

DOWNEY FINANCIAL CORP

Form 10-Q

May 03, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

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**FORM 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended **March 31, 2005**

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number **1-13578**

**DOWNEY FINANCIAL CORP.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**33-0633413**

(I.R.S. Employer Identification No.)

**3501 Jamboree Road, Newport Beach, CA**

(Address of principal executive office)

**92660**

(Zip Code)

Registrant's telephone number, including area code

**(949) 854-0300**

**N/A**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant

was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  
 Yes  No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

At March 31, 2005, 27,853,783 shares of the Registrant's Common Stock, \$0.01 par value were outstanding.

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## DOWNEY FINANCIAL CORP.

### MARCH 31, 2005 QUARTERLY REPORT ON FORM 10-Q

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**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****DOWNEY FINANCIAL CORP. AND SUBSIDIARIES****Consolidated Balance Sheets**

(Dollars in Thousands, Except Per Share Data)

March 31, December 31, March 31,  
2005 2004 2004

| <b>Assets</b>  |               |               |               |
|--|---------------|---------------|---------------|
| Cash   | \$ 133,621    | \$ 119,502    | \$ 115,905    |
| Federal funds  | 10,003        | -             | 2,300         |
| Cash and cash equivalents  | 143,624       | 119,502       | 118,205       |
| U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value | 511,703       | 497,009       | 872,103       |
| Loans held for sale, at lower of cost or fair value  | 1,255,104     | 1,118,475     | 529,085       |
| Mortgage-backed securities available for sale, at fair value   | 296           | 304           | 327           |
| Loans receivable held for investment   | 14,473,108    | 13,423,999    | 11,064,686    |
| Investments in real estate and joint ventures  | 56,964        | 55,411        | 35,768        |
| Real estate acquired in settlement of loans  | 2,783         | 2,555         | 5,189         |
| Premises and equipment   | 105,596       | 106,238       | 108,372       |
| Federal Home Loan Bank stock, at cost  | 243,613       | 243,613       | 124,277       |
| Investment in Downey Financial Capital Trust I   | -             | -             | 3,711         |
| Mortgage servicing rights, net   | 19,610        | 17,964        | 69,721        |
| Other assets   | 80,936        | 63,738        | 593,685       |
|  | \$ 16,893,337 | \$ 15,648,808 | \$ 13,525,129 |
| <b>Liabilities and Stockholders Equity</b>   |               |               |               |
| Deposits   | \$ 10,309,077 | \$ 9,657,978  | \$ 8,817,173  |
| Securities sold under agreements to repurchase   | -             | -             | 507,027       |
| Federal Home Loan Bank advances  | 5,093,874     | 4,559,622     | 2,424,230     |
| Real estate notes  | -             | -             | 4,144         |
| Senior notes   | 197,964       | 197,924       | -             |
| Junior subordinated debentures   | -             | -             | 123,711       |
| Accounts payable and accrued liabilities   | 117,008       | 108,217       | 604,757       |
| Deferred income taxes  | 121,078       | 117,416       | 119,530       |
| Total liabilities  | 15,839,001    | 14,641,157    | 12,600,572    |
| <b>Stockholders equity:</b>  |               |               |               |
| Preferred stock, par value of \$0.01 per share; authorized 5,000,000 shares;                                   |               |               |               |

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|  |                      |                      |                      |
|--|----------------------|----------------------|----------------------|
| outstanding none   | -                    | -                    | -                    |
| Common stock, par value of \$0.01 per share; authorized 50,000,000 shares;<br>issued 28,235,022 shares at March 31, 2005, December 31, 2004 and<br>March 31, 2004; outstanding 27,853,783 shares at both March 31, 2005 and<br>December 31, 2004 and 27,953,747 shares at March 31, 2004 | 282                  | 282                  | 282                  |
| Additional paid-in capital   | 93,792               | 93,792               | 93,792               |
| Accumulated other comprehensive income (loss)  | (1,951 )             | 318                  | 1,753                |
| Retained earnings  | 979,005              | 930,051              | 839,898              |
| Treasury stock, at cost, 381,239 shares at both March 31, 2005 and<br>December 31, 2004 and 281,275 shares at March 31, 2004   | (16,792 )            | (16,792 )            | (11,168 )            |
| <b>Total stockholders equity</b>   | <b>1,054,336</b>     | <b>1,007,651</b>     | <b>924,557</b>       |
|  | <b>\$ 16,893,337</b> | <b>\$ 15,648,808</b> | <b>\$ 13,525,129</b> |

*See accompanying notes to consolidated financial statements.*

**DOWNEY FINANCIAL CORP. AND SUBSIDIARIES****Consolidated Statements of Income**

*Three Months Ended  
March 31,*

*(Dollars in Thousands, Except Per Share Data)*

2005      2004

**Interest income**

|   |            |            |
|---|------------|------------|
| Loans receivable                                | \$ 173,007 | \$ 115,530 |
| U.S. Treasury securities and agency obligations | 4,838      | 4,064      |
| Mortgage-backed securities                      | 3          | 3          |
| Other investments                               | 2,538      | 1,198      |

|                       |         |         |
|-----------------------|---------|---------|
| Total interest income | 180,386 | 120,795 |
|-----------------------|---------|---------|

**Interest expense**

|  |        |        |
|--|--------|--------|
| Deposits   | 49,023 | 32,600 |
| Federal Home Loan Bank advances and other borrowings | 33,980 | 15,705 |
| Senior notes   | 3,295  | -      |
| Junior subordinated debentures                       | -      | 3,134  |

|                        |        |        |
|------------------------|--------|--------|
| Total interest expense | 86,298 | 51,439 |
|------------------------|--------|--------|

|                            |        |        |
|----------------------------|--------|--------|
| <b>Net interest income</b> | 94,088 | 69,356 |
|----------------------------|--------|--------|

|                                  |       |       |
|----------------------------------|-------|-------|
| <b>Provision for loan losses</b> | 2,038 | 1,804 |
|----------------------------------|-------|-------|

|   |        |        |
|---|--------|--------|
| Net interest income after provision for loan losses | 92,050 | 67,552 |
|---|--------|--------|

**Other income, net**

|  |        |           |
|--|--------|-----------|
| Loan and deposit related fees                              | 19,507 | 12,456    |
| Real estate and joint ventures held for investment, net    | 2,580  | 926       |
| Secondary marketing activities:                            |        |           |
| Loan servicing income (loss), net                          | 1,484  | (14,245 ) |
| Net gains on sales of loans and mortgage-backed securities | 30,615 | 1,372     |
| Net gains on sales of mortgage servicing rights            | 981    | -         |
| Net gains on sales of investment securities                | 27     | 2,112     |
| Other  | 520    | 332       |

|                         |        |       |
|-------------------------|--------|-------|
| Total other income, net | 55,714 | 2,953 |
|-------------------------|--------|-------|

**Operating expense**

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|  |            |            |
|--|------------|------------|
| Salaries and related costs                                   | 39,155     | 35,569     |
| Premises and equipment costs                                 | 8,000      | 8,208      |
| Advertising expense  | 1,350      | 1,708      |
| SAIF insurance premiums and regulatory assessments           | 927        | 757        |
| Professional fees  | 336        | 368        |
| Other general and administrative expense                     | 8,392      | 8,482      |
| <hr/>  |            |            |
| Total general and administrative expense                     | 58,160     | 55,092     |
| Net operation of real estate acquired in settlement of loans | 64         | (72 )      |
| <hr/>  |            |            |
| Total operating expense                                      | 58,224     | 55,020     |
| <hr/>  |            |            |
| <b>Income before income taxes</b>                            | 89,540     | 15,485     |
| Income taxes   | 37,801     | 6,573      |
| <hr/>  |            |            |
| <b>Net income</b>  | \$ 51,739  | \$ 8,912   |
| <hr/>  |            |            |
| <b>PER SHARE INFORMATION</b>                                 |            |            |
| <b>Basic</b>   | \$ 1.86    | \$ 0.32    |
| <hr/>  |            |            |
| <b>Diluted</b>   | \$ 1.86    | \$ 0.32    |
| <hr/>  |            |            |
| <b>Cash dividends declared and paid</b>                      | \$ 0.10    | \$ 0.10    |
| <hr/>  |            |            |
| Weighted average diluted shares outstanding                  | 27,881,839 | 27,980,542 |
| <hr/>  |            |            |

See accompanying notes to consolidated financial statements.

