade on a daily basis, the pricing vendors use available information as applicable, such as benchmark yield curves, benchmarking of like securities, sector groupings, and matrix pricing, to determine the prices for individual securities. Each pricing vendor has an established challenge process in place for all security valuations, which facilitates resolution of price discrepancies identified by the Bank.

In January 2014, the Bank conducted reviews of the four pricing vendors to update and confirm its understanding of the vendors' pricing processes, methodologies, and control procedures.

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**Notes to Financial Statements (continued)**

The Bank's valuation technique for estimating the fair values of its MBS first requires the establishment of a median vendor price for each security. If four vendor prices are received, the average of the middle two prices is the median price; if three prices are received, the middle price is the median price; if two prices are received, the average of the two prices is the median price; and if one price is received, it is the median price (and also the default fair value) subject to additional validation. All vendor prices that are within a specified tolerance threshold of the median price are included in the cluster of vendor prices that are averaged to establish a default fair value. All vendor prices that are outside the threshold (outliers) are subject to further analysis including, but not limited to, comparison to prices provided by an additional third-party valuation service, prices for similar securities and/or dealer estimates, or use of internal model prices, which are deemed to be reflective of all relevant facts and circumstances that a market participant would consider. Such analysis is also applied in those limited instances where no third-party vendor price or only one third-party vendor price is available in order to arrive at an estimated fair value. If an outlier (or some other price identified in the analysis) is determined to be a better estimate of fair value, then the outlier (or the other price, as appropriate) is used as the fair value rather than the default fair value. If, instead, the analysis confirms that an outlier is (or outliers are) not representative of fair value and the default fair value is the best estimate, then the default fair value is used as the fair value.

If all vendor prices received for a security are outside the tolerance threshold level of the median price, then there is no default fair value, and the fair value is determined by an evaluation of all outlier prices (or the other prices, as appropriate) as described above.

As of March 31, 2014, four vendor prices were received for most of the Bank's MBS, and the fair value estimates for most of those securities were determined by averaging the four vendor prices. Based on the Bank's reviews of the pricing methods employed by the third-party pricing vendors and the relative lack of dispersion among the vendor prices (or, in those instances in which there were outliers or significant yield variances, the Bank's additional analyses), the Bank believes that its fair value estimates are reasonable and that the fair value measurements are classified appropriately in the fair value hierarchy. Based on limited market liquidity for PLRMBS, the fair value measurements for these securities were classified as Level 3 within the fair value hierarchy.

As an additional step, the Bank reviewed the fair value estimates of its PLRMBS as of March 31, 2014, for reasonableness using a market-implied yield test. The Bank calculated a market-implied yield for each of its PLRMBS using the estimated fair value derived from the process described above and the security's projected cash flows from the Bank's OTTI process and compared the market-implied yield to the yields for comparable securities according to dealers and other third-party sources to the extent comparable market yield data was available. This analysis did not indicate that any adjustments to the fair value estimates were necessary.

*Investment Securities – FFCB Bonds and CalHFA Bonds* – The Bank estimates the fair values of these securities using the methodology described above for *Investment Securities – MBS*.

*Advances* – Because quoted prices are not available for advances, the fair values are measured using model-based valuation techniques (such as calculating the present value of future cash flows and reducing the amount for accrued interest receivable).

The Bank's primary inputs for measuring the fair value of advances are market-based consolidated obligation yield curve (CO Curve) inputs obtained from the Office of Finance. The CO Curve is then adjusted to reflect the rates on replacement advances with similar terms and collateral. These spread adjustments are not market-observable and are evaluated for significance in the overall fair value measurement and the fair value hierarchy level of the advance. The Bank obtains market-observable inputs from derivative dealers for complex advances. These inputs may include volatility assumptions, which are market-based expectations of future interest rate volatility implied from current market prices for similar options (swaption volatility and volatility skew). The discount rates used in these calculations are the replacement advance rates for advances with similar terms. Pursuant to the Finance

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

Agency's advances regulation, advances with an original term to 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. The Bank determined that no adjustment is required to the fair value measurement of advances for prepayment fees. In addition, the Bank did not adjust its fair value measurement of advances for creditworthiness primarily because advances were fully collateralized.

*Mortgage Loans Held for Portfolio* – The estimated fair value for mortgage loans represents modeled prices based on observable market prices for seasoned Agency mortgage-backed passthrough securities adjusted for differences in coupon, average loan rate, credit, and cash flow remittance between the Bank's mortgage loans and the referenced instruments. Market prices are highly dependent on the underlying prepayment assumptions. Changes in the prepayment speeds often have a material effect on the fair value estimates. These underlying prepayment assumptions are susceptible to material changes in the near term because they are made at a specific point in time.

*Accrued Interest Receivable and Payable* – The estimated fair value approximates the carrying value of accrued interest receivable and accrued interest payable.

*Derivative Assets and Liabilities* – In general, derivative instruments transacted and held by the Bank for risk management activities are traded in over-the-counter markets where quoted market prices are not readily available. These derivatives are interest rate-related. For these derivatives, the Bank measures fair value using internally developed discounted cash flow models that use market-observable inputs, such as the overnight index swap (OIS) curve; volatility assumptions, which are market-based expectations of future interest rate volatility implied from current market prices for similar options (swaption volatility and volatility skew) adjusted for counterparty credit risk, as necessary; and prepayment assumptions. Effective December 31, 2012, the Bank refined its method for estimating the fair values of its derivatives by using the OIS curve to discount the cash flows of its derivatives to determine fair value, instead of using the LIBOR swap curve, which was used in prior periods.

