DOWNEY FINANCIAL CORP
Form 10-K
March 07, 2001

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)
|X| Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2000.

|X| 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)

3501 Jamboree Road, Newport Beach, California 92660
(Address of principal executive offices) (Zip Code)

I.R.S. Employer Identification No.: 33-0633413

Registrant's telephone number, including area code: (949) 854-0300

Securities registered pursuant to Section 12(b) of the Act:

TITLE OF EACH CLASS	NAME OF EACH EXCHANGE
Common Stock, $0.01 par value	New York Stock Exchange
	Pacific Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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 |X| No |_|

Indicate by a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. |_|

The aggregate market value of the voting stock held by non-affiliates of the registrant, based upon the closing sale price of its Common Stock on February 28, 2001, on the New York Stock Exchange was $923,319,826.

At February 28, 2001, 28,211,048 shares of the Registrant's Common Stock, $0.01 par value were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE: Portions of the Registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the Annual Meeting of Stockholders to be held April 25, 2001 are incorporated by reference in Part III hereof.

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PART I

Certain matters discussed in this Annual Report may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the "Reform Act") and, as such, may involve risks and uncertainties. These forward-looking statements relate to, among other things, expectations of the business environment in which Downey Financial Corp. ("Downey," "we," "us" and "our") operates, projections of future performance, perceived opportunities in the market and statements regarding Downey's mission and vision. Downey's actual results, performance or achievements may differ significantly from the results, performance or achievements expressed or implied in such forward-looking statements. For discussion of the factors that might cause such a difference, see Business--Factors That May Affect Future Results on page 20.

ITEM 1. BUSINESS

GENERAL

We were incorporated in Delaware on October 21, 1994. On January 23, 1995, after we obtained necessary stockholder and regulatory approvals, we acquired 100% of the issued and outstanding capital stock of Downey Savings and Loan Association (the "Bank") and the Bank's stockholders became holders of our stock. Downey was thereafter funded by the Bank and presently operates as the Bank's holding company. Our stock is traded on the New York Stock Exchange and Pacific Exchange under the trading symbol "DSL."

The Bank was formed in 1957 as a California-licensed savings and loan association and converted to a federal charter in 1995. As of December 31, 2000, it conducts its business through 114 retail deposit branches, including 49 full-service in-store branches. Residential loans are originated by residential loan officers who work out of 46 of the Bank's California retail deposit branches. Residential loan officers also originate residential loans through the Internet from two California call centers. Wholesale loans submitted by mortgage brokers are originated from six California loan origination centers, two of which are located in or by a Bank office.

The Bank is regulated or affected by the following governmental entities and laws:

- As a federally chartered savings association, the Bank's activities and investments are generally governed by the Home Owners' Loan Act, as amended, and regulations and policies of the Office of Thrift Supervision (the "OTS").

- The Bank and Downey are subject to the primary regulatory and supervisory jurisdiction of the OTS.

- As a federally insured depository institution, the Bank is regulated and supervised by the Federal Deposit Insurance Corporation (the "FDIC") with respect to some of its activities and investments.

- The Bank is a member of the Federal Home Loan Bank (the "FHLB") of San Francisco, which is one of the 12 regional banks for federally insured depository institutions comprising the Federal Home Loan Bank System.

- The Bank's savings deposits are insured through the Savings Association Insurance Fund ("SAIF") of the FDIC, an instrumentality of the United States government.

- The Bank is regulated by the Federal Reserve with respect to reserves the Bank is required to maintain against deposits and other matters.

General economic conditions, the monetary and fiscal policies of the federal government and the regulatory policies of governmental authorities significantly influence our operations. Additionally, interest rates on competing investments and general market interest rates influence our deposit flows and the costs we incur on interest-bearing liabilities, which represents our cost of funds. Similarly, market interest rates and other factors that affect the supply of and demand for housing and the availability of funds affect our loan volume and our yields on loans and mortgage-backed securities.

Our primary business is banking and we are also involved in real estate investments, each of which we discuss further below.

BANKING ACTIVITIES

Our primary business is banking. Our banking activities focus on:

- attracting funds from the general public and institutions; and
- originating and investing in loans, primarily residential real estate mortgage loans, investment securities and mortgage-backed securities.

These mortgage-backed securities include mortgage pass-through securities issued by other entities and securities issued or guaranteed by government-sponsored enterprises like the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association.

Our primary sources of revenue from our banking business are:

- interest we earn on loans, investment securities and mortgage-backed securities;
- fees we earn in connection with loans and deposits;
- gains on sales of our loans, investment securities and mortgage-backed securities; and
- income we earn on loans and mortgage-backed securities we service for investors.

Our principal expenses in connection with our banking business are:

- interest we incur on our interest-bearing liabilities, including deposits, borrowings and capital securities; and
- general and administrative costs.

Our primary sources of funds from our banking business are:

- deposits;
- principal and interest payments on our loans and mortgage-backed securities;
- proceeds from sales of our loans and mortgage-backed securities; and
- borrowings and capital securities.

Scheduled payments we receive on our loans and mortgage-backed securities are a relatively stable source of funds. However, the funds we receive from deposits and prepayment of loans and mortgage-backed securities vary widely. Below is a detailed discussion of our banking activities.