**DOWNEY FINANCIAL CORP. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income**

| <i>(In Thousands)</i>  | <i>Three Months Ended</i> |             |
|--|---------------------------|-------------|
|  | <i>2005</i>               | <i>2004</i> |
| <b>Net income</b>  | \$ 51,739                 | \$ 8,912    |
| <b>Other comprehensive income (loss), net of income taxes (benefits)</b>       |                           |             |
| Unrealized gains (losses) on securities available for sale:                    |                           |             |
| U.S. Treasury securities, agency obligations and other investment              |                           |             |
| securities available for sale, at fair value                                   | (2,443 )                  | (310 )      |
| Mortgage-backed securities available for sale, at fair value                   | -                         | (1 )        |
| Reclassification of realized amounts included in net income                    | (17 )                     | -           |
| Unrealized gains (losses) on cash flow hedges:                                 |                           |             |
| Net derivative instruments   | (78 )                     | 638         |
| Reclassification of realized amounts included in net income                    | 269                       | 619         |
| <b>Total other comprehensive income (loss), net of income taxes (benefits)</b> | (2,269 )                  | 946         |
| <b>Comprehensive income</b>  | \$ 49,470                 | \$ 9,858    |

See accompanying notes to consolidated financial statements.



**DOWNEY FINANCIAL CORP. AND SUBSIDIARIES****Consolidated Statements of Cash Flows**

*Three Months Ended*  
*March 31,*

*(In Thousands)*

2005

2004

**Cash flows from operating activities**

|            |           |          |
|------------|-----------|----------|
| Net income | \$ 51,739 | \$ 8,912 |
|------------|-----------|----------|

Adjustments to reconcile net income to net cash used for operating activities:

|                               |        |        |
|-------------------------------|--------|--------|
| Depreciation and amortization | 19,939 | 19,771 |
|-------------------------------|--------|--------|

Provision for losses on loans, real estate acquired in settlement of loans, investments

|   |     |        |
|---|-----|--------|
| in real estate and joint ventures, mortgage servicing rights and other assets | 835 | 14,757 |
|---|-----|--------|

Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights,

|   |           |          |
|---|-----------|----------|
| investment securities, real estate and other assets | (33,092 ) | (3,670 ) |
|---|-----------|----------|

|   |           |          |
|---|-----------|----------|
| Interest capitalized on loans (negative amortization) | (18,707 ) | (1,553 ) |
|---|-----------|----------|

|  |   |          |
|--|---|----------|
| Federal Home Loan Bank stock dividends | - | (1,188 ) |
|--|---|----------|

|   |              |            |
|---|--------------|------------|
| Loans originated and purchased for sale | (2,181,392 ) | (927,777 ) |
|---|--------------|------------|

Proceeds from sales of loans held for sale, including those sold

|                               |           |         |
|-------------------------------|-----------|---------|
| as mortgage-backed securities | 2,059,786 | 677,001 |
|-------------------------------|-----------|---------|

|            |           |           |
|------------|-----------|-----------|
| Other, net | (48,432 ) | (20,680 ) |
|------------|-----------|-----------|

|  |            |            |
|--|------------|------------|
| Net cash used for operating activities | (149,324 ) | (234,427 ) |
|--|------------|------------|

**Cash flows from investing activities**

Proceeds from sales of:

U.S. Treasury securities, agency obligations and other investment securities

|                    |   |       |
|--------------------|---|-------|
| available for sale | - | 4,150 |
|--------------------|---|-------|

|  |     |       |
|--|-----|-------|
| Wholly owned real estate and real estate acquired in settlement of loans | 663 | 1,979 |
|--|-----|-------|

Proceeds from maturities or calls of U.S. Treasury securities, agency obligations

|  |       |         |
|--|-------|---------|
| and other investment securities available for sale | 8,100 | 377,746 |
|--|-------|---------|

Purchase of:

U.S. Treasury securities, agency obligations and other investment securities

|                    |           |            |
|--------------------|-----------|------------|
| available for sale | (27,044 ) | (539,057 ) |
|--------------------|-----------|------------|

|                                      |           |           |
|--------------------------------------|-----------|-----------|
| Loans receivable held for investment | (25,360 ) | (65,537 ) |
|--------------------------------------|-----------|-----------|

|                        |          |          |
|------------------------|----------|----------|
| Premises and equipment | (4,673 ) | (2,164 ) |
|------------------------|----------|----------|

Originations of loans receivable held for investment (net of refinances of \$166,659 for the

three months ended March 31, 2005 and \$153,812 for three months ended

|                 |              |              |
|-----------------|--------------|--------------|
| March 31, 2004) | (1,876,331 ) | (1,808,959 ) |
|-----------------|--------------|--------------|

Principal payments on loans receivable held for investment and mortgage-backed

|                               |         |         |
|-------------------------------|---------|---------|
| securities available for sale | 876,996 | 910,487 |
|-------------------------------|---------|---------|

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|  |              |              |
|--|--------------|--------------|
| Net change in undisbursed loan funds           | 36,450       | 41,560       |
| Investments in real estate held for investment | (136 )       | (145 )       |
| Other, net                                     | 2,175        | 379          |
| <hr/>  |              |              |
| Net cash used for investing activities         | (1,009,160 ) | (1,079,561 ) |
| <hr/>  |              |              |

*See accompanying notes to consolidated financial statements.*

**DOWNEY FINANCIAL CORP. AND SUBSIDIARIES****Consolidated Statements of Cash Flows (Continued)**

*Three Months Ended  
March 31,*

*(In Thousands)*

2005

2004

**Cash flows from financing activities**

|  |               |              |
|--|---------------|--------------|
| Net increase in deposits   | \$ 651,099    | \$ 523,415   |
| Proceeds from Federal Home Loan Bank advances and other borrowings       | 10,558,350    | 3,630,560    |
| Repayments of Federal Home Loan Bank advances and other borrowings       | (10,015,350 ) | (2,828,550 ) |
| Proceeds from reissuance of treasury stock and exercise of stock options | -             | 474          |
| Cash dividends   | (2,785 )      | (2,793 )     |
| Other, net   | (8,708 )      | (4,080 )     |

|   |           |           |
|---|-----------|-----------|
| Net cash provided by financing activities | 1,182,606 | 1,319,026 |
|---|-----------|-----------|

|  |         |         |
|--|---------|---------|
| Net increase in cash and cash equivalents        | 24,122  | 5,038   |
| Cash and cash equivalents at beginning of period | 119,502 | 113,167 |

|   |                   |                   |
|---|-------------------|-------------------|
| <b>Cash and cash equivalents at end of period</b> | <b>\$ 143,624</b> | <b>\$ 118,205</b> |
|---|-------------------|-------------------|

**Supplemental disclosure of cash flow information:**

## Cash paid during the period for:

|              |           |           |
|--------------|-----------|-----------|
| Interest     | \$ 83,249 | \$ 51,281 |
| Income taxes | 18,872    | 347       |

**Supplemental disclosure of non-cash investing:**

|   |         |         |
|---|---------|---------|
| Loans transferred to held for investment from held for sale                 | 9,972   | -       |
| Loans transferred from held for investment to held for sale                 | 106     | 283     |
| Loans exchanged for mortgage-backed securities                              | 269,411 | 523,136 |
| Investment securities purchased and not settled                             | -       | 529,802 |
| Investment securities sold and not settled                                  | -       | 506,718 |
| Real estate acquired in settlement of loans                                 | 805     | 1,422   |
| Loans to facilitate the sale of real estate acquired in settlement of loans | 65      | 98      |

*See accompanying notes to consolidated financial statements.*



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**NOTE (1) Basis of Financial Statement Presentation**

In the opinion of Downey Financial Corp. and subsidiaries ( Downey, we, us and our ), the accompanying consolidated financial statements contain all adjustments (consisting of normal recurring accruals unless otherwise disclosed in this Form 10-Q) necessary for a fair presentation of Downey's financial condition as of March 31, 2005, December 31, 2004 and March 31, 2004, and the results of operations, comprehensive income and changes in cash flows for the three months ended March 31, 2005 and 2004. Certain prior period amounts have been reclassified to conform to the current period presentation.