The Bank is subject to credit risk because of the risk of potential nonperformance by its derivative counterparties. To mitigate this risk, the Bank executes bilateral derivative transactions only with highly rated derivative dealers and major banks (derivative dealer counterparties) that meet the Bank's eligibility criteria. In addition, the Bank has entered into master netting agreements and bilateral security agreements with all active derivative dealer counterparties that provide for delivery of collateral at specified levels to limit the Bank's net unsecured credit exposure to these counterparties. Under these policies and agreements, the amount of unsecured credit exposure to an individual derivative dealer counterparty is limited to an absolute dollar credit exposure limit according to the counterparty's credit rating, as determined by rating agency long-term credit ratings of the counterparty's debt securities or deposits. The Bank clears its cleared derivative transactions only through clearing agents that meet the Bank's strict eligibility requirements, and the Bank's credit exposure to the clearinghouse is secured by variation margin received from the clearinghouse. All credit exposure from derivative transactions entered into by the Bank with member counterparties that are not derivative dealers must be fully secured by eligible collateral. The Bank evaluated the potential for the fair value of the instruments to be affected by counterparty credit risk and determined that no adjustments to the overall fair value measurements were required.

The fair values of the derivative assets and liabilities include accrued interest receivable/payable and cash collateral remitted to/received from counterparties. The estimated fair values of the accrued interest receivable/payable and cash collateral approximate their carrying values because of their short-term nature. The fair values of derivatives that met the netting requirements are presented on a net basis. If these netted amounts are positive, they are classified as an asset and, if negative, they are classified as a liability.

*Deposits* – The fair value of deposits is generally equal to the carrying value of the deposits because the deposits are primarily overnight deposits or due on demand. The Bank determines the fair values of term deposits by calculating the present value of expected future cash flows from the deposits and reducing the amount for accrued interest payable. The discount rates used in these calculations are the cost of deposits with similar terms.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

*Consolidated Obligations* – Because quoted prices in active markets are not generally available for identical liabilities, the Bank measures fair values using internally developed models that use primarily market-observable inputs. The Bank’s primary inputs for measuring the fair value of consolidated obligation bonds are market-based CO Curve inputs obtained from the Office of Finance. The Office of Finance constructs the CO Curve using the Treasury yield curve as a base curve, which may be adjusted by indicative spreads obtained from market-observable sources. These market indications are generally derived from pricing indications from dealers, historical pricing relationships, and market activity for similar liabilities, such as recent GSE trades or secondary market activity. For consolidated obligation bonds with embedded options, the Bank also obtains market-observable quotes and inputs from derivative dealers. These inputs may include volatility assumptions, which are market-based expectations of future interest rate volatility implied from current market prices for similar options (swaption volatility and volatility skew).

Adjustments may be necessary to reflect the Bank’s credit quality or the credit quality of the FHLBank System when valuing consolidated obligation bonds measured at fair value. The Bank monitors its own creditworthiness and the creditworthiness of the other 11 FHLBanks and the FHLBank System to determine whether any adjustments are necessary for creditworthiness in its fair value measurement of consolidated obligation bonds. The credit ratings of the FHLBank System and any changes to the credit ratings are the basis for the Bank to determine whether the fair values of consolidated obligations have been significantly affected during the reporting period by changes in the instrument-specific credit risk.

*Mandatorily Redeemable Capital Stock* – The estimated fair value of capital stock subject to mandatory redemption is generally at par value as indicated by contemporaneous purchases, redemptions, and repurchases at par value. Fair value includes estimated dividends earned at the time of reclassification from capital to liabilities, until such amount is paid, and any subsequently declared capital stock dividend. The Bank’s capital stock can only be acquired by members at par value and redeemed or repurchased at par value, subject to statutory and regulatory requirements. The Bank’s capital stock is not traded, and no market mechanism exists for the exchange of Bank capital stock outside the cooperative ownership structure.

*Commitments* – The estimated fair value of standby letters of credit is based on the present value of fees currently charged for similar agreements and is recorded in other liabilities. The estimated fair value of off-balance sheet fixed rate commitments to fund advances and commitments to issue consolidated obligations takes into account the difference between current and committed interest rates.

**Subjectivity of Estimates Related to Fair Values of Financial Instruments.** Estimates of the fair value of financial assets and liabilities using the methodologies described above are subjective and require judgments regarding significant matters, such as the amount and timing of future cash flows, prepayment speed assumptions, expected interest rate volatility, methods to determine possible distributions of future interest rates used to value options, 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.

**Fair Value Measurements.** The tables below present the fair value of assets and liabilities, which are recorded on a recurring or nonrecurring basis at March 31, 2014, and December 31, 2013, by level within the fair value hierarchy.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**March 31, 2014**

	Fair Value Measurement Using:			Netting	
	Level 1	Level 2	Level 3	Adjustments <sup>(1)</sup>	Total
Recurring fair value measurements – Assets:					
Trading securities:					
GSEs – FFCB bonds	\$ —	\$ 3,114	\$ —	\$ —	\$ 3,114
MBS:					
Other U.S. obligations – Ginnie Mae	—	13	—	—	13
Total trading securities	—	3,127	—	—	3,127
AFS securities:					
PLRMBS	—	—	6,916	—	6,916
Total AFS securities	—	—	6,916	—	6,916
Advances <sup>(2)</sup>	—	6,936	—	—	6,936
Derivative assets, net: interest rate-related	—	713	—	(576)	137
Other assets	11	—	—	—	11
Total recurring fair value measurements – Assets	\$ 11	\$ 10,776	\$ 6,916	\$ (576)	\$ 17,127
Recurring fair value measurements – Liabilities:					
Consolidated obligation bonds <sup>(3)</sup>	\$ —	\$ 7,298	\$ —	\$ —	\$ 7,298
Derivative liabilities, net: interest rate-related	—	338	—	(300)	38
Total recurring fair value measurements – Liabilities	\$ —	\$ 7,636	\$ —	\$ (300)	\$ 7,336
Nonrecurring fair value measurements – Assets:					
REO	\$ —	\$ —	\$ 2	\$ —	\$ 2