LENDING ACTIVITIES

Historically, our lending activities have primarily emphasized our origination of first mortgage loans secured by residential properties and retail neighborhood shopping centers. To a lesser extent, our lending activities have emphasized our origination of real estate loans secured by multi-family and commercial and industrial properties, including office buildings, land and other properties with income producing capabilities. In addition, we have provided construction loan financing for single family and multi-family residential properties and commercial retail neighborhood shopping center projects. These construction loan financings have included loans to joint ventures, which were being engaged in by DSL Service Company, a wholly owned subsidiary of the Bank, with other participants. We also originate loans to businesses through our commercial banking operations.

We originate automobile loans directly through our branch network. We also conducted an indirect auto-lending program through our purchase of new or used automobile sales contracts from auto dealers in California and other western states. Downey Auto Finance Corp., a previous wholly owned subsidiary of the Bank, operated this indirect auto-lending program, but was sold in February 2000. For more information, see Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Sale of Subsidiary on page 61.

Our primary focus will continue to be our origination of:

- adjustable rate single family mortgage loans, including subprime loans which carry higher interest rates; and

- consumer loans.

We will also continue our secondary marketing activities of originating and selling single family loans to various investors.

For more information, see below under the caption entitled Secondary Marketing and Loan Servicing Activities on page 5. For additional information on the composition of our loan and mortgage-backed securities portfolio, see Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Loans and Mortgage-Backed Securities on page 35.

LOAN AND MORTGAGE-BACKED SECURITIES PORTFOLIO

We carry loans receivable held for investment at cost. Our net loans receivable are adjusted for amortization of premiums and accretion of discounts which are recognized in interest income using the interest method. Our investments in mortgage-backed securities represent participating interests in pools of first mortgage loans originated and serviced by the issuers of the securities. We carry mortgage-backed securities held to maturity at unpaid principal balances, which are adjusted for unamortized premiums and unearned discounts. We amortize premiums and discounts on mortgage-backed securities by using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments.

We identify loans that may be sold before their maturity. In our balance sheets, we classify these as loans held for sale and record them at the lower of amortized cost or market value. We recognize net unrealized losses on these loans, if any, in a valuation allowance by making charges to our income.

We carry mortgage-backed securities available for sale at fair value. We report net unrealized gains or losses on these securities net of income taxes in stockholders' equity and as a separate component of our other comprehensive income until realized.

The residential mortgage loans we originate typically have contractual maturities at origination of 15 to 40 years. To limit the interest rate risk associated with these 15- to 40-year maturities, we, among other things, principally originate adjustable rate mortgages for our own loan portfolio. We originate fixed rate loans with the intention to sell the majority of them in the secondary market on a non-recourse basis for cash. However, we occasionally originate fixed rate loans for our own portfolio to facilitate the sale of real estate we acquire in settlement of loans or which meet specific yield and other approved guidelines. For more information, see Asset/Liability Management on page 8. In addition, the average term of these fixed rate mortgage loans we originate for our own portfolio historically has been significantly shorter than their contractual maturity due to loan payoffs as a result of home sales or refinancings and prepayments.

RESIDENTIAL REAL ESTATE LENDING

Our primary lending activity is our origination of mortgage loans secured by single family residential properties consisting of one-to-four units located primarily in California. We provide these mortgage loans for borrowers to purchase residences or to refinance their existing mortgages at lower rates or upon different terms. Our primary strategy is to originate adjustable rate mortgages for our portfolio of loans we hold for investment. For more information, see Asset/Liability Management on page 8. We also originate residential fixed rate mortgage loans to meet consumer demand, but we intend to sell the majority of these loans in the secondary market, rather than hold them in our portfolio. We may, however, place residential fixed rate loans in our portfolio of loans held for investment if these fixed rate loans are funded with long-term funds to mitigate interest rate risk. In addition, we originate a small volume of fixed rate loans for our own investment if they meet specific yield and other approved guidelines or to facilitate our sale of real estate acquired in settlement of loans. For more information, see Secondary Marketing and Loan Servicing Activities on page 5.

Our adjustable rate mortgages generally:

- begin with an incentive interest rate, which is an interest rate below the current market rate, that adjusts to the applicable index plus a defined spread, subject to periodic and lifetime caps, after one, three, six or twelve months;

- provide that the maximum interest rate we can charge borrowers cannot exceed the incentive rate by more than six to nine percentage points, depending on the type of loan and the initial rate offered; and

- limit interest rate adjustments to 1% per adjustment period for those that adjust semi-annually and 2% per adjustment period for those that adjust annually.

Most of our adjustable rate mortgages adjust monthly instead of semi-annually. These monthly adjustable rate mortgages:

- have a lifetime interest rate cap, but no specified periodic interest rate adjustment cap;

- have a periodic cap on changes in required monthly payments, which adjust annually; and

- allow for negative amortization, which is the addition to loan principal of accrued interest that exceeds the required monthly loan payments.

Regarding negative amortization, if a loan incurs significant negative amortization, then there is an increased risk that the market value of the underlying collateral on the loan would be insufficient to satisfy fully the outstanding principal and interest. We currently impose a limit on the amount of negative amortization, so that the principal plus the added amount cannot exceed 110% of the original loan amount. In the past, the limit was 125% on loans with an original loan-to-value ratio of 80% or less. A loan-to-value ratio is the ratio of the principal amount of the loan to the appraised value at origination of the property securing the loan. At year-end 2000, loans with the higher limit on negative amortization represented about one-third of our adjustable rate one-to-four unit residential portfolio. We permit adjustable rate mortgages to be assumed by qualified borrowers.