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements and are in compliance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial condition, results of operations, comprehensive income and cash flows. The information under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations presumes that the interim consolidated financial statements will be read in conjunction with Downey's Annual Report on Form 10-K for the year ended December 31, 2004, which contains among other things, a description of the business, the latest audited consolidated financial statements and notes thereto, together with Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2004 and for the year then ended. Therefore, only material changes in financial condition and results of operations are discussed in the remainder of Part I.

**NOTE (2) Mortgage Servicing Rights ("MSRs")**

The following table summarizes the activity in MSRs and its related allowance for the periods indicated and other related financial data.

|  | <i>Three Months Ended</i>       |                                    |                                     |                                |                                 |
|--|---------------------------------|------------------------------------|-------------------------------------|--------------------------------|---------------------------------|
|  | <i>March 31,</i><br><i>2005</i> | <i>December 31,</i><br><i>2004</i> | <i>September 30,</i><br><i>2004</i> | <i>June 30,</i><br><i>2004</i> | <i>March 31,</i><br><i>2004</i> |
| <i>(Dollars in Thousands)</i>                |                                 |                                    |                                     |                                |                                 |
| Gross balance at beginning of period         | \$ 20,502                       | \$ 99,127                          | \$ 95,813                           | \$ 91,766                      | \$ 95,183                       |
| Additions                                    | 1,609                           | 1,835                              | 12,114                              | 12,074                         | 5,968                           |
| Amortization                                 | (1,160 )                        | (2,998 )                           | (5,190 )                            | (4,082 )                       | (5,519 )                        |
| Sales  | (14 )                           | (61,663 )                          | -                                   | -                              | -                               |
| Impairment write-down                        | (103 )                          | (15,799 )                          | (3,610 )                            | (3,945 )                       | (3,866 )                        |
| Gross balance at end of period               | 20,834                          | 20,502                             | 99,127                              | 95,813                         | 91,766                          |
| Allowance balance at beginning of period     | 2,538                           | 16,832                             | 3,764                               | 22,045                         | 13,008                          |
| Provision for (reduction of) impairment      | (1,211 )                        | 1,505                              | 16,678                              | (14,336 )                      | 12,903                          |
| Impairment write-down                        | (103 )                          | (15,799 )                          | (3,610 )                            | (3,945 )                       | (3,866 )                        |
| Allowance balance at end of period           | 1,224                           | 2,538                              | 16,832                              | 3,764                          | 22,045                          |
| Total mortgage servicing rights, net         | \$ 19,610                       | \$ 17,964                          | \$ 82,295                           | \$ 92,049                      | \$ 69,721                       |
| As a percentage of associated mortgage loans | 0.89 %                          | 0.86 %                             | 0.82 %                              | 1.00 %                         | 0.76 %                          |
| Estimated fair value <sup>(a)</sup>          | \$ 19,665                       | \$ 17,968                          | \$ 82,401                           | \$ 92,483                      | \$ 69,721                       |
| Weighted average expected life (in months)   | 54                              | 53                                 | 57                                  | 67                             | 49                              |

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|                                 |        |        |        |        |        |
|---------------------------------|--------|--------|--------|--------|--------|
| Custodial account earnings rate | 3.21 % | 2.69 % | 2.24 % | 2.10 % | 1.47 % |
| Weighted average discount rate  | 9.13   | 9.03   | 9.27   | 8.97   | 8.98   |

**At period end**

Mortgage loans serviced for others:

|       |              |              |               |              |              |
|-------|--------------|--------------|---------------|--------------|--------------|
| Total | \$ 8,043,655 | \$ 6,672,984 | \$ 10,568,339 | \$ 9,279,359 | \$ 9,167,834 |
|-------|--------------|--------------|---------------|--------------|--------------|

With capitalized mortgage servicing rights:<sup>(a)</sup>

|        |           |           |            |           |           |
|--------|-----------|-----------|------------|-----------|-----------|
| Amount | 2,207,403 | 2,100,452 | 10,075,028 | 9,242,641 | 9,126,444 |
|--------|-----------|-----------|------------|-----------|-----------|

|                                |        |        |        |        |        |
|--------------------------------|--------|--------|--------|--------|--------|
| Weighted average interest rate | 5.57 % | 5.59 % | 5.52 % | 5.61 % | 5.73 % |
|--------------------------------|--------|--------|--------|--------|--------|

Total loans sub-serviced without mortgage

servicing rights:<sup>(b)</sup>

|                           |           |           |         |   |   |
|---------------------------|-----------|-----------|---------|---|---|
| Term less than six months | 475,327   | 610,263   | -       | - | - |
| Term indefinite           | 5,332,613 | 3,931,483 | 459,307 | - | - |

|                            |            |            |            |            |            |
|----------------------------|------------|------------|------------|------------|------------|
| Custodial account balances | \$ 157,624 | \$ 143,765 | \$ 229,704 | \$ 238,914 | \$ 359,146 |
|----------------------------|------------|------------|------------|------------|------------|

<sup>(a)</sup> The estimated fair value may exceed book value for certain asset strata and excluded loans sold or securitized prior to 1996 and loans sub-serviced without capitalized MSR's.

<sup>(b)</sup> Servicing is performed for a fixed fee per loan each month.

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Key assumptions, which vary due to changes in market interest rates and are used to determine the fair value of MSR, include: expected prepayment speeds, which impact the average life of the portfolio; the earnings rate on custodial accounts, which impacts the value of custodial accounts; and the discount rate used in valuing future cash flows. The following table summarizes the estimated changes in the fair value of MSR for changes in those assumptions individually and in combination associated with an immediate 100 basis point increase or decrease in market rates. The table also summarizes the earnings impact associated with provisions for or reductions of the valuation allowance for MSR. Impairment is measured on a disaggregated basis based upon the predominant risk characteristics of the underlying mortgage loans, such as term and interest rate. Certain stratum may have impairment, while other stratum may not. Therefore, changes in overall fair value may not equal provisions for or reductions of the valuation allowance.

The sensitivity analysis in the table below is hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 100 basis point variation in assumptions generally cannot be easily extrapolated because the relationship of the change in the assumptions to the change in fair value may not be linear. Also, in this table, the effect that a change in a particular assumption may have on the fair value is calculated without changing any other assumptions. In reality, changes in one factor may result in changes that might magnify or counteract the sensitivities from another factor.

| <i>(Dollars in Thousands)</i>                          | <i>Expected<br/>Prepayment<br/>Speeds</i> | <i>Custodial<br/>Accounts<br/>Rate</i> | <i>Discount<br/>Rate</i> | <i>Combination</i> |
|--|---|--|--------------------------|--------------------|
| <b>Increase rates 100 basis points: <sup>(a)</sup></b> |   |  |                          |                    |
| Increase (decrease) in fair value                      | \$ 2,585                                  | \$ 1,013                               | \$ (718 )                | \$ 2,791           |
| Reduction of (increase in) valuation allowance         | 711                                       | 776                                    | (707 )                   | 1,020              |
| <b>Decrease rates 100 basis points: <sup>(b)</sup></b> |   |  |                          |                    |
| Increase (decrease) in fair value                      | (7,025 )                                  | (1,055 )                               | 719                      | (8,000 )           |
| Reduction of (increase in) valuation allowance         | (6,971 )                                  | (1,027 )                               | 554                      | (7,947 )           |

<sup>(a)</sup> The weighted-average expected life of the MSR portfolio is 66 months.

<sup>(b)</sup> The weighted-average expected life of the MSR portfolio is 29 months.