**December 31, 2013**

	Fair Value Measurement Using:			Netting	
	Level 1	Level 2	Level 3	Adjustments <sup>(1)</sup>	Total
Recurring fair value measurements – Assets:					
Trading securities:					
GSEs – FFCB bonds	\$ —	\$ 3,194	\$ —	\$ —	\$ 3,194
MBS:					
Other U.S. obligations – Ginnie Mae	—	14	—	—	14
Total trading securities	—	3,208	—	—	3,208
AFS securities:					
PLRMBS	—	—	7,047	—	7,047
Total AFS securities	—	—	7,047	—	7,047
Advances <sup>(2)</sup>	—	7,069	—	—	7,069
Derivative assets, net: interest rate-related	—	720	—	(604)	116
Other assets	10	—	—	—	10
Total recurring fair value measurements – Assets	\$ 10	\$ 10,997	\$ 7,047	\$ (604)	\$ 17,450
Recurring fair value measurements – Liabilities:					
Consolidated obligation bonds <sup>(3)</sup>	\$ —	\$ 10,115	\$ —	\$ —	\$ 10,115
Derivative liabilities, net: interest rate-related	—	402	—	(355)	47
Total recurring fair value measurements – Liabilities	\$ —	\$ 10,517	\$ —	\$ (355)	\$ 10,162
Nonrecurring fair value measurements – Assets:					
REO	\$ —	\$ —	\$ 2	\$ —	\$ 2

(1) Amounts represent the netting of derivative assets and liabilities by counterparty, including cash collateral, where the netting requirements have been met.

(2) Includes \$6,936 and \$7,069 of advances recorded under the fair value option at March 31, 2014, and December 31, 2013, respectively. There were no advances recorded at fair value at March 31, 2014, or December 31, 2013, where the exposure to overall changes in fair value was hedged in accordance with the accounting for derivative instruments and hedging activities.



**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

- (3) Includes \$7,298 and \$10,115 of consolidated obligation bonds recorded under the fair value option at March 31, 2014, and December 31, 2013, respectively. There were no consolidated obligation bonds recorded at fair value at March 31, 2014, or December 31, 2013, where the exposure to overall changes in fair value was hedged in accordance with the accounting for derivative instruments and hedging activities.

The following table presents a reconciliation of the Bank's AFS PLRMBS that are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three months ended March 31, 2014 and 2013.

	Three Months Ended	
	March 31, 2014	March 31, 2013
Balance, beginning of the period	\$ 7,047	\$ 7,604
Total gain/(loss) realized and unrealized included in:		
Interest income	15	—
Net OTTI loss, credit-related	—	(3)
Unrealized gain/(loss) of other-than-temporarily impaired securities included in AOCI	81	340
Reclassification of non-credit-related OTTI included in net income/(loss)	(1)	2
Settlements	(226)	(309)
Transfers of HTM securities to AFS securities	—	19
Balance, end of the period	\$ 6,916	\$ 7,653
Total amount of gain/(loss) for the period included in earnings attributable to the change in unrealized gains/losses relating to assets and liabilities still held at the end of the period	\$ 15	\$ (3)

**Fair Value Option.** The fair value option provides an entity with an irrevocable option to elect fair value as an alternative measurement for selected financial assets, financial liabilities, unrecognized firm commitments, and written loan commitments not previously carried at fair value. It requires an entity to display the fair value of those assets and liabilities for which the entity has chosen to use fair value on the face of the Statements of Condition. Fair value is used for both the initial and subsequent measurement of the designated assets, liabilities, and commitments, with the changes in fair value recognized in net income. Interest income and interest expense on advances and consolidated bonds carried at fair value are recognized solely on the contractual amount of interest due or unpaid. Any transaction fees or costs are immediately recognized in non-interest income or non-interest expense.

For more information on the Bank's election of the fair value option, see "Item 8. Financial Statements and Supplementary Data – Note 20 – Fair Values" in the Bank's 2013 Form 10-K.

The Bank has elected the fair value option for certain financial instruments to assist in mitigating potential earnings volatility that can arise from economic hedging relationships in which the carrying value of the hedged item is not adjusted for changes in fair value. The potential earnings volatility associated with using fair value only for the derivative is the Bank's primary reason for electing the fair value option for financial assets and liabilities that do not qualify for hedge accounting or that have not previously met or may be at risk for not meeting the hedge effectiveness requirements.

The following table summarizes the activity related to financial assets and liabilities for which the Bank elected the fair value option during the three months ended March 31, 2014 and 2013:

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	Three Months Ended			
	March 31, 2014		March 31, 2013	
	Advances	Consolidated Obligation Bonds	Advances	Consolidated Obligation Bonds
Balance, beginning of the period	\$ 7,069	\$ 10,115	\$ 7,390	\$ 27,884
New transactions elected for fair value option	138	700	157	885
Maturities and terminations	(279)	(3,565)	(133)	(2,810)
Net gain/(loss) on advances and net (gain)/loss on consolidated obligation bonds held under fair value option	8	47	(26)	(15)
Change in accrued interest	—	1	(1)	—
Balance, end of the period	\$ 6,936	\$ 7,298	\$ 7,387	\$ 25,944

For instruments for which the fair value option has been elected, the related contractual interest income and contractual interest expense are recorded as part of net interest income on the Statements of Income. The remaining changes in fair value for instruments for which the fair value option has been elected are recorded as net gains/(losses) on financial instruments held under the fair value option in the Statements of Income. The change in fair value does not include changes in instrument-specific credit risk. For advances and consolidated obligations recorded under the fair value option, the Bank determined that no adjustments to the fair values of these instruments for instrument-specific credit risk were necessary for the three months ended March 31, 2014 and 2013.

The following table presents the difference between the aggregate remaining contractual principal balance outstanding and aggregate fair value of advances and consolidated obligation bonds for which the Bank elected the fair value option at March 31, 2014, and December 31, 2013:

	At March 31, 2014			At December 31, 2013		
	Principal Balance	Fair Value	Fair Value Over/(Under) Principal Balance	Principal Balance	Fair Value	Fair Value Over/(Under) Principal Balance
Advances <sup>(1)</sup>	\$ 6,816	\$ 6,936	\$ 120	\$ 6,956	\$ 7,069	\$ 113
Consolidated obligation bonds	7,365	7,298	(67)	10,230	10,115	(115)

(1) At March 31, 2014, and December 31, 2013, none of these advances were 90 days or more past due or had been placed on nonaccrual status.