During 2000, approximately 87% of our one-to-four unit residential real estate loans were obtained by our wholesale loan representatives but originated through outside mortgage brokers. We pay our wholesale loan representatives on a commission basis. We consider the compensation we pay outside mortgage brokers when we set the overall price of our mortgage loan products. These mortgage brokers do not operate from our offices and are not our employees. Our retail loan account representatives generated approximately 13% of our one-to-four unit residential loans during 2000. We compensate our retail loan account representatives located in our call centers on a salary basis plus a fixed amount per loan they originate. Retail loan account representatives located in our branch offices are compensated on a commission only basis. Retail loan account representatives typically receive loan referrals from real estate agents, builders and customers. Our call centers receive loan referrals from retail advertising and other sources, including over the Internet.

We require that our residential real estate loans be approved at various levels of management, depending upon the amount of the loan. On a single family residential loan we originate for our portfolio, the maximum amount we generally will lend is $1 million. Our average loan size, however, is much lower. In 2000, our average loan size was $260,210. We generally make loans with loan-to-value ratios not exceeding 80%. We will make loans with loan-to-value ratios of over 80%, but not exceeding 97% of the value of the property, if the borrower obtains private mortgage insurance to reduce the effective loan-to-value ratio to between 70% to 78%, consistent with secondary marketing requirements. In addition, we require that borrowers obtain hazard insurance for all residential real estate loans covering the lower of the loan amount or the replacement value of the residence.

In our approval process for the loans we originate or purchase, we assess both the value of the property securing the loan and the applicant's ability to repay the loan. Loan underwriters analyze the loan application and the property involved. Qualified appraisers on our staff or outside appraisers establish the value of the collateral through the use of full appraisals or alternative valuation formats that meet regulatory requirements. Appraisal reports prepared by outside appraisers are selectively reviewed by our staff appraisers or by approved fee appraisers. We also obtain information about the applicant's income, financial condition, employment and credit history. Typically, we will verify an applicant's credit information for loans originated by our retail loan representatives. For loans submitted from outside mortgage brokers, we require the mortgage broker to obtain, review and verify the applicant's credit information and employment. In addition, in underwriting and qualifying the loan applicant, we obtain credit information about the applicant and perform other underwriting tests of these broker-originated loans.

On our adjustable rate mortgages we offer with incentive interest rates, we qualify applicants:

- o for loan programs with no negative amortization at the higher of:
  - o the initial incentive interest rate; or
  - o the fully indexed interest rate.
- o for loan programs that include negative amortization and are owner occupied, at the minimum qualifying interest rate of 7.50%.

- o for loan programs that include negative amortization and are non-owner occupied, at the minimum qualifying interest rate of 7.75%.

Late in 1996, we began offering one-to-four unit residential loans to borrowers who have or, in the case of purchases, will have equity in their homes but whose credit rating contains exceptions which preclude them from qualifying for lower or better market interest rates and terms. We refer to these lower grade credits, which we characterize as "A-," "B" and "C" loans, as subprime loans in our loan portfolio. Our subprime loans are characterized by lower loan-to-value ratios and higher average interest rates than higher credit grade loans or "A" loans. We believe these lower credit grade borrowers represent an opportunity for us to earn a higher net return for the risks we assume. We have developed specific underwriting guidelines for each classification of subprime credit and qualify these applicants at the fully indexed rate. For further information, see Regulation--Regulation of the Bank--Regulatory Capital Requirements on page 13.

SECONDARY MARKETING AND LOAN SERVICING ACTIVITIES

As part of our secondary marketing activities, we originate some residential real estate adjustable rate mortgages and fixed rate mortgages, which we intend to sell. Accordingly, we classify these loans as held for sale and carry them at the lower of cost or market. These loans are secured by first liens on one-to-four unit residential properties and generally have maturities of 30 years or less.

Generally, we use various hedging programs to manage the interest rate risk of our fixed rate mortgage origination process. For further information, see Asset/Liability Management on page 8.

We believe that servicing loans for others can be an important asset/liability management tool because it produces operating results which, in response to changes in market interest rates, tend to move opposite to changes in net interest income. Because adjustable rate mortgages take longer to adjust to market interest rates, net interest income associated with these loans is expected to decline in periods of rising interest rates and increase in periods of falling rates. In contrast, the value of a loan servicing portfolio normally:

- o increases as interest rates rise and loan prepayments decrease; and
- o declines as interest rates fall and loan prepayments increase.

In addition, increased levels of servicing activities and the opportunity to offer our other financial services in servicing loans for others can provide us with additional income with minimal additional overhead costs.