The following table presents a breakdown of the components of loan servicing income (loss), net included in Downey's results of operations for the periods indicated.

| <i>(In Thousands)</i>   | <i>Three Months Ended</i> |                                  |                                   |                          |                           |
|---|---------------------------|----------------------------------|-----------------------------------|--------------------------|---------------------------|
|   | <i>March 31,<br/>2005</i> | <i>December<br/>31,<br/>2004</i> | <i>September<br/>30,<br/>2004</i> | <i>June 30,<br/>2004</i> | <i>March 31,<br/>2004</i> |
| Net cash servicing fees   | \$ 1,627                  | \$ 3,595                         | \$ 6,031                          | \$ 5,615                 | \$ 5,704                  |
| Payoff and curtailment interest cost <sup>(a)</sup>                     | (194 )                    | (968 )                           | (1,053 )                          | (2,083 )                 | (1,527 )                  |
| Amortization of mortgage servicing rights                               | (1,160 )                  | (2,998 )                         | (5,190 )                          | (4,082 )                 | (5,519 )                  |
| (Provision for) reduction of impairment<br>of mortgage servicing rights | 1,211                     | (1,505 )                         | (16,678 )                         | 14,336                   | (12,903 )                 |
| <b>Total loan servicing income (loss), net</b>                          | <b>\$ 1,484</b>           | <b>\$ (1,876 )</b>               | <b>\$ (16,890 )</b>               | <b>\$ 13,786</b>         | <b>\$ (14,245 )</b>       |

<sup>(a)</sup> Represents the difference between the contractual obligation to pay interest to the investor for an entire month and the actual interest received when a loan prepays prior to the end of the month. This does not include the benefit of the use of repaid loan funds to increase net

*interest income.*

**NOTE (3) Derivatives, Derivative Hedging Activities, Financial Instruments with Off-Balance Sheet Risks and Other Contractual Obligations (Risk Management)**

***Derivatives***

Downey offers short-term interest rate lock commitments to help attract potential home loan borrowers. The commitments guarantee a specified interest rate for a loan if underwriting standards are met, but do not obligate the potential borrower. Accordingly, some commitments never become loans and merely expire. The residential one-to-four unit rate lock commitments Downey ultimately expects to result in loans and sell in the secondary market are treated as derivatives. Consequently, as derivatives, the hedging of the expected rate lock commitments do not qualify for hedge accounting. Associated fair value adjustments to the notional amount of the expected rate lock commitments are recorded in current earnings under net gains (losses) on sales of loans and mortgage-backed securities with an offset to the balance sheet in either



other assets, or accounts payable and accrued liabilities. Fair values for the notional amount of expected rate lock commitments are based on observable market prices acquired from third parties. The carrying amount of loans held for sale includes a basis adjustment to the loan balance at funding resulting from the change in fair value of the rate lock derivative from the date of commitment to the date of funding. At March 31, 2005, Downey had a notional amount of expected rate lock commitments identified to sell as part of its secondary marketing activities of \$728 million, with a change in fair value resulting in a loss of \$0.3 million.

Downey does not generally enter into derivative transactions for purely speculative purposes.

#### *Derivative Hedging Activities*

As part of secondary marketing activities, Downey typically utilizes short-term forward sale and purchase contracts derivatives that mature in less than one year to offset the impact of changes in market interest rates on the value of residential one-to-four unit expected rate lock commitments and loans held for sale. In general, rate lock commitments associated with fixed rate loans require a higher percentage of forward sale contracts to mitigate interest rate risk than those associated with adjustable rate loans. Contracts designated as hedges for the forecasted sale of loans from the held for sale portfolio are accounted for as cash flow hedges because these contracts have a high correlation to the price movement of the loans being hedged (within a range of 80% - 125%). The measurement approach for determining the ineffective aspects of the hedge is established at the inception of the hedge. Changes in fair value of the notional amount of forward sale contracts not designated as cash flow hedges and the ineffectiveness of hedge transactions that are not perfectly correlated are recorded in net gains (losses) on sales of loans and mortgage-backed securities. Changes in expected future cash flows related to the fair value of the notional amount of forward sale contracts designated as cash flow hedges for the forecasted sale of loans held for sale are recorded in other comprehensive income, net of tax, provided cash flow hedge requirements are met. The offset to these changes are recorded in the balance sheet as either other assets, or accounts payable and accrued liabilities. The amounts recorded in accumulated other comprehensive income will be recognized in the income statement when the hedged forecasted transactions settle. Downey estimates that all of the related unrealized gains or losses in accumulated other comprehensive income will be reclassified into earnings within the next three months. Fair values for the notional amount of forward sale contracts are based on observable market prices acquired from third parties. At March 31, 2005, the notional amount of forward sale contracts amounted to \$1.881 billion, with a change in fair value resulting in a gain of \$0.2 million related to undesignated contracts and \$1.5 million related to designated cash flow hedges with a notional amount of \$1.248 billion. There were no forward purchase contracts at March 31, 2005.

Downey has not discontinued any designated derivative instruments associated with loans held for sale due to a change in the probability of settling a forecasted transaction.

In connection with its interest rate risk management, Downey from time-to-time enters into interest rate exchange agreements ("swap contracts") with certain national investment banking firms or the Federal Home Loan Bank ("FHLB") under terms that provide mutual payment of interest on the outstanding notional amount of swap contracts. These swap contracts help Downey manage the effects of adverse changes in interest rates on net interest income. Downey has interest rate swap contracts on which Downey pays variable interest based on the 3-month London Inter-Bank Offered Rate ("LIBOR") while receiving fixed interest. The swaps were designated as a hedge of changes in the fair value of certain FHLB fixed rate advances due to changes in market interest rates. The payment and maturity dates of the swap contracts match those of the advances. This hedge effectively converts fixed interest rate advances into debt that adjusts quarterly to movements in 3-month LIBOR. Because the terms of the swap contracts match those of the advances, the hedge has no ineffectiveness and results are reported in interest expense. The fair value of interest rate swap contracts is based on observable market prices acquired from third parties and represents the estimated amount Downey would receive or pay upon terminating the contracts, taking into consideration current interest rates and the remaining contract terms. The fair value of the swap contracts is recorded on the balance sheet in either other assets or accounts payable and accrued liabilities. With no ineffectiveness, the recorded swap contract values will essentially act as fair value adjustments to the advances being hedged. At March 31, 2005, swap contracts with a notional amount totaling \$430 million were outstanding and had a fair value loss of \$17.2 million recorded on the balance sheet in other liabilities and as a decrease to the advances being hedged.

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The following table summarizes Downey's interest rate swap contracts at March 31, 2005:

| <i>(Dollars in Thousands)</i> | <i>Notional<br/>Amount</i> | <i>Weighted<br/>Average<br/>Interest<br/>Rate</i> | <i>Term</i> |               |
|-------------------------------|----------------------------|---|-------------|---------------|
| Pay Variable (3-month LIBOR)  | \$ (100,000 )              | 2.89 %  | March 2004  | October 2008  |
| Receive Fixed                 | 100,000                    | 3.20  |             |               |
| Pay Variable (3-month LIBOR)  | (130,000 )                 | 2.89  | March 2004  | October 2008  |
| Receive Fixed                 | 130,000                    | 3.21  |             |               |
| Pay Variable (3-month LIBOR)  | (100,000 )                 | 2.89  | March 2004  | November 2008 |
| Receive Fixed                 | 100,000                    | 3.26  |             |               |
| Pay Variable (3-month LIBOR)  | (100,000 )                 | 2.89  | March 2004  | November 2008 |
| Receive Fixed                 | 100,000                    | 3.27  |             |               |

The following table shows the impact from non-qualifying hedges and the ineffectiveness of cash flow hedges on net gains (losses) on sales of loans and mortgage-backed securities (*i.e.*, SFAS 133 effect), as well as the impact to other comprehensive income (loss) from qualifying cash flow transactions for the years indicated. Also shown is the notional amount or balance for Downey's non-qualifying and qualifying hedge transactions.

| <i>(In Thousands)</i>  | <i>Three Months Ended</i> |                              |                                   |                          |                           |
|--|---------------------------|------------------------------|-----------------------------------|--------------------------|---------------------------|
|  | <i>March 31,<br/>2005</i> | <i>December 31,<br/>2004</i> | <i>September<br/>30,<br/>2004</i> | <i>June 30,<br/>2004</i> | <i>March 31,<br/>2004</i> |
| Net gains (losses) on non-qualifying hedge transactions  | \$ 2,913                  | \$ (5,030 )                  | \$ 2,595                          | \$ 3,352                 | \$ (3,282 )               |
| Net gains (losses) on qualifying cash flow hedge transactions:   |                           |                              |                                   |                          |                           |
| Unrealized hedge ineffectiveness   | -                         | -                            | -                                 | -                        | -                         |
| Less reclassification of realized hedge ineffectiveness  | -                         | -                            | -                                 | -                        | -                         |
| Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect) | 2,913                     | (5,030 )                     | 2,595                             | 3,352                    | (3,282 )                  |
| Other comprehensive income (loss)  | 191                       | (293 )                       | 822                               | (1,694 )                 | 1,257                     |
| <b>Notional amount or balance at period end</b>  |                           |                              |                                   |                          |                           |
| Non-qualifying hedge transactions:   |                           |                              |                                   |                          |                           |
| Expected rate lock commitments   | \$ 727,899                | \$ 367,650                   | \$ 462,441                        | \$ 541,358               | \$ 441,747                |
| Associated forward sale contracts  | 633,031                   | 368,822                      | 448,999                           | 374,462                  | 429,066                   |
| Associated forward purchase contracts  | -                         | -                            | -                                 | -                        | 4,000                     |
| Qualifying cash flow hedge transactions:   |                           |                              |                                   |                          |                           |