### Note 17 — Commitments and Contingencies

As provided by the FHLBank Act or regulations governing the operations of the FHLBanks, all FHLBanks have joint and several liability for all FHLBank consolidated obligations, which are backed only by the financial resources of the FHLBanks. The joint and several liability regulation authorizes the Finance Agency to require any FHLBank to repay all or a portion of the principal or interest on consolidated obligations for which another FHLBank is the primary obligor. The regulations provide a general framework for addressing the possibility that an FHLBank may be unable to repay the consolidated obligations for which it is the primary obligor. The Bank has never been asked or required to repay the principal or interest on any consolidated obligation on behalf of another FHLBank, and as of March 31, 2014, and through the filing date of this report, does not believe that it is probable that it will be asked to do so. The par value of the outstanding consolidated obligations of all 12 FHLBanks was \$753,941 at March 31, 2014, and \$766,837 at December 31, 2013. The par value of the Bank's participation in consolidated obligations was \$77,616 at March 31, 2014, and \$76,968 at December 31, 2013. For more information on the joint and several liability regulation, see "Item 8. Financial Statements and Supplementary Data – Note 21 – Commitments and Contingencies" in the Bank's 2013 Form 10-K.

Off-balance sheet commitments as of March 31, 2014, and December 31, 2013, were as follows:



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**Notes to Financial Statements (continued)**

	March 31, 2014			December 31, 2013		
	Expire Within One Year	Expire After One Year	Total	Expire Within One Year	Expire After One Year	Total
Standby letters of credit outstanding	\$ 2,102	\$ 2,655	\$ 4,757	\$ 1,031	\$ 2,572	\$ 3,603
Commitments to fund advances <sup>(1)</sup>	54	3	57	4	4	8
Commitments to issue consolidated obligation bonds, par <sup>(2)</sup>	805	—	805	1,640	—	1,640

(1) At March 31, 2014, and December 31, 2013, none of the commitments to fund additional advances were hedged with associated interest rate swaps.

(2) At March 31, 2014, and December 31, 2013, \$805 and \$1,640, respectively, of the unsettled consolidated obligation bonds were hedged with associated interest rate swaps.

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 a payment for a beneficiary's drawing under a letter of credit, the amount is immediately due and payable by the member to the Bank and is charged to the member's demand deposit account with the Bank. The original terms of these standby letters of credit range from 107 days to 10 years, including a final expiration in 2024. The Bank monitors the creditworthiness of members that have standby letters of credit. In addition, standby letters of credit are fully collateralized. As a result, the Bank determined that it was not necessary to record any allowance for losses on these commitments.

The value of the Bank's obligations related to standby letters of credit is recorded in other liabilities and amounted to \$12 at March 31, 2014, and \$12 at December 31, 2013. Letters of credit are fully collateralized at the time of issuance. Based on the Bank's credit analyses of members' financial condition and collateral requirements, the Bank deemed it unnecessary to record any additional liability on the letters of credit outstanding as of March 31, 2014, and December 31, 2013.

Commitments to fund advances totaled \$57 at March 31, 2014, and \$8 at December 31, 2013. Advances funded under advance commitments are fully collateralized at the time of funding (see Note 9 – Allowance for Credit Losses). Based on the Bank's credit analyses of members' financial condition and collateral requirements, the Bank deemed it unnecessary to record any additional liability on the advance commitments outstanding as of March 31, 2014, and December 31, 2013.

The Bank executes over-the-counter bilateral interest rate exchange agreements with major banks and derivative entities affiliated with broker-dealers and with its members. The Bank enters into master agreements with netting provisions with all bilateral swap counterparties and into bilateral security agreements with all active derivative dealer counterparties. All member counterparty master agreements, excluding those with derivative dealers, are subject to the terms of the Bank's Advances and Security Agreement with members, and all member counterparties (except for those that are derivative dealers) must fully collateralize the Bank's net credit exposure. For cleared derivatives, the clearinghouse is the Bank's counterparty, and the Bank has clearing agreements with clearing agents that provide for delivery of initial margin to, and exchange of variation margin with, the clearinghouse. See Note 15 – Derivatives and Hedging Activities for additional information about the Bank's pledged collateral and other credit-risk-related contingent features. As of March 31, 2014, the Bank had pledged cash collateral of \$230 to counterparties and the clearing house that had market risk exposure to the Bank related to derivatives. As of December 31, 2013, the Bank had pledged cash collateral of \$149 to counterparties and the clearing house that had market risk exposure to the Bank related to derivatives.

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

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

**Note 18 — Transactions with Certain Members, Certain Nonmembers, and Other FHLBanks**

**Transactions with Certain Members and Certain Nonmembers.** The following tables set forth information at the dates and for the periods indicated with respect to transactions with: (i) members and nonmembers that held more than 10% of the outstanding shares of the Bank's capital stock, including mandatorily redeemable capital stock, at any time during the periods indicated, (ii) members that had an officer or director serving on the Bank's Board of Directors at any time during the periods indicated, and (iii) affiliates of the foregoing members and nonmembers. All transactions with members, the nonmembers described in the preceding sentence, and their respective affiliates are entered into in the normal course of business. The tables include securities transactions where certain members, nonmembers, and their affiliates (as described above) are the issuers or obligors of the securities, but do not include securities purchased, sold or issued through, or otherwise underwritten by, affiliates of certain members and nonmembers. The tables also do not include any AHP or Community Investment Cash Advance (CICA) grants. Securities purchased, sold or issued through, or otherwise underwritten by, and AHP or CICA grants provided to, the affiliates of certain members and nonmembers are in the ordinary course of the Bank's business.