Depending upon market pricing for servicing, we sell loans either servicing retained or servicing released. When we sell loans servicing retained, we record gains or losses from these loans at the time of sale. We calculate gains or losses from our sale as the difference between the net sales proceeds and the allocated basis of the loans sold. We capitalize mortgage servicing rights we acquire through either our purchase or origination of mortgage loans we intend to sell with servicing rights retained. We allocate the total cost of the mortgage loans designated for sale to both the mortgage servicing rights and to the mortgage loans without mortgage servicing rights based on their relative fair values. We disclose our mortgage servicing rights in our financial statements and include them as a component of the gain on sale of loans. We recognize impairment losses on the mortgage servicing rights through a valuation allowance and record any associated provision as a component of loan servicing fees. At December 31, 2000, our mortgage servicing rights totaled $41 million.

We may exchange loans we originate for sale with government agencies for mortgage-backed securities collateralized by these loans. Our cost for the exchange, a monthly guaranty fee, is expressed as a percentage of the unpaid principal balance and is deducted from interest income. We can use the securities we receive to collateralize various types of our borrowings at rates that frequently are more favorable than rates on other types of liabilities and also carry a lower risk-based capital requirement than whole loans. We carry these mortgage-backed securities available for sale at fair value. However, we record no gain or loss on the exchange in our statement of income until the securities are sold to a third party. Before we sell these securities to third parties, we show all changes in fair value as a separate component of stockholders' equity as accumulated other comprehensive income, net of income taxes.

COMMERCIAL REAL ESTATE AND MULTI-FAMILY LENDING

We have provided permanent loans secured by retail neighborhood shopping centers and multi-family properties. Our major loan officers conduct our commercial real estate and multi-family lending activities. We compensate these officers on a salary basis.

Commercial real estate and multi-family loans generally entail additional risks as compared to single family residential mortgage lending. We subject each loan, including loans to facilitate the sale of real estate we own, to our underwriting standards, which generally include:

- our evaluation of the creditworthiness and reputation of the borrower; and

- the amount of the borrower's equity in the project as determined on the basis of appraisal, sales and leasing information on the property and cash flow projections.

To protect the value of the security for our loan, we require borrowers to maintain casualty insurance for the loan amount or replacement cost. In addition, for non-residential loans in excess of $500,000, we require the borrower to obtain comprehensive general liability insurance. All commercial real estate loans we originate must be approved by at least two of our officers, one of whom must be the originating loan account officer and the other a designated officer with appropriate loan approval authority.

CONSTRUCTION LENDING

We have provided construction loan financing for single family and multi-family residential properties and commercial real estate projects, like retail neighborhood shopping centers. Our major loan officers principally originate these loans. We generally make construction loans at floating interest rates based upon the prime or reference rate of a major commercial bank. Generally, we require a loan-to-value ratio of 75% or less on construction lending and we subject each loan to our underwriting standards.

Construction loans involve risks different from completed project lending because we advance loan funds based upon the security of the completed project under construction. If the borrower defaults on the loan, then we may have to advance additional funds to finance the project's completion before the project can be sold. Moreover, construction projects are affected by uncertainties inherent in estimating:

- construction costs;
- potential delays in construction time;
- market demand; and
- the accuracy of the estimate of value on the completed project.

When providing construction loans, we require the general contractor to, among other things, carry contractor's liability insurance equal to specific prescribed minimum amounts, carry builder's risk insurance and have a blanket bond against employee misappropriation.

COMMERCIAL LENDING

We originate commercial loans and revolving lines of credit and issue standby letters of credit for our middle market commercial customers. We offer the various credit products on both a secured and unsecured basis with interest rates being either fixed or variable. Our portfolio emphasis is toward secured, floating rate credit facilities. Our commercial banking group directs these activities and focuses on our long-term, relationship-based customers. We also utilize our retail branch network as a source of commercial customers, with the lending to these customers being typically managed by the branch manager. We believe our commercial borrowers are desirable because these borrowers generally have lower cost deposit accounts.

CONSUMER LENDING

Until its sale in February 2000, we originated fixed rate automobile loans through an indirect lending program of Downey Auto Finance Corp. which used preapproved automobile dealers to finance consumer purchases of new and used automobiles. For additional information regarding Downey Auto Finance Corp., see Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Sale of Subsidiary on page 61.

In addition, the Bank originates direct automobile loans, home equity loans and lines of credit, and other consumer loan products. Before we make a consumer loan, we assess the applicant's ability to repay the loan and, if applicable, the value of the collateral securing the loan. The risk involved with home equity loans and lines of credit is similar to the risk involved with residential real estate loans. We offer customers a credit card through a third party, who extends the credit and services the loans made to our customers.

INVESTMENT ACTIVITIES

Federal and state regulations require the Bank to maintain a specified minimum amount of liquid assets invested in particular short-term obligations and other securities. For additional information regarding liquidity requirements and the Bank's compliance with the liquidity requirements, see Regulation--Regulation of the Bank--Liquidity Requirements on page 19 and Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Capital Resources and Liquidity on page 57. As a federally chartered savings association, the Bank's ability to make other securities investments is prescribed under the OTS regulations and the Home Owners' Loan Act. The Bank's authorized officers make investment decisions within guidelines established by the Bank's Board of Directors. The Bank manages these investments in an effort to produce the highest yield, while at the same time maintaining safety of principal, minimizing interest rate risk and complying with applicable regulations.