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|   |           |           |         |         |         |
|---|-----------|-----------|---------|---------|---------|
| Loans held for sale, at lower of cost or fair value | 1,255,104 | 1,118,475 | 845,913 | 661,481 | 529,085 |
| Associated forward sale contracts                   | 1,247,969 | 1,115,636 | 838,567 | 652,796 | 509,710 |
| Qualifying fair value hedge transactions:           |           |           |         |         |         |
| Designated FHLB advances pay-fixed                  | 430,000   | 430,000   | 430,000 | 430,000 | 430,000 |
| Associated interest rate swap contracts             |           |           |         |         |         |
| pay-variable, receive-fixed                         | 430,000   | 430,000   | 430,000 | 430,000 | 430,000 |

These forward and swap contracts expose Downey to credit risk in the event of nonperformance by the other parties national investment banking firms, government-sponsored enterprises such as Federal National Mortgage Association and the FHLB. This risk consists primarily of the termination value of agreements where Downey is in an unfavorable position. Downey controls the credit risk associated with these parties to the various derivative agreements through credit review, exposure limits and monitoring procedures. Downey does not anticipate nonperformance by the other parties.

***Financial Instruments with Off-Balance Sheet Risk***

Downey utilizes financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to originate fixed and variable rate mortgage loans held for investment, undisbursed loan funds, lines and letters of credit, commitments to purchase loans and mortgage-backed securities for portfolio and commitments to invest in affordable housing funds. The contract or notional amounts of those instruments reflect the extent of involvement Downey has in particular classes of financial instruments.

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Commitments to originate fixed and variable rate mortgage loans are agreements to lend to a customer as long as there is no violation of any condition established in the commitment. Commitments generally have fixed expiration dates or other termination clauses and some require payment of a fee. Since some commitments expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Undisbursed loan funds on construction projects and unused lines of credit on home equity and commercial loans include committed funds not disbursed. Letters of credit are conditional commitments issued by Downey to guarantee the performance of a customer to a third party. Downey also enters into commitments to purchase loans and mortgage-backed securities, investment securities and to invest in affordable housing funds.

The following is a summary of commitments with off-balance sheet risk at the dates indicated.

| <i>(In Thousands)</i>                               | <i>March 31,</i><br>2005 | <i>December 31,</i><br>2004 | <i>September 30,</i><br>2004 | <i>June 30,</i><br>2004 | <i>March 31,</i><br>2004 |
|---|--------------------------|-----------------------------|------------------------------|-------------------------|--------------------------|
| Commitments to originate loans held for investment: |                          |                             |                              |                         |                          |
| Adjustable  | \$ 241,414               | \$ 738,102                  | \$ 683,429                   | \$ 479,968              | \$ 650,948               |
| Commitments to purchase loans                       | -                        | -                           | -                            | -                       | 495                      |
| Undisbursed loan funds and unused lines of credit   | 494,210                  | 457,815                     | 426,055                      | 372,464                 | 281,821                  |
| Commitments to invest in affordable housing funds   | 5,445                    | 5,129                       | 5,771                        | 5,226                   | 3,090                    |

Downey uses the same credit policies in making commitments to originate loans held for investment and lines and letters of credit as it does for on-balance sheet instruments. For commitments to originate loans held for investment, the contract amounts represent exposure to loss from market fluctuations as well as credit loss. For these commitments, adverse changes from market fluctuations are generally not hedged. Downey controls the credit risk of its commitments to originate loans held for investment through credit approvals, limits and monitoring procedures. The credit risk involved in issuing lines and letters of credit requires the same creditworthiness evaluation as that involved in extending loan facilities to customers. Downey evaluates each customer's creditworthiness.

Downey receives collateral to support commitments for which collateral is deemed necessary. The most significant categories of collateral include real estate properties underlying mortgage loans, liens on personal property and cash on deposit with Downey.

### ***Other Contractual Obligations***

Downey sells all loans without recourse. When a loan sold to an investor without recourse fails to perform according to the contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred and whether such defects give rise to a violation of a representation or warranty made to the investor in connection with the sale. If such a defect is identified, Downey may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, Downey has no commitment to repurchase the loan. During the first quarter of 2005, Downey recorded less than a \$1 million repurchase loss related to defects in the origination process. This was the first loss due to defects since 2002. These loan and servicing sale contracts typically contain provisions to refund sales price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Downey had a reserve of \$1 million at March 31, 2005, \$7 million at December 31, 2004 and less than \$1 million at March 31, 2004 to cover the estimated loss exposure related to early payoffs.

Through the normal course of operations, Downey has entered into certain contractual obligations. Downey's obligations generally relate to the funding of operations through deposits and borrowings, loan servicing, as well as leases for premises and equipment. Downey also has vendor contractual relationships, but the contracts are not considered to be material.

Downey has obligations under long-term operating leases, principally for building space and land. Lease terms generally cover a five-year period, with options to extend, and are non-cancelable.

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At March 31, 2005, scheduled maturities of certificates of deposit, FHLB advances, senior notes and future operating minimum lease commitments were as follows:

| <i>(In Thousands)</i>                      | <i>Within<br/>1 Year</i> | <i>1 3<br/>Years</i> | <i>4 5<br/>Years</i> | <i>Over<br/>5 Years</i> | <i>Total<br/>Balance</i> |
|--|--------------------------|----------------------|----------------------|-------------------------|--------------------------|
| Certificates of deposit                    | \$ 5,275,504             | \$ 996,942           | \$ 200,128           | \$ 100                  | \$ 6,472,674             |
| FHLB advances                              | 4,508,574                | 126,300              | 430,000              | 29,000                  | 5,093,874                |
| Senior notes                               | -                        | -                    | -                    | 197,964                 | 197,964                  |
| Operating leases                           | 5,142                    | 7,021                | 3,779                | 1,523                   | 17,465                   |
| <b>Total other contractual obligations</b> | <b>\$ 9,789,220</b>      | <b>\$ 1,130,263</b>  | <b>\$ 633,907</b>    | <b>\$ 228,587</b>       | <b>\$ 11,781,977</b>     |

### **Litigation**

On July 23, 2004, two former in-store banking employees brought an action in Los Angeles Superior Court, Case No. BC318964, entitled "Michelle Cox and Mary Ann Tierra et al. v. Downey Savings and Loan Association." The complaint seeks unspecified damages for alleged unpaid overtime wages, inadequate meal and rest breaks, and other unlawful business practices and related claims. The plaintiffs also seek class action status to represent all other current and former California employees who held the position of branch manager or assistant manager at in-store branches who (a) were treated as exempt and not paid overtime between July 23, 2000 and November 2002 and (b) allegedly received inadequate meal/rest periods since October 1, 2000. At a mediation in March 2005, the parties agreed to settle the lawsuit. The settlement is subject to mutually acceptable documentation and court approval. Based upon the proposed settlement, management has adjusted the previously established reserve for this matter and believes the adjusted reserve constitutes a reasonable estimate of the loss exposure. While acknowledging the uncertainties of litigation, management believes that the ultimate outcome of this matter will not have a material adverse effect on its operations, cash flows or financial position.

Downey has been named as a defendant in other legal actions arising in the ordinary course of business, none of which, in the opinion of management, is material.

### **NOTE (4) Income Taxes**

Downey and its wholly owned subsidiaries file a consolidated federal income tax return and various state income and franchise tax returns on a calendar year basis. The Internal Revenue Service has examined Downey's tax returns for all tax years through 2002, while state taxing authorities have reviewed tax returns through 2000. Downey's management believes it has adequately provided for potential exposure to issues that may be raised by tax auditors in years which remain open to review.

