

“The year 2007 will no



John F. Moore
First Vice President and
Chief Operating Officer

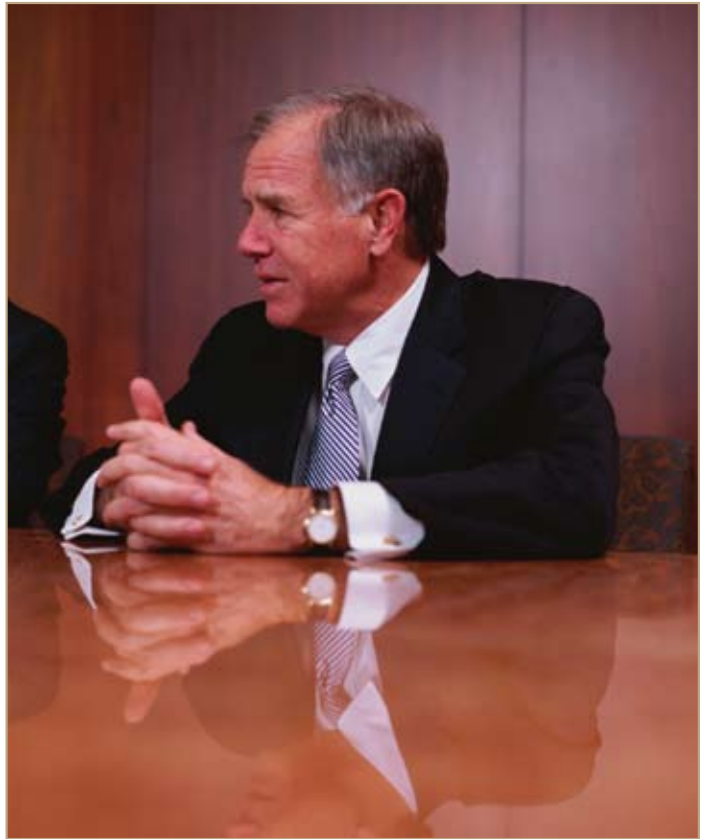


Janet L. Yellen
President and
Chief Executive Officer

doubt long be remembered . . .”



David K.Y. Tang
Chairman



T. Gary Rogers
Deputy Chairman

LETTER FROM THE PRESIDENT

The year 2007 will no doubt long be remembered as the year of the subprime mortgage crisis. Few have been untouched by it, including many in this Reserve District. During the first half of the year, the economy appeared to be on track for modest growth in spite of a serious downturn in the housing market. In mid-July, financial markets became highly volatile and increasingly averse to risk, triggered by concern about growing delinquencies in subprime mortgages. As the year drew to a close, economic prospects had dimmed considerably. The consequence is that credit conditions have tightened broadly throughout the economy and especially in the housing sector. Indeed, as I write this letter, we remain deeply concerned about the ongoing problems in the housing sector—rising delinquencies and foreclosures and falling house prices—and the distress it is causing for families and for communities. We are also concerned about the impact of these developments for the economic prospects of the national and Twelfth District economies. Federal Reserve policymakers are working hard on many fronts to understand the implications of the subprime crisis for households, financial markets, and the broader economy and to implement policies to mitigate the impacts and help prevent a recurrence of such events.

The personal toll of the subprime crisis for some homeowners and communities in our District is serious and deserves our close attention. Although our region continues to have some of the better performing housing markets, we also have some of the highest concentrations of delinquencies and foreclosures in the nation. Understanding and responding to these problems is a major strategic focus for our Bank.

This report features the work that staff in two areas of our Bank are doing to understand and address the subprime mortgage situation and its fallout. In the

main essay, economists from our Research department examine the factors that led to the rise in subprime delinquencies and foreclosures and to the subsequent turmoil in the financial markets. The essay profiles national and Twelfth District developments and draws some significant conclusions about the importance of house-price appreciation as a contributing factor. The essay also provides insight into “lessons learned” about mortgage financing and capital markets that may contribute to financial market stability going forward.