We carry securities held to maturity at amortized cost. We adjust these costs for amortization of premiums and accretion of discounts, which we recognize as interest income using the interest method. We carry securities available for sale at fair value. We exclude unrealized holding gains and losses, or valuation allowances established for net unrealized losses, from our earnings and report them as a separate component of our stockholders' equity as accumulated other comprehensive income, net of income taxes, unless the security is deemed other than temporarily impaired. If the security is determined to be other than temporarily impaired, we charge the amount of the impairment to operations. For further information on the composition of our investment portfolio, see Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Investment Securities on page 38.

DEPOSIT ACTIVITIES

We prefer to use deposits as our principal source of funds for supporting our lending activities, because the cost of these funds generally is less than that of borrowings or other funding sources with comparable maturities. We traditionally have obtained our savings deposits primarily from areas surrounding the Bank's California branch offices. However, we occasionally raise some retail deposits through Wall Street activities.

General economic conditions affect deposit flows. Funds may flow from depository institutions such as savings associations into direct vehicles like government and corporate securities or other financial intermediaries. Our ability to attract and retain deposits will continue to be affected by money market conditions and prevailing interest rates. Generally, state or federal regulation does not restrict interest rates we pay on deposits.

In 1996, we began establishing full-service branch facilities in selected supermarket locations throughout California. Each in-store branch offers a full range of financial services including checking and savings accounts as well as residential and consumer loans.

When consistent with our maintenance of appropriate capital levels, we may consider opportunities to augment our retail branch system and deposit base through our acquisition of selected branches or deposits.

For further information, see Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Deposits on page 41.

BORROWING ACTIVITIES

Our principal source of funds has been and continues to be deposits we raise through our retail branch system. At various times, however, we have utilized other sources to fund our loan origination and other business activities. We have at times relied upon our borrowings from the FHLB of San Francisco as an additional source of funds. The FHLB of San Francisco makes advances to us through several different credit programs it offers.

From time to time, we obtain additional sources of funds by selling some of our securities and mortgage loans under agreements to repurchase. These reverse repurchase agreements are generally short-term and are

collateralized by our mortgage-backed or investment securities and our mortgage loans. We only deal with investment banking firms that are recognized as primary dealers in U.S. government securities or major commercial banks in connection with these reverse repurchase agreements. In addition, we limit the amounts of our borrowings from any single institution.

For further information, see Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Borrowings on page 43.

CAPITAL SECURITIES

On July 23, 1999, we issued $120 million in capital securities through Downey Financial Capital Trust I. The capital securities pay quarterly cumulative cash distributions at an annual rate of 10.00% of the liquidation value of $25 per share. Of the $115 million of net proceeds, we invested $108 million as additional common stock of the Bank thereby increasing the Bank's regulatory core/tangible capital by that same amount. The balance of the net proceeds have been used for general corporate purposes. For further information regarding our capital securities, see Note 19 on page 93 of Notes to Consolidated Financial Statements.

ASSET/LIABILITY MANAGEMENT

Savings institutions are affected by interest rate risks to the degree that their interest-bearing liabilities, consisting principally of customer deposits, FHLB advances, other borrowings and capital securities, mature or reprice on a different basis than their interest-earning assets, which consist predominantly of intermediate or long-term real estate loans. While having liabilities that on average mature or reprice more frequently than assets may be beneficial in times of declining interest rates, this asset/liability structure may result in declining net earnings during periods of rising interest rates. One of our principal objectives is to manage the effects of adverse changes in interest rates on our interest income while maintaining our asset quality and an acceptable interest rate spread. To improve the rate sensitivity and maturity balance of our interest-earning assets and liabilities, we have emphasized the origination of loans with adjustable interest rates or relatively short maturities. Loans with adjustable interest rates have the beneficial effect of allowing the yield on our assets to increase during periods of rising interest rates, although these loans have contractual limitations on the frequency and extent of interest rate adjustments.

For further information see Lending Activities on page 2 and Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Asset/Liability Management and Market Risk on page 44.

EARNINGS SPREAD

We determine our net interest income or the interest rate spread by calculating the difference between:

- the yield we earn on our interest-earning assets like loans, mortgage-backed securities and investment securities; and

- the cost we pay on our interest-bearing liabilities like deposits, borrowings and capital securities.

Our net interest income is also determined by the relative dollar amounts of our interest-earning assets and interest-bearing liabilities.

Our effective interest rate spread, which reflects the relative level of our interest-earning assets to our interest-bearing liabilities, equals:

- the difference between interest income on our interest-earning assets and interest expense on our interest-bearing liabilities, divided by

- our average interest-earning assets for the period.

For information regarding our net income and the components thereof and for management's analysis of our financial condition and results of operations, see Management's Discussion and Analysis of Financial Condition and Results of Operations beginning on page 26. For information regarding the return on our assets and other selected financial data see Selected Financial Data on page 24.

INSURANCE AGENCY ACTIVITIES

Downey Affiliated Insurance Agency was incorporated on January 25, 1995, as Downey's wholly owned subsidiary. We capitalized Downey Affiliated Insurance Agency on February 24, 1995 with $400,000. In the 1995 second quarter, Downey Affiliated Insurance Agency commenced operations at which time representatives of Downey Affiliated Insurance Agency were available in our branches to offer annuity products. During 1996, Downey Affiliated Insurance Agency began offering forced-placed casualty insurance policies on mortgage loans and stopped offering annuity products. The offering of forced-placed casualty insurance policies ceased in April 1999.