### **NOTE (5) Employee Stock Option Plans**

Downey has a Long Term Incentive Plan (the LTIP), which provides for the granting of stock appreciation rights, restricted stock, performance awards and other awards. The LTIP specifies an authorization of 434,110 shares (adjusted for stock dividends and splits) of common stock to be available for issuance, of which 131,851 shares are available for future grants. Under the LTIP, options are exercisable over vesting periods specified in each grant and, unless exercised, the options terminate in five or ten years from the date of the grant. Further, under the LTIP, the option price shall at least equal or exceed the fair market value of such shares on the date the options are granted. No shares have been granted under the LTIP since 1998. At March 31, 2005, Downey had 381,239 shares of treasury stock that may be used to satisfy the exercise of options or for payment of other awards. No other stock-based compensation plan exists.

Downey measures its employee stock-based compensation arrangements under the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Accordingly, no compensation expense has been recognized for the stock options, as stock options were granted at fair value at the date of grant. Had compensation expense for stock options been determined based on the fair value at the grant date for previous awards, stock-based compensation would have been fully expensed as of December 31, 2002.

**NOTE (6) Earnings Per Share**

Earnings per share is calculated on both a basic and diluted basis, excluding common shares in treasury. Basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted from the issuance of common stock that then shared in earnings.

The following table presents a reconciliation of the components used to derive basic and diluted earnings per share for the periods indicated.

|  | <i>Three Months Ended March 31,</i> |  |                                 |               |  |                                 |
|--|-------------------------------------|--|---------------------------------|---------------|--|---------------------------------|
|  | <i>2005</i>                         |  |                                 | <i>2004</i>   |  |                                 |
|  | <i>Net</i>                          | <i>Weighted<br/>Average<br/>Shares<br/>Outstanding</i> | <i>Per<br/>Share<br/>Amount</i> | <i>Net</i>    | <i>Weighted<br/>Average<br/>Shares<br/>Outstanding</i> | <i>Per<br/>Share<br/>Amount</i> |
| <i>(Dollars in Thousands, Except Per Share Data)</i> | <i>Income</i>                       | <i>Outstanding</i>                                     | <i>Amount</i>                   | <i>Income</i> | <i>Outstanding</i>                                     | <i>Amount</i>                   |
| Basic earnings per share                             | \$ 51,739                           | 27,853,783   | \$ 1.86                         | \$ 8,912      | 27,944,406   | \$ 0.32                         |
| Effect of dilutive stock options                     | -                                   | 28,056   | -                               | -             | 36,136   | -                               |
| Diluted earnings per share                           | \$ 51,739                           | 27,881,839   | \$ 1.86                         | \$ 8,912      | 27,980,542   | \$ 0.32                         |

There were no options excluded from the computation of earnings per share due to anti-dilution.

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**NOTE (7) Business Segment Reporting**

The following table presents the operating results and selected financial data by major business segments for the periods indicated.

| <i>(In Thousands)</i>                         | <i>Banking</i> | <i>Real Estate<br/>Investment</i> | <i>Elimination</i> | <i>Totals</i> |
|---|----------------|-----------------------------------|--------------------|---------------|
| <b>Three months ended March 31, 2005</b>      |                |                                   |                    |               |
| Net interest income                           | \$ 93,985      | \$ 103                            | \$ -               | \$ 94,088     |
| Provision for loan losses                     | 2,038          | -                                 | -                  | 2,038         |
| Other income                                  | 52,898         | 2,816                             | -                  | 55,714        |
| Operating expense                             | 57,858         | 366                               | -                  | 58,224        |
| Net intercompany income (expense)             | (38 )          | 38                                | -                  | -             |
| <hr/>   |                |                                   |                    |               |
| Income before income taxes                    | 86,949         | 2,591                             | -                  | 89,540        |
| Income taxes                                  | 36,739         | 1,062                             | -                  | 37,801        |
| <hr/>   |                |                                   |                    |               |
| Net income                                    | \$ 50,210      | \$ 1,529                          | \$ -               | \$ 51,739     |
| <hr/>   |                |                                   |                    |               |
| <b>At March 31, 2005</b>                      |                |                                   |                    |               |
| Assets:                                       |                |                                   |                    |               |
| Loans and mortgage-backed securities          | \$ 15,728,508  | \$ -                              | \$ -               | \$ 15,728,508 |
| Investments in real estate and joint ventures | -              | 56,964                            | -                  | 56,964        |
| Other   | 1,157,208      | 17,877                            | (67,220 )          | 1,107,865     |
| <hr/>   |                |                                   |                    |               |
| Total assets                                  | 16,885,716     | 74,841                            | (67,220 )          | 16,893,337    |
| <hr/>   |                |                                   |                    |               |
| Equity  | \$ 1,054,336   | \$ 67,220                         | \$ (67,220 )       | \$ 1,054,336  |
| <hr/>   |                |                                   |                    |               |
| <b>Three months ended March 31, 2004</b>      |                |                                   |                    |               |
| Net interest income (expense)                 | \$ 69,444      | \$ (88 )                          | \$ -               | \$ 69,356     |
| Provision for loan losses                     | 1,804          | -                                 | -                  | 1,804         |
| Other income                                  | 1,691          | 1,262                             | -                  | 2,953         |
| Operating expense                             | 54,699         | 321                               | -                  | 55,020        |
| Net intercompany income (expense)             | (38 )          | 38                                | -                  | -             |
| <hr/>   |                |                                   |                    |               |
| Income before income taxes                    | 14,594         | 891                               | -                  | 15,485        |
| Income taxes                                  | 6,207          | 366                               | -                  | 6,573         |
| <hr/>   |                |                                   |                    |               |
| Net income                                    | \$ 8,387       | \$ 525                            | \$ -               | \$ 8,912      |
| <hr/>   |                |                                   |                    |               |
| <b>At March 31, 2004</b>                      |                |                                   |                    |               |
| Assets:                                       |                |                                   |                    |               |
|   | \$ 11,594,098  | \$ -                              | \$ -               | \$ 11,594,098 |

|   |            |           |              |            |
|---|------------|-----------|--------------|------------|
| Loans and mortgage-backed securities          |            |           |              |            |
| Investments in real estate and joint ventures | -          | 35,768    | -            | 35,768     |
| Other   | 1,919,401  | 3,994     | (28,132 )    | 1,895,263  |
| <hr/>   |            |           |              |            |
| Total assets                                  | 13,513,499 | 39,762    | (28,132 )    | 13,525,129 |
| <hr/>   |            |           |              |            |
| Equity  | \$ 924,557 | \$ 28,132 | \$ (28,132 ) | \$ 924,557 |
| <hr/>   |            |           |              |            |



**NOTE (8) Current Accounting Issues**

***Statement of Financial Accounting Standards No. 123R***

Statement of Financial Accounting Standards No. 123R, "Share-Based Payment" ("SFAS 123R"), is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation." SFAS 123R does not change the accounting guidance for share-based payment transactions with parties other than employees provided in SFAS 123 as originally issued and EITF Issue No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." Accounting for employee-stock-ownership-plan transaction ("ESOP s") will continue to be accounted for in accordance with SOP 93-6, "Employers Accounting for Employee Stock Ownership Plans." SFAS 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees, but expresses no preference for a type of valuation model. SFAS 123R is effective for the first interim or annual reporting period of the first fiscal year beginning on or after June 15, 2005. It is not expected that SFAS 123R will have a material financial impact on Downey, unless a significant number of new option grants are made.

***Statement of Financial Accounting Standards No. 153***

Statement of Financial Accounting Standards No. 153, "Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29" ("SFAS 153"), require exchanges of nonmonetary assets be measured based on the fair value of the assets exchanged. The amendments eliminate the narrow exception for nonmonetary exchanges of similar productive assets and replace it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has a commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. Previously, APB Opinion No. 29, "Accounting for Nonmonetary Transactions," required that the accounting for an exchange of a productive asset for a similar productive asset should be based on the recorded amount of the asset relinquished with no gain recognition. SFAS 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 and is to be applied prospectively. SFAS 153 is not expected to have a material financial impact on Downey.