	March 31, 2014	December 31, 2013
<b>Assets:</b>		
Cash and due from banks	\$ —	\$ —
Investments <sup>(1)</sup>	1,124	1,176
Advances	11,125	11,268
Mortgage loans held for portfolio	719	760
Accrued interest receivable	22	25
Other assets	31	37
Derivative assets, net	277	257
<b>Total Assets</b>	<b>\$ 13,298</b>	<b>\$ 13,523</b>
<b>Liabilities:</b>		
Deposits	\$ 277	\$ 260
Mandatorily redeemable capital stock	1,083	1,356
Derivative liabilities, net	31	37
<b>Total Liabilities</b>	<b>\$ 1,391</b>	<b>\$ 1,653</b>
Notional amount of derivatives	\$ 12,774	\$ 12,256
Standby letters of credit	59	205

- (1) Investments consist of securities purchased under agreements to resell, Federal funds sold, AFS securities, and HTM securities issued by and/or purchased from the members or nonmembers described in this section or their affiliates.

**Federal Home Loan Bank of San Francisco**  
**Notes to Financial Statements (continued)**

	Three Months Ended	
	March 31, 2014	March 31, 2013
<b>Interest Income:</b>		
Investments <sup>(1)</sup>	\$ 5	\$ 8
Advances <sup>(2)</sup>	24	39
Mortgage loans held for portfolio	9	12
<b>Total Interest Income</b>	<b>\$ 38</b>	<b>\$ 59</b>
<b>Interest Expense:</b>		
Mandatorily redeemable capital stock	\$ 25	\$ 23
Consolidated obligations <sup>(2)</sup>	(36)	(46)
<b>Total Interest Expense</b>	<b>\$ (11)</b>	<b>\$ (23)</b>
<b>Other Income/(Loss):</b>		
Net gain/(loss) on derivatives and hedging activities	\$ (44)	\$ (35)
Other income	—	—
<b>Total Other Income/(Loss)</b>	<b>\$ (44)</b>	<b>\$ (35)</b>

(1) Investments consist of securities purchased under agreements to resell, Federal funds sold, AFS securities, and HTM securities issued by and/or purchased from the members or nonmembers described in this section or their affiliates.

(2) Reflects the effect of associated derivatives with the members or nonmembers described in this section or their affiliates.

**Transactions with Other FHLBanks.** Transactions with other FHLBanks are identified on the face of the Bank's financial statements.

**Note 19 — Subsequent Events**

The Bank evaluated events subsequent to March 31, 2014, until the time of the Form 10-Q filing with the Securities and Exchange Commission, and no material subsequent events were identified.

## APPENDIX E

### FORM OF CONTINUING DISCLOSURE AGREEMENT

\$7,100,000

California Statewide Communities Development Authority  
Variable Rate Demand Multifamily Housing Revenue Bonds  
(Heritage II Apartments Project), 2014 Series G

This Continuing Disclosure Agreement, dated as of May 1, 2014 (this “Continuing Disclosure Agreement”), is executed and delivered by Heritage II, L.P., a California limited partnership (the “Developer”) and Wilmington Trust, National Association, as dissemination agent (the “Dissemination Agent”) and trustee (the “Trustee”) for the above-captioned bonds (the “Bonds”). The Bonds are being issued pursuant to an Indenture of Trust, dated as of May 1, 2014 (the “Indenture”) between the California Statewide Communities Development Authority (the “Issuer”) and the Trustee. Simultaneously with the issuance of the Bonds, there will be executed and delivered a Loan Agreement, dated as of the date of the Indenture (the “Loan Agreement”), by and among the Issuer, the Trustee and the Developer, pursuant to which the Issuer will loan the proceeds of the Bonds to the Developer (the “Loan”) for the purpose of finance the construction and development of a multifamily rental housing development known as the Heritage II Apartments, to be located within the City of Lompoc, California (the “Project”). Pursuant to the Indenture and the Loan Agreement, the Dissemination Agent and the Developer covenant and agree as follows:

**Section 1. Purpose of the Continuing Disclosure Agreement.** This Continuing Disclosure Agreement is being executed and delivered by the Developer and the Dissemination Agent for the benefit of the Bondholders and in order to assist the Participating Underwriter in complying with the Rule (defined below). The Developer and the Dissemination Agent acknowledge that the Issuer has undertaken no responsibility with respect to any reports, notices or disclosures provided or required under this Continuing Disclosure Agreement, and has no liability to any Person, including any holder of the Bonds or Beneficial Owner, with respect to any such reports, notices or disclosures.

**Section 2. Definitions.** In addition to the definitions set forth in the Indenture, which apply to any capitalized term used in this Continuing Disclosure Agreement unless otherwise defined in this Section, the following capitalized terms shall have the following meanings:

“Annual Report” shall mean any Annual Report provided by the Developer pursuant to, and as described in, Sections 3 and 4 of this Continuing Disclosure Agreement.

“Audited Financial Statements” means, in the case of the Developer, the annual audited financial statements prepared in accordance with generally accepted accounting principles, if any.

“Beneficial Owner” shall mean any Person which (a) has the power, directly or indirectly, to vote or consent with respect to, or to dispose of ownership of, any Bonds (including Persons holding Bonds through nominees, depositories or other intermediaries), or (b) is treated as the owner of any Bonds for federal income tax purposes.

“Disclosure Representative” shall mean the administrator of the Project or his or her designee, or such other Person as the Developer shall designate in writing to the Dissemination Agent from time to time.

“Dissemination Agent” shall mean Wilmington Trust, National Association, acting in its capacity as Dissemination Agent hereunder, or any successor Dissemination Agent designated in writing by the Developer and which has filed with the Trustee a written acceptance of such designation.

“Material Events” shall mean any of the events listed in Section 5(a) of this Continuing Disclosure Agreement.

“MSRB” means the Municipal Securities Rulemaking Board established pursuant to Section 15B(b)(1) of the Securities Exchange Act of 1934. All documents provided to the MSRB shall be in an electronic format and accompanied by identifying information, as prescribed by the MSRB. Initially, all document submissions to the MSRB pursuant to this Continuing Disclosure Agreement shall use the MSRB’s Electronic Municipal Market Access (EMMA) system at [www.emma.msrb.org](http://www.emma.msrb.org).

“Participating Underwriter” means Hutchinson, Shockey, Erley & Co. and Stern Brothers & Co., together, and their successors and assigns.