REAL ESTATE INVESTMENT ACTIVITIES

In addition to our primary business of banking, which has been described above, we are also involved in real estate investment activities, which are conducted primarily through DSL Service Company, a wholly owned subsidiary of the Bank. DSL Service Company is a diversified real estate development company which was established in 1966 as a neighborhood shopping center and residential tract developer, as well as the general contractor for the Bank's branch locations. Today its capabilities include development, construction and property management activities relating to its portfolio of projects primarily within California, but also in Arizona. In addition to DSL Service Company developing its own real estate projects, it associates with other qualified developers to engage in joint ventures. The primary revenue sources of our real estate investment activities include net rental income and gains from the sale of real estate investments. The primary expenses of our real estate investment activities are interest expense and general and administrative expense.

Before Congress passed the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA"), the Bank conducted real estate development and joint venture operations directly, in addition to operations conducted through DSL Service Company. Since FIRREA, however, the Bank's ability to engage in new real estate development and joint venture activities and to retain its existing real estate investments was curtailed dramatically. In addition, these activities may be economically unfeasible for the Bank because of the capital requirements FIRREA imposes on these activities. FIRREA requires, with some limited exceptions, a savings institution like the Bank to exclude from the Bank's regulatory capital:

- o the Bank's investments in, and extensions of credit to, real estate subsidiaries like DSL Service Company; and

- o the Bank's direct equity investments in real estate development and joint venture operations.

FIRREA also prohibits the Bank from making new investments in real estate development and joint venture operations.

The Bank is required to deduct the full amount of its investment in DSL Service Company in calculating its applicable ratios under the core, tangible and risk-based capital standards. Savings associations generally may invest in service corporation subsidiaries, like DSL Service Company, to the extent of 2% of the association's assets, plus up to an additional 1% of assets for investments which serve primarily community, inner-city or community development purposes. In addition, "conforming loans" by the Bank to DSL's joint venture partnerships are limited to 50% of the Bank's risk-based capital. "Conforming loans" are those generally limited to 80% of appraised value, bear a market rate of interest and require payments sufficient to amortize the principal balance of the loan. We are in compliance with each of these investment limitations.

To the extent Downey or a subsidiary of Downey, other than the Bank or its subsidiaries, makes real estate investments, the above-mentioned capital deductions and limitations do not apply as they only pertain to the specific investments by savings associations or their subsidiaries.

For further information, see Management's Discussion and Analysis of Financial Condition and Results of Operations--Financial Condition--Investments in Real Estate and Joint Ventures on page 39.

COMPETITION

We face competition both in attracting deposits and in making loans. Our most direct competition for deposits has historically come from other savings institutions and from commercial banks located in our principal market areas, including many large financial institutions based in other parts of the country or their subsidiaries. In addition, we face additional significant competition for investors' funds from short-term money market securities

and other corporate and government securities. Our ability to attract and retain savings deposits depends, generally, on our ability to provide a rate of return, liquidity and risk comparable to that offered by competing investment opportunities and the appropriate level of customer service.

We experience competition for real estate loans principally from other savings institutions, commercial banks, mortgage banking companies and insurance companies. We compete for loans principally through our interest rates and loan fees we charge and our efficiency and quality of services we provide borrowers and real estate brokers.

EMPLOYEES

At December 31, 2000, we had approximately 1,294 full-time employees and 489 part-time employees. We provide our employees with health and welfare benefits and a retirement and savings plan. Additionally, we offer qualifying employees participation in our stock purchase plan. Our employees are not represented by any union or collective bargaining group, and we consider our employee relations to be good.

REGULATION

GENERAL

Federal and state law extensively regulates savings and loan holding companies and savings associations. This regulation is intended primarily for the protection of our depositors and the SAIF and not for the benefit of our stockholders. In the following information, we describe some of the regulations applicable to us and the Bank. We do not claim this discussion is complete and qualify our discussion in its entirety by reference to applicable statutory or regulatory provisions.

REGULATION OF DOWNEY

General. We are a savings and loan holding company. We are subject to regulatory oversight by the OTS. Thus, we are required to register and file reports with the OTS and are regulated and examined by the OTS. In addition, the OTS has enforcement authority over us, which also permits the OTS to restrict or prohibit our activities that it determines to be a serious risk to the Bank.

Activities Restrictions. As a savings and loan holding company with only one savings and loan association subsidiary, we generally are not limited by OTS activity restrictions, provided the Bank satisfies the qualified thrift lender test or meets the definition of a domestic building and loan association in the Internal Revenue Code. If we acquire control of another savings association as a separate subsidiary of Downey, we would become a multiple savings and loan holding company. As a multiple savings and loan holding company, our activities, other than the activities of the Bank or any other SAIF-insured savings association, would become subject to restrictions applicable to bank holding companies unless these other savings associations were acquired in a supervisory acquisition and each also satisfies the qualified thrift lender test or meets the definition of a domestic building and loan association. Furthermore, if we were in the future to sell control of the Bank to any other company, such company would not succeed to our grandfathered status as a unitary thrift holding company and would be subject to the same business activity restrictions as a bank holding company. For more information, see Recent Legislation on page 11 and Regulation of the Bank--Qualified Thrift Lender Test on page 15.