***Emerging Issues Task Force Issue No. 03-1***

In March of 2004, the Emerging Issues Task Force ("EITF") reached consensus on the guidance provided in EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments." Among other investments, this guidance is applicable to debt and equity securities that are within the scope of Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. Paragraph 10 of EITF 03-1 specifies that an impairment would be considered other-than-temporary unless (a) the investor has the ability and intent to hold an investment for a reasonable period of time sufficient for the recovery of the fair value up to (or beyond) the cost of the investment and (b) evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. A company s liquidity and capital requirements should be considered when assessing its intent and ability to hold an investment for a reasonable period of time that would allow the fair value of the investment to recover up to or beyond its cost. A pattern of selling investments prior to the forecasted fair value recovery may call into question a company s intent. In addition, the severity and duration of the impairment should also be considered when determining whether the impairment is other-than-temporary. This guidance was effective for reporting periods beginning after June 15, 2004 with the exception of paragraphs 10 - 20 of EITF 03-1, which will be deliberated further. This delay does not suspend the requirement to recognize other-than-temporary impairments as required by existing authoritative literature. The outcome of this deliberation may accelerate the recognition of losses from declines in value on debt securities due to interest rates; however, it is not anticipated to have a significant impact on stockholders equity as changes in market value of available-for-sale securities are already included in Accumulated Other Comprehensive Income.

***Statement of Position 03-3***

Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer" ("SOP 03-3"), addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor s initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality. It includes such loans acquired in purchase business combinations and applies to all nongovernmental entities, including not-for-profit organizations. SOP 03-3 does not apply to loans originated by the entity. SOP 03-3 limits the yield that may be accreted (accretable yield) to the excess of the investor s estimate of undiscounted expected principal, interest, and other cash flows (cash flows expected at acquisition to be collected) over the investor s initial

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investment in the loan. SOP 03-3 requires that the excess of contractual cash flows over cash flows expected to be collected (nonaccretable difference) not be recognized as an adjustment of yield, loss accrual, or valuation allowance. SOP 03-3 prohibits investors from displaying accretable yield and nonaccretable difference in the balance sheet. Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as impairment. SOP 03-3 prohibits "carrying over" or creation of valuation allowances in the initial accounting of all loans acquired in a transfer that are within the scope of SOP 03-3. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a purchase business combination. SOP 03-3 was effective January 1, 2005 and is not expected to have a material financial impact on Downey.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*Certain statements under this caption may constitute "forward-looking statements" under the Private Securities Litigation Reform Act of 1995, which involve risks and uncertainties. Forward-looking statements do not relate strictly to historical information or current facts. Some forward-looking statements may be identified by use of terms such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," or words of similar meaning, or future or conditional verbs such as "will," "would," "should," "could" or "may." Our actual results may differ significantly from the results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made.*

**OVERVIEW**

Our net income for the first quarter of 2005 totaled a record \$51.7 million or \$1.86 per share on a diluted basis, up from \$8.9 million or \$0.32 per share in the first quarter of 2004.

The increase in our net income between first quarters primarily reflected:

- a \$29.2 million increase in our net gains from sales of loans and mortgage-backed securities due to both a higher volume of sales and a higher gain per dollar of loan sold;
- a \$24.7 million increase in our net interest income reflecting growth in average interest-earning assets;
- a \$15.7 million improvement in loan servicing activities due primarily to a positive change in the valuation allowance associated with mortgage servicing rights (MSRs);
- a \$7.1 million increase in loan and deposit related fees primarily reflecting higher loan prepayment fees; and
- a \$1.7 million increase in our income from real estate and joint ventures held for investment due primarily to higher gains from sales.

Those favorable factors were partially offset by:

- a \$3.1 million or 5.6% increase in general and administrative expense; and
- a \$2.1 million decline in gains from sales of securities, as the year-ago quarter included a gain associated with a partial economic hedge against value changes of MSRs.

For the first quarter of 2005, our return on average assets was 1.28%, up from 0.30% a year ago, while our return on average equity was 20.09%, up from 3.88% a year ago.

Our loan originations, including purchases, increased from \$2.956 billion in the year-ago quarter to \$4.250 billion in the current quarter, of which \$2.181 billion were originated for sale in the secondary market. Of the current quarter total, \$1.916 billion represented originations of single family loans for portfolio, of which \$173 million were subprime credits. In addition to single family loans, we originated \$152 million of other loans during the quarter, including \$95 million of home equity lines of credit.

At quarter end, our assets totaled \$16.893 billion, up \$3.368 billion or 24.9% from a year ago and up \$1.245 billion or 8.0% from year-end 2004. During the current quarter, portfolio originations exceeded loan payoffs, resulting in an increase of \$1.049 billion in our loans held for investment. In addition, our loans held for sale increased by \$137 million and our securities available for sale increased by \$15 million.

At March 31, 2005, our deposits totaled \$10.309 billion, up 16.9% from the year-ago level and \$651 million or 6.7% since year-end 2004. During the quarter, two in-store branches were closed due to the sale of the grocery stores in which they were located. The associated deposits have been temporarily transferred to another branch pending the opening of a replacement location expected in the second quarter. In addition, during the quarter one new in-store and one new traditional branch were opened. This leaves our total number of branches unchanged at 169, of which 92 were in-store and four were located in Arizona. A year ago, we had 171 branches, of which 99 were in-store and three were located in Arizona.

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Our non-performing assets declined \$5 million during the quarter to \$29 million or 0.17% of total assets. The decrease occurred in both our prime and subprime residential loan categories.

At March 31, 2005, Downey Savings and Loan Association, F.A. (the "Bank"), our primary subsidiary, exceeded all regulatory capital tests, with capital-to-asset ratios of 6.84% for both tangible and core capital and 13.22% for risk-based capital. These capital levels are significantly above the well capitalized standards defined by the federal banking regulators of 5% for core and tangible capital and 10% for risk-based capital.

**CRITICAL ACCOUNTING POLICIES**

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey's Annual Report on Form 10-K for the year ended December 31, 2004. Certain accounting policies require us to make significant estimates and assumptions which could have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and our results of operations for the reporting periods. Management has discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors.

We believe the following are critical accounting policies that require the most significant estimates and assumptions, which are particularly susceptible to significant change in the preparation of our financial statements:

- The valuation of expected interest rate lock commitments. We enter into commitments to make loans that we intend to sell to investors whereby the interest rate on the loan is set prior to funding. These interest rate lock commitments are considered to be derivatives and are recorded at fair value. This value is calculated using market sources, adjusted by an anticipated fallout factor for interest rate lock commitments that are not expected to fund. At March 31, 2005, we had a liability recorded for interest rate lock derivatives of \$0.3 million and a capitalized basis adjustment decreasing loans held for sale by \$1.4 million, which reflects the change in fair value of the interest rate lock derivative from the date of commitment to the date of funding. At March 31, 2004, we had a liability recorded for interest rate lock derivatives of \$1.3 million and a capitalized basis adjustment increasing loans held for sale by \$1.4 million. The offset to these items was recorded in net gains on sales of loans and mortgage-backed securities. For further information, see Note 3 on page 7 of Notes to Consolidated Financial Statements.
- The allowance for losses on loans and real estate. The allowance for losses on loans and real estate are maintained at an amount management deems adequate to cover inherent losses in the portfolios. We use an internal asset review system and loan loss allowance methodology designed to provide for the detection of problem assets and an adequate allowance to cover losses. In determining the allowance for loan losses related to loans over \$5 million, we evaluate the loans on an individual basis, including an analysis of the creditworthiness, cash flows and financial status of the borrower, and the condition and the estimated value of the collateral. Generally, we review all loans under \$5 million by analyzing their performance and the composition of their collateral as a whole because of the relatively homogeneous nature of the loans, unless an individual loan or borrower relationship warrants separate analysis. This allowance is determined by applying against asset balances the associated factors for each major asset type that consider past loss experience and asset duration or loss statistics against current classified asset balances. These allowances totaled \$38 million at March 31, 2005 and \$34 million at March 31, 2004. For further information, see Allowance for Losses on Loans and Real Estate on page 40.
- The valuation of MSRs. The fair value of MSRs is measured using a discounted cash flow analysis based on available market quotes, anticipated prepayment speeds, a custodial account rate and market-adjusted discount rates. Market sources are used to determine prepayment speeds, the net cost of servicing per loan, inflation rate, and default and interest rates for mortgages. MSRs are reviewed for impairment based on their fair value. We capitalize and measure MSR impairment on a disaggregated basis based on predominant risk characteristics of the underlying mortgage loans, which include fixed-rate mortgage loans by loan term and coupon rate (less than 7%, 150 basis point increments between 7% and 10%, and greater than 10%) and adjustable rate mortgages by loan term. Impairment losses are recognized through a valuation allowance for each impaired stratum, with any associated provision recorded as a component of loan servicing income (loss). At March 31, 2005, the MSR valuation allowance totaled \$1 million, compared to \$22 million at March 31, 2004. For further information, see Note 2 on page 6 of Notes to Consolidated Financial Statements.
- The prepayment reserves related to sales of loans and of MSRs. The gains on sales of loans and of MSRs are recorded net of reserves for anticipated prepayments. These sales contracts typically contain provisions to refund sale price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Loan and MSR sales reserves are estimated using the prepayment experience of similar products. The estimates are updated during the 120 day period for actual payoffs. At March 31, 2005, the reserves were \$1 million, compared to reserves of less than \$1 million at March 31, 2004. For further information, see Note 2 on page 6 and Note 3 on page 7 of Notes to Consolidated Financial Statements and Secondary Marketing Activities on page 22.