“Rule” means Rule 15c2-12(b)(5) adopted by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as the same may be amended from time to time.

**Section 3. Provision of Annual Reports.** (a) The Developer will, or will cause the Dissemination Agent to, not later than 180 days following the end of the Developer’s fiscal year, commencing with the fiscal year ending on December 31, 2014, provide to the MSRB an Annual Report which is consistent with the requirements described below. No later than 15 Business Days prior to said date, the Developer will provide the Annual Report to the Dissemination Agent and the Trustee (if the Trustee is not the Dissemination Agent). In each case, the Annual Report may be submitted as a single document or as separate documents comprising a package and may cross reference other information, provided that the audited financial statements for the prior calendar year of the Developer may be submitted separately from the balance of the Annual Report.

(b) If by 15 Business Days prior to the date specified in subsection (a) for providing the Annual Report to the MSRB, the Dissemination Agent has not received a copy of the Annual Report, the Dissemination Agent will contact the Disclosure Representative to determine if the Developer is in compliance with subsection (a).

(c) If the Dissemination Agent is unable to verify that an Annual Report has been provided to the MSRB by the date required in subsection (a), the Dissemination Agent will send a notice to the MSRB in substantially the form attached as Exhibit B to this Continuing Disclosure Agreement.

(d) The Dissemination Agent will file a report with the Developer and (if the Dissemination Agent is not the Trustee) the Trustee certifying that the Annual Report has been provided pursuant to this Continuing Disclosure Agreement, stating the date it was provided.

**Section 4. Content of Annual Reports.** The Developer’s Annual Report will contain or incorporate by reference the financial information or operating data with respect to the Project, provided at least annually, of the type included in Exhibit A hereto, which Annual Report may, but is not required to, include Audited Financial Statements. Audited Financial Statements are expected to be filed as part of the Developer’s Annual Report. If the Developer’s audited financial statements are not available by the time the Annual Report is required to be filed, the Annual Report will contain unaudited financial statements in a format similar to the financial statements contained in the final Official Statement, and the audited financial statements will be filed in the same manner as the Annual Report when they become available; and

Any or all of the items listed above may be incorporated by reference from other documents, including official statements of debt issues with respect to which the Developer is an “Obligated Person” (as defined by the Rule), which have been filed with the MSRB. The Developer will clearly identify each such other document so incorporated by reference.

**Section 5. Reporting of Material Events.** (a) This Section 5 shall govern the giving of notices of the occurrence of any of the following events (each, a “Material Event”):

- (i) Principal and interest payment delinquencies;
- (ii) Non-payment related defaults, if material;
- (iii) Unscheduled draws on debt service reserves reflecting financial difficulty;
- (iv) Unscheduled draws on credit enhancements reflecting financial difficulty;
- (v) Substitution of credit or liquidity providers, or their failure to perform;
- (vi) Adverse tax opinions, the issuance by the Internal Revenue Service of proposed or final determinations of taxability, Notices of Proposed Issue (IRS Form 5701-TEB) or other material notices or determinations with respect to the tax status of the Bonds, or other material events affecting the tax status of the Bonds;
- (vii) Modifications to rights of Bondholders, if material;
- (viii) Bond calls, if material, and tender offers;
- (ix) Defeasances;
- (x) Release, substitution or sale of property securing repayment of the Bonds, if material;
- (xi) Rating changes;
- (xii) Bankruptcy, insolvency, receivership or similar event of the Developer. For purposes of this clause (xii), any such event shall be considered to have occurred when any of the following occur: the appointment of a receiver, fiscal agent or similar officer for the Developer in a proceeding under the U.S. Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the Developer, or if such jurisdiction has been assumed by leaving the existing governing body and officials or officers in possession but subject to the supervision and orders of a court or governmental authority, or the entry of an order confirming a plan of reorganization, arrangement or liquidation by a court or governmental authority having supervision or jurisdiction over substantially all of the assets or business of the Developer;
- (xiii) The consummation of a merger, consolidation, or acquisition involving the Developer or the sale of all or substantially all of the assets of the Developer, other than in the ordinary course of business, the entry into a definitive agreement to undertake such an action or the termination of a definitive agreement relating to any such actions, other than pursuant to its terms, if material; and
- (xiv) Appointment of a successor or additional trustee or paying agent or the change of the name of a trustee or paying agent, if material.

(b) The Dissemination Agent shall, within three (3) Business Days of obtaining actual knowledge of the occurrence of any potential Material Event, pursuant to subsection (c) of this Section or otherwise, provide the Disclosure Representative with notice (by facsimile transmission confirmed by telephone). While the Dissemination Agent is also the Trustee, the Dissemination Agent shall be deemed to have actual knowledge of those items listed in clauses (i), (iii) (solely with respect to funds held by the Trustee), (iv), (v), (vii), (viii), (ix), (x) and (xiv) above without the Dissemination Agent having received notice of such event. While the Dissemination Agent is not also the Trustee, the Dissemination Agent shall not be deemed to have actual knowledge of any items listed in clauses (i) - (xiv) above without the Dissemination Agent having received written notice of such event. For purposes of providing notice to the Disclosure Representative, the Dissemination Agent shall assume that the unscheduled draws described in clauses (iii) and (iv) reflect financial difficulty.

(c) Whenever the Developer obtains knowledge of the occurrence of a potential Material Event, the Developer shall, within five (5) Business Days of obtaining such knowledge and in any event no more than eight (8) Business Days after the occurrence of such event, determine if such event is in fact a Material Event that is required by the Rule to be disclosed and provide the Dissemination Agent with notice and instructions pursuant to subsections (d) or (e) below, as applicable.

(d) If the Developer has determined that a Material Event is required to be disclosed then the Developer shall prepare a written notice describing the Material Event and provide the same to the Dissemination Agent along with instructions to file the same pursuant to subsection (f) below.

(e) If the Developer determines that an event is not required to be disclosed as a Material Event then the Developer shall so notify the Dissemination Agent in writing and instruct the Dissemination Agent not to report the occurrence pursuant to subsection (f).