On October 27, 2000, the OTS issued a proposed rule that would require some savings and loan holding companies to notify the OTS 30 days before undertaking certain significant new business activities. As proposed, holding companies would have to give the OTS advance notice of:

- the incurrence of debt, when combined with all other transactions by the company or any subsidiaries other than the thrift during the past 12 months, increases non-thrift liabilities by 5 percent or more; and non-thrift liabilities, after the debt transaction, equal 50 percent or more of the company's consolidated core capital;

- o an asset acquisition or series of such transactions by the company or non-thrift subsidiary during the past 12 months that involves assets other than cash, cash equivalents and securities or other obligations guaranteed by the U.S. Government and exceeds 15 percent of the company's consolidated assets; and

- o any transaction that, when combined with all other transactions during the past 12 months, reduces the company's capital by 10 percent or more.

Exempt from the notice requirement would be any holding company with consolidated subsidiary thrift assets of less than 20 percent of total assets or consolidated holding company capital of at least 10 percent. The OTS could object to or conditionally approve an activity or transaction if it finds a material risk to the safety and soundness and stability of the thrift. The review period could be extended an additional 30 days if necessary.

The OTS proposal also would codify current practices and the factors relevant to a holding company's need for capital. To determine the need for and level of an explicit holding company capital requirement, the OTS will look at overall risk at the thrift and the consolidated entity, their tangible and equity capital, whether the holding company's debt-to-capital ratio is rising, what investments or activities are funded by debt, its cash flow, how much the holding company relies on dividends from its subsidiary thrift to service debt or fulfill other obligations, earnings volatility and the thrift's standing in the corporate structure.

The comment period for the proposed rule was extended to February 9, 2001. It is not possible at this time to predict the impact of the proposed rule on our financial condition or results of operation.

Restrictions on Acquisitions. We must obtain approval from the OTS before acquiring control of any other SAIF-insured association. The OTS generally prohibits these types of acquisitions if they result in a multiple savings and loan holding company controlling savings associations in more than one state. However, the OTS permits interstate acquisitions if the acquisition is authorized by specific state authorization or a supervisory acquisition of a failing savings association.

Federal law generally provides that no "person," acting directly or indirectly or through or in concert with one or more other persons, may acquire "control" of a federally insured savings association unless the person gives at least 60 days written notice to the OTS. The OTS then has the opportunity to disapprove the proposed acquisition. In addition, no company may acquire control of this type of an institution without prior OTS approval. These provisions also prohibit, among other things, any director or officer of a savings and loan holding company, or any individual who owns or controls more than 25% of the voting shares of a savings and loan holding company, from acquiring control of any savings association not a subsidiary of the savings and loan holding company, unless the acquisition is approved by the OTS.

Recent Legislation. On November 12, 1999, the Gramm-Leach-Bliley Act of 1999 (the "Financial Services Modernization Act") was signed into law. The Financial Services Modernization Act repeals the two affiliation provisions of the Glass-Steagall Act:

- o Section 20, which restricted the affiliation of Federal Reserve member banks with firms "engaged principally" in specified securities activities; and

o Section 32, which restricts officer, director or employee interlocks between a member bank and any company or person "primarily engaged" in specified securities activities.

In addition, the Financial Services Modernization Act contains provisions that expressly preempt any state law restricting the establishment of financial affiliations, primarily related to insurance. The general effect of the law is to establish a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company to engage in a full range of financial activities through a new entity known as a "Financial Holding Company." "Financial activities" is broadly defined to include not only banking, insurance and securities activities, but also merchant banking and additional activities that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines to be financial in nature, related or incidental to such financial activities, or complementary activities that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

The Financial Services Modernization Act provides that no company may acquire control of an insured savings association, unless that company engages, and continues to engage, only in the financial activities permissible for a Financial Holding Company, unless grandfathered as a unitary savings and loan holding company. The Financial Institution Modernization Act grandfathers any company that was a unitary savings and loan holding company on May 4, 1999 or became a unitary savings and loan holding company pursuant to an application pending on that date. Downey is a grandfathered unitary savings and loan holding company and we

may continue to operate under present law as long as we continue to control only the Bank and the Bank continues to meet the qualified thrift lender test.

We do not believe that the Financial Services Modernization Act will have a material adverse effect on our operations in the near-term. However, to the extent that the act permits banks, securities firms and insurance companies to affiliate, the financial services industry may experience further consolidation. The Financial Services Modernization Act is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis and which unitary savings and loan holding companies, such as Downey, already possess. Nevertheless, this act may have the result of increasing the amount of competition that we face from larger institutions and other types of companies offering financial products, many of which may have greater financial resources than we do. In addition, the Financial Services Modernization Act may have an anti-takeover effect because it may tend to limit the range of potential acquirers of Downey to other savings and loan holding companies and Financial Holding Companies.

REGULATION OF THE BANK

General. The OTS and the FDIC extensively regulate the Bank because the Bank is a federally chartered, SAIF-insured savings association. The Bank must ensure that its lending activities and its other investments comply with various statutory and regulatory requirements. The Bank is also regulated by the Federal Reserve.

The OTS, in conjunction with the FDIC, regularly examines the Bank and prepares reports for the Bank's Board of Directors to consider with respect to any deficiencies the OTS or the FDIC finds in the Bank's operations. Federal and state laws also regulate the relationship between the Bank and its depositors and borrowers, especially in matters regarding the ownership of savings accounts and the form and content of mortgage documents used by the Bank.