## RESULTS OF OPERATIONS

### Net Interest Income

Net interest income is the difference between the interest and dividends earned on loans, mortgage-backed securities and investment securities ( interest-earning assets ) and the interest paid on deposits and borrowings ( interest-bearing liabilities ). The spread between the yield on interest-earning assets and the cost of interest-bearing liabilities and the relative dollar amounts of these assets and liabilities principally affects net interest income.

Our net interest income totaled \$94.1 million in the current quarter, up \$24.7 million or 35.7% from the same period last year. The increase reflected higher interest-earning assets, which averaged \$15.822 billion during the quarter, up 37.7% from the year-ago level. The effective interest rate spread averaged 2.38% in the current quarter, down from 2.42% a year ago, but up from 2.35% in the previous quarter.

The following table presents for the periods indicated the total dollar amount of:

- interest income from average interest-earning assets and the resultant yields; and
- interest expense on average interest-bearing liabilities and the resultant costs, expressed as rates.

The table also sets forth our net interest income, interest rate spread and effective interest rate spread. The effective interest rate spread reflects the relative level of interest-earning assets to interest-bearing liabilities and equals:

- the difference between interest income on interest-earning assets and interest expense on interest-bearing liabilities, divided by
- average interest-earning assets for the period.

The table also sets forth our net interest-earning balance the difference between the average balance of interest-earning assets and the average balance of total deposits and borrowings for the quarters indicated. We included non-accrual loans in the average interest-earning assets balance. We included interest from non-accrual loans in interest income only to the extent we received payments and believe we will recover the remaining principal balance of the loans. We computed average balances for the quarter using the average of each month s daily average balance during the periods indicated.

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Three Months Ended

|   | March 31, 2005     |                     |                           | December 31, 2004  |                     |                           | March 31, 2004     |                     |                           |
|---|--------------------|---------------------|---------------------------|--------------------|---------------------|---------------------------|--------------------|---------------------|---------------------------|
|   | Average<br>Balance | Average<br>Interest | Average<br>Yield/<br>Rate | Average<br>Balance | Average<br>Interest | Average<br>Yield/<br>Rate | Average<br>Balance | Average<br>Interest | Average<br>Yield/<br>Rate |
| Interest-earning assets:  |                    |                     |                           |                    |                     |                           |                    |                     |                           |
| Cash  | \$ 15,081,234      | \$ 173,007          | 4.59 %                    | \$ 14,567,425      | \$ 159,837          | 4.39 %                    | \$ 10,825,710      | \$ 115,530          | 4.27 %                    |
| Mortgage-backed securities  | 301                | 3                   | 3.99                      | 312                | 3                   | 3.85                      | 331                | 3                   | 3.63                      |
| Investment securities <sup>(a)</sup>                                | 740,503            | 7,376               | 4.04                      | 747,709            | 6,632               | 3.53                      | 660,750            | 5,262               | 3.20                      |
| Total interest-earning assets                                       | 15,822,038         | 180,386             | 4.56                      | 15,315,446         | 166,472             | 4.35                      | 11,486,791         | 120,795             | 4.21                      |
| Non-interest-earning assets   | 384,519            |                     |                           | 399,435            |                     |                           | 406,088            |                     |                           |
| Total assets  | \$ 16,206,557      |                     |                           | \$ 15,714,881      |                     |                           | \$ 11,892,879      |                     |                           |
| Transaction accounts:   |                    |                     |                           |                    |                     |                           |                    |                     |                           |
| Non-interest-bearing checking                                       | \$ 613,945         | \$ -                | - %                       | \$ 569,859         | \$ -                | - %                       | \$ 445,618         | \$ -                | - %                       |
| Interest-bearing checking <sup>(b)</sup>                            | 532,416            | 476                 | 0.36                      | 538,127            | 499                 | 0.37                      | 519,572            | 459                 | 0.36                      |
| Money market  | 158,491            | 410                 | 1.05                      | 154,755            | 409                 | 1.05                      | 140,055            | 364                 | 1.05                      |
| Regular passbook  | 2,635,858          | 7,166               | 1.10                      | 3,044,570          | 8,256               | 1.08                      | 3,917,514          | 10,863              | 1.12                      |
| Total transaction accounts  | 3,940,710          | 8,052               | 0.83                      | 4,307,311          | 9,164               | 0.85                      | 5,022,759          | 11,686              | 0.94                      |
| Certificates of deposit   | 6,016,710          | 40,971              | 2.76                      | 5,368,624          | 35,117              | 2.60                      | 3,460,434          | 20,914              | 2.43                      |
| Total deposits  | 9,957,420          | 49,023              | 2.00                      | 9,675,935          | 44,281              | 1.82                      | 8,483,193          | 32,600              | 1.55                      |
| Bank advances and other borrowings <sup>(c)</sup>                   | 4,791,811          | 33,980              | 2.88                      | 4,595,267          | 28,913              | 2.50                      | 2,206,909          | 15,705              | 2.86                      |
| Senior notes and junior subordinated debt securities <sup>(d)</sup> | 197,949            | 3,295               | 6.66                      | 197,909            | 3,295               | 6.66                      | 123,711            | 3,134               | 10.13                     |
| Total deposits and borrowings                                       | 14,947,180         | 86,298              | 2.34                      | 14,469,111         | 76,489              | 2.10                      | 10,813,813         | 51,439              | 1.91                      |
| Other liabilities   | 229,195            |                     |                           | 260,351            |                     |                           | 159,349            |                     |                           |
| Stockholders' equity  | 1,030,182          |                     |                           | 985,419            |                     |                           | 919,717            |                     |                           |
| Total liabilities and stockholders' equity                          | \$ 16,206,557      |                     |                           | \$ 15,714,881      |                     |                           | \$ 11,892,879      |                     |                           |
|   | \$ 94,088          | 2.22 %              |                           | \$ 89,983          | 2.25 %              |                           | \$ 69,356          | 2.30 %              |                           |

|                                 |    |         |    |         |
|---------------------------------|----|---------|----|---------|
| interest income/interest spread |    |         |    |         |
| ess of interest-earning ts over |    |         |    |         |
| osits and borrowings            | \$ | 874,858 | \$ | 846,335 |
| ective interest rate spread     |    | 2.38    |    | 2.35    |
|                                 |    |         |    | 2.42    |

*(a) Yields for securities available for sale are calculated using historical cost balances and do not give effect to changes in fair value that are reflected as a component of stockholders' equity.*

*(b) Included amounts swept into money market deposit accounts.*

*(c) Starting in the first quarter of 2004, the impact of swap contracts was included, with notional amounts totaling \$430 million of receive-fixed, pay-3-month LIBOR variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.*

*(d) In June 2004, we issued \$200 million of 6.5% 10-year senior notes. In July 2004, we redeemed our junior subordinated debentures before their maturity.*



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Changes in our net interest income are a function of changes in both rates and volumes of interest-earning assets and interest-bearing liabilities. The following table sets forth information regarding changes in our interest income and expense for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, we have provided information on changes attributable to:

- changes in volume changes in volume multiplied by comparative period rate;
- changes in rate changes in rate multiplied by comparative period volume; and
- changes in rate/volume changes in rate multiplied by changes in volume.

Interest-earning asset and interest-bearing liability balances used in the calculations represent quarterly average balances computed using the average of each month's daily average balance during the period indicated.