(f) If the Dissemination Agent has been provided with a written notice describing a Material Event pursuant to subsection (c) of this Section or otherwise, and is instructed by the Developer to report the occurrence of such Material Event, the Dissemination Agent shall, within two (2) Business Days of its receipt of such written notice and in any event no more than ten (10) Business Days after the occurrence of the Material Event, file the notice with the MSRB and send a copy to the Developer. The foregoing notwithstanding, notice of a Material Event described in subsections (a)(viii) and (ix) need not be given under this subsection any earlier than the notice (if any) of the underlying event is given to the Holders of affected Bonds pursuant to the Indenture.

**Section 6. Amendment; Waiver.** Notwithstanding any other provision of this Continuing Disclosure Agreement, the Developer and the Dissemination Agent may amend this Continuing Disclosure Agreement (and the Dissemination Agent will agree to any amendment so requested by the Developer unless such amendment adversely affects its rights, duties, protections, immunities, indemnities or standard of care, as determined by the Dissemination Agent) and any provision of this Continuing Disclosure Agreement may be waived, provided that the following conditions are satisfied:

(a) If the amendment or waiver relates to the provisions described under paragraph (a) under “Provision of Annual Reports,” “Contents of Annual Reports” or paragraph (a) under “Reporting of Material Events,” it may only be made in connection with a change in circumstances that arises from a change in legal requirements, change in law or change in the identity, nature or status of an Obligated Person with respect to the Bonds or the type of business conducted;

(b) The undertaking, as amended or taking into account such waiver, would, in the opinion of nationally recognized bond counsel, have complied with the requirements of the Rule at the time of the

original issuance of the Bonds, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances; and

(c) The amendment or waiver either (i) is approved by the Holders of the Bonds in the same manner as provided in the Indenture for amendments to the Indenture with the consent of Holders or (ii) does not, in the opinion of nationally recognized bond counsel, materially impair the interests of the Holders or Beneficial Owners of the Bonds.

In the event of any amendment or waiver of a provision of this Continuing Disclosure Agreement, the Developer will describe such amendment in the next Annual Report and will include, as applicable, a narrative explanation of the reason for the amendment or waiver and its impact on the type (or, in the case of a change of accounting principles, on the presentation) of financial information or operating data being presented by the Developer. In addition, if the amendment relates to the accounting principles to be followed in preparing financial statements, (i) notice of such change will be given in the same manner as for a Material Event under Section 5(f) hereof and (ii) the Annual Report for the year in which the change is made should present a comparison (in narrative form and also, if feasible, in quantitative form) between the financial statements as prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles.

**Section 7. Default.** In the event of a failure of the Developer or the Dissemination Agent to comply with any provision of this Continuing Disclosure Agreement, the Trustee may (and, at the request of the Participating Underwriter or the Holders of at least 25% aggregate principal amount of Outstanding Bonds and upon being indemnified to its satisfaction, will), or the Developer or any Holder or Beneficial Owner of the Bonds may, take such actions as may be necessary and appropriate, including seeking, or specific performance by court order, to cause the Developer or the Dissemination Agent, as the case may be, to comply with its obligations under this Continuing Disclosure Agreement. A default under this Continuing Disclosure Agreement will not be deemed an Event of Default under the Indenture or the Loan Agreement, and the sole remedy under this Continuing Disclosure Agreement in the event of any failure of the Developer or the Dissemination Agent to comply with this Continuing Disclosure Agreement will be an action to compel performance.

**Section 8. Beneficiaries.** This Continuing Disclosure Agreement will inure solely to the benefit of the Developer, the Trustee, the Dissemination Agent, the Participating Underwriter and Holders from time to time of the Bonds and will create no rights in any other Person or entity.

**Section 9. Additional Information.** Nothing in this Continuing Disclosure Agreement shall be deemed to prevent the Developer from disseminating any other information, using the means of dissemination set forth in this Continuing Disclosure Agreement or any other means of communication, or including any other information in any Annual Report or notice of occurrence of a Material Event, in addition to that which is required by this Continuing Disclosure Agreement. If the Developer chooses to include any information in any Annual Report or notice of occurrence of a Material Event, in addition to that which is specifically required by this Continuing Disclosure Agreement, the Developer shall have no obligation under this Continuing Disclosure Agreement to update such information or include it in any future Annual Report or notice of occurrence of a Material Event.

**Section 10. Duties, Immunities and Liabilities of Trustee and Dissemination Agent.** Article VIII of the Indenture is hereby made applicable to this Continuing Disclosure Agreement as if this Continuing Disclosure Agreement were (solely for this purpose) contained in the Indenture and the Dissemination Agent shall be entitled to the same protections, limitations from liability and indemnities afforded the Trustee thereunder. The Dissemination Agent and the Trustee shall have only such duties as are specifically set forth in this Continuing Disclosure Agreement, and the Developer agrees to indemnify



and save the Dissemination Agent, the Trustee, their officers, directors, employees and agents, harmless against any loss, expense and liabilities which they may incur arising out of or in the exercise or performance of their rights, obligations, powers and duties hereunder, including the costs and expenses (including reasonable attorneys fees) of defending against any claim of liability, but excluding liabilities due to the Dissemination Agent's or Trustee's respective negligence or willful misconduct. The obligations of the Developer under this Section shall survive the termination of this Continuing Disclosure Agreement, the resignation or removal of the Dissemination Agent or the Trustee and payment of the Bonds. The Dissemination Agent and the Trustee shall have no duty or obligation to review any information provided to it hereunder and shall not be deemed to be acting in any fiduciary capacity for the Developer, the Bondholders, or any other party. Neither the Trustee or the Dissemination Agent shall have any liability to the Bondholders or any other party for any monetary damages or financial liability of any kind whatsoever related to or arising from the breach of this Continuing Disclosure Agreement.