The second essay spotlights a major initiative our Community Development department launched in 2007 to help homeowners in hard-hit communities avoid foreclosure. The initiative is an extension of the longstanding role Community Development has played through research, education, and collaborative outreach to support sustainable, affordable homeownership in our District.

The individuals involved in these efforts have provided me with regular briefings on developments in the housing and associated financial markets, and their work has provided important support for my participation in the Federal Open Market Committee’s (FOMC) monetary policy deliberations. Starting in September, the FOMC began to lower the federal funds rate target to address growing concerns about tightening credit conditions and the risks posed to the broader economy. As of this writing in late March, the Committee had lowered the federal funds rate by 300 basis points.

Since last August, the Federal Reserve also has launched a number of initiatives to address liquidity concerns. The Board of Governors has cut the differential between the discount window lending rate and the federal funds rate for banks borrowing from the Fed from the customary 100 basis points to 25 basis points. At year-end, with liquidity strains still quite evident, the Board of Governors introduced the Term

Auction Facility as a new option for banks to tap into the Fed's lending function. In recent weeks, the Board and FOMC have also stepped in to provide liquidity to primary dealers through a new Term Securities Lending Facility and also through a new Primary Dealer Credit Facility that enables primary dealers to borrow directly at the discount window.

Other areas of the Bank also faced serious challenges in 2007. During the summer, as part of the Federal Reserve's ongoing check restructuring effort, our San Francisco Head Office's check operation merged into the Los Angeles Branch in one of the District's most ambitious consolidations to date. It is never easy to cut jobs, and it is certainly never easy for those employees who suffer the loss of their jobs. Nonetheless, morale and performance levels remained high as our team worked around the clock to meet the consolidation deadline.

I would like to take this opportunity to thank the team for their commitment and high standard of service to this Reserve Bank and to the public. I would also like to thank all the employees whose work I have not specifically mentioned in this letter. Throughout the Bank, many are dealing with significant transition issues as they strive to meet the Bank's objectives. I'm very pleased to say that their dedication and hard work have resulted in the achievement of our major goals, and we are featuring those accomplishments in the Bank Highlights of 2007 section of this report.

We are fortunate to be guided in our efforts by the diverse insights of our boards of directors and advisory council members, who represent a broad spectrum of industries and organizations within the Twelfth District. Their independent assessment of economic and financial conditions throughout our nine western states also plays an invaluable role in the formulation of monetary policy, and I thank them for their unflagging commitment to this critical public service.

In particular, I would like to acknowledge the many contributions of Richard W. Decker, Jr., chairman and cofounder, Belvedere Capital Partners LLC, San Francisco, California, and Jack McNally, principal, JKM Consulting, Sacramento, California, both of whom completed their terms of service on the Head Office Board at the end of 2007, after serving six and seven years, respectively.

In addition, I would like to express my sincere thanks and appreciation to the other directors and Federal Advisory Council and Economic Advisory Council members who concluded their terms of service during 2007:

- *on the Los Angeles Branch Board:* Anita Santiago, chief executive officer, Anita Santiago Advertising, Santa Monica, California;
- *on the Salt Lake City Branch Board:* Gary L. Crocker, chairman of the board, Merrimack Pharmaceuticals, Inc., Salt Lake City, Utah;
- *on the Seattle Branch Board:* Mic R. Dinsmore, president, Infrastructure Investment Division, Stark Investments, Seattle, Washington, who served as chairman of the Seattle Branch Board for the past five years;
- *as the Twelfth District member of the Federal Advisory Council:* Richard M. Kovacevich, chairman, Wells Fargo & Company, San Francisco, California; and
- *on the Twelfth District Economic Advisory Council:* John P. Connolly, national executive director, Actors' Equity Association, New York, New York.



Janet L. Yellen

President and Chief Executive Officer