The Dissemination Agent agrees to disseminate the information provided to it hereunder in the form delivered by the Developer. The Dissemination Agent is acting hereunder solely in an agency capacity and as such is merely a conduit for the Developer, and shall have no liability or responsibility for the form, content, accuracy or completeness of any information furnished hereunder. Any such information may contain a legend to that effect.

The Dissemination Agent shall have no obligation to make disclosure concerning the Bonds, the Project or any other matter except as expressly set out herein, provided that no provision of this Continuing Disclosure Agreement shall limit the duties, trusts, rights, powers or obligations of the Trustee under the Indenture. The fact that the Trustee has or may have any banking, fiduciary or other relationship with the Developer or any other party in connection with the Project or otherwise, apart from the relationship created by the Indenture and this Continuing Disclosure Agreement, shall not be construed to mean that the Trustee has knowledge or notice of any event or condition relating to the Bonds or the Project except in its respective capacities under such agreements.

No provision of this Continuing Disclosure Agreement shall require or be construed to require the Developer or the Dissemination Agent to interpret or provide an opinion concerning any information disclosed hereunder.

The Annual Report may contain such disclaimer language as the Developer may deem appropriate. Any information disclosed hereunder by the Dissemination Agent may contain such disclaimer language as the Dissemination Agent may deem appropriate.

The Developer hereby agrees to compensate the Dissemination Agent for the services provided and the expenses incurred pursuant to this Continuing Disclosure Agreement, in an amount to be agreed upon from time to time hereunder, and to reimburse the Dissemination Agent upon its request for all reasonable expenses, disbursements and advances incurred by the Dissemination Agent hereunder (including any reasonable compensation and expenses of counsel) except any such expense, disbursement or advance that may be attributable to its negligence or willful misconduct.

The Dissemination Agent may consult with counsel of its choice and the written advice of such counsel or any opinion of counsel shall be full and complete authorization and protection in respect of any action taken, suffered or omitted by it hereunder in good faith and in reliance thereon, it being understood that for purposes of this provision, that such counsel may be counsel to the Developer.

No provision of this Continuing Disclosure Agreement shall require the Dissemination Agent to expend or risk its own funds or otherwise incur any financial liability in the performance of any of its duties hereunder, or in the exercise of any of its rights or powers.

**Section 11. Notices.** Any notices or communications to or among any of the parties to this Continuing Disclosure Agreement may be given at the addresses set forth in the Indenture. Any person may, by written notice to the other persons listed above, designate a different address or telephone number(s) to which subsequent notices of communications should be sent, effective only upon receipt.

**Section 12. Governing Law.** This Continuing Disclosure Agreement shall be governed by the laws of the State of California.

**Section 13. Termination of this Continuing Disclosure Agreement.** The Developer or the Dissemination Agent may terminate this Continuing Disclosure Agreement by giving written notice to the other party at least 30 days prior to such termination. The Dissemination Agent shall be fully discharged at the time any such termination is effective.

**Section 14. Counterparts.** This Continuing Disclosure Agreement may be executed in several counterparts, each of which shall be an original and all of which shall constitute but one and the same instrument.

[Remainder of Page Left Blank Intentionally]

[Developer's Signature Page to Continuing Disclosure Agreement]

HERITAGE II, L.P., a California limited partnership

By Foundation for Affordable Housing II, Inc., a  
California nonprofit public benefit corporation  
Its Managing General Partner

By \_\_\_\_\_  
Thomas E. Willard, President

By Investment Concepts, Inc., a California corporation  
Its Co-General Partner

By \_\_\_\_\_  
George Chami, Chief Executive Officer

[Trustee's signature page to Continuing Disclosure Agreement]

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee and Dissemination Agent

By \_\_\_\_\_  
Its \_\_\_\_\_

**EXHIBIT A**  
**ANNUAL REPORT**

\$7,100,000  
California Statewide Communities Development Authority  
Variable Rate Demand Multifamily Housing Revenue Bonds  
(Heritage II Apartments Project), 2014 Series G

Report for Period Ending \_\_\_\_\_

**THE PROJECT**

Name: \_\_\_\_\_  
Address: \_\_\_\_\_  
Occupancy \_\_\_\_\_  
Number of Units \_\_\_\_\_  
Number of Units Occupied as of Report Date \_\_\_\_\_

**OPERATING HISTORY OF THE PROJECT**

The following table sets forth a summary of the operating results of the Project for fiscal year ended \_\_\_\_\_, as derived from the Developer's [un]audited financial statements.

Revenues  
Operating Expenses<sup>1</sup>  
Net Operating Income  
Debt Service on the Loan  
Net Operating Income/(Loss)  
After Debt Service

The average occupancy of the Project for the fiscal year ended [\_\_\_\_] was [\_\_\_\_] %.

<sup>1</sup>Excludes depreciation and other non-cash expenses, includes management fee.

**EXHIBIT B**

**NOTICE TO MUNICIPAL SECURITIES RULEMAKING BOARD OF  
FAILURE TO FILE ANNUAL REPORT**

Name of Issuer: California Statewide Communities Development Authority

Name of Bond Issue: \$7,100,000 California Statewide Communities Development Authority  
Variable Rate Demand Multifamily Housing Revenue Bonds  
(Heritage II Apartments Project), 2014 Series G

Name of Developer: Heritage II, L.P., a California limited partnership

Date of Issuance: May 29, 2014

NOTICE IS HEREBY GIVEN that the above-referenced developer (the “Developer”) has not provided an Annual Report in connection with the above-captioned bonds (the “Bonds”) as required by a Indenture of Trust, dated as of May 1, 2014 (the “Indenture”), between the above-named Issuer (the “Issuer”) and Wilmington Trust, National Association, as trustee (the “Trustee”) and the Loan Agreement, dated as of the date of the Indenture (the “Loan Agreement”), by and among the Issuer, the Trustee and the Developer. The undersigned has been informed by the Developer that it anticipates that the Annual Report will be filed by \_\_\_\_\_.

Dated:

WILMINGTON TRUST, NATIONAL ASSOCIATION,  
as Trustee and Dissemination Agent

By \_\_\_\_\_  
Its \_\_\_\_\_

cc: Developer