The Bank must file reports with the OTS and the FDIC concerning its activities and financial condition. In addition, the Bank must obtain regulatory approvals before entering into some transactions like mergers with or acquisitions of other financial institutions. This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily for the protection of the SAIF and our depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in regulations, whether by the OTS, the FDIC or the Congress, could have a material adverse impact on us, the Bank and our operations.

Insurance of Deposit Accounts. The SAIF, as administered by the FDIC, insures the Bank's deposit accounts up to the maximum amount permitted by law. The FDIC may terminate insurance of deposits upon a finding that the institution:

- has engaged in unsafe or unsound practices;
- is in an unsafe or unsound condition to continue operations; or
- has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or the institution's primary regulator.

The FDIC charges an annual assessment for the insurance of deposits based on the risk a particular institution poses to its deposit insurance fund. Under this system as of December 31, 2000, SAIF members paid within a range of 0 cents to 27 cents per $100 of domestic deposits, depending upon the institution's risk classification. This risk classification is based on an institution's capital group and supervisory subgroup assignment.

The Bank also pays, in addition to its normal deposit insurance premium as a member of the SAIF, an amount equal to approximately 0.0212% of insured deposits toward the retirement of the Financing Corporation bonds (known as FICO Bonds) issued in the 1980s to assist in the recovery of the savings and loan industry. These assessments will continue until the FICO Bonds mature in 2017.

Regulatory Capital Requirements. The Bank must meet regulatory capital standards to be deemed in compliance with OTS capital requirements. OTS capital regulations require savings associations to meet the following three capital standards:

- tangible capital equal to 1.5% of total adjusted assets;
- leverage capital, or "core capital," equal to 3% of total adjusted assets for institutions such as the Bank; and
- risk-based capital equal to 8.0% of total risk-based assets.

A savings association with a greater than "normal" level of interest rate exposure must deduct an interest rate risk component in calculating its total capital for purposes of determining whether it meets its risk-based capital requirement. Interest rate exposure is measured, generally, as equal to:

- the decline in an institution's net portfolio value that would result from a 200 basis point increase or decrease in market interest rates, whichever would result in a lower net portfolio value, divided by

- the estimated economic value of the savings association's assets.

The interest rate risk component a savings association must deduct from its total capital is equal to:

- one-half of the difference between an institution's measured exposure and "normal" interest rate risk exposure, which the OTS defines as 2%, multiplied by

- the estimated economic value of the institution's assets.

In August 1995, the OTS indefinitely delayed implementation of its interest rate risk regulation. However, based on the asset/liability structure of the Bank, at December 31, 2000, the Bank would not have been required to deduct an interest rate risk component in calculating its total risk-based capital had OTS's interest rate risk regulation been in effect.

The OTS views its capital regulation requirements as minimum standards, and it expects most institutions to maintain capital levels well above the minimum. In addition, the OTS regulations provide that the OTS may establish minimum capital levels higher than those provided in the regulations for individual savings associations, upon a determination that the savings association's capital is or may become inadequate in view of its circumstances. The OTS regulations provide that higher individual minimum regulatory capital requirements may be appropriate in circumstances where, among others:

- a savings association has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration of credit risk, other risks arising from nontraditional activities, or similar risks or a high proportion of off-balance sheet risk;

- a savings association is growing, either internally or through acquisitions, at a rate that presents supervisory issues; or

- a savings association may be adversely affected by activities or condition of its holding company, affiliates, subsidiaries or other persons, or savings associations with which it has significant business relationships.

The Bank is not required to meet any individual minimum regulatory capital requirement. At December 31, 2000, the Bank's regulatory capital exceeded all minimum regulatory capital requirements.

As a result of a number of federally insured financial institutions extending their risk selection standards to attract lower credit quality accounts due to their having higher interest rates and fees, the federal banking regulatory agencies jointly issued Interagency Guidelines on Subprime Lending in March 1999. In addition, expanded guidelines were issued by the agencies on January 31, 2001. Subprime lending involves extending credit to individuals with less than perfect credit histories.

The agencies' guidelines consider subprime lending a high-risk activity that is unsafe and unsound if the risks associated with subprime lending are not properly controlled. Specifically, the 2001 guidelines direct examiners to

expect regulatory capital one and one-half to three times higher than that typically set aside for prime assets for institutions that:

- o have subprime assets equal to 25% or higher of Tier 1 capital, or
- o have subprime portfolios experiencing rapid growth or adverse performance trends, are administered by inexperienced management, or have inadequate or weak controls.

Our subprime portfolio, pursuant to our definition, represented 250% of Tier 1 capital as of year-end 2000. Any requirement for us to maintain additional regulatory capital as a result of our activities in subprime lending could have an adverse affect on our future prospects and operations and may restrict our ability to grow. If we are unable to comply with any new capital requirements imposed upon regulatory examination, we may be subject to the prompt corrective action regulations of the OTS. Although we believe we maintain appropriate controls and regulatory capital for our subprime activities, we cannot determine whether, or to what extent, additional capital requirements will be imposed on us after periodic examinations by the OTS.

The Home Owners' Loan Act permits savings associations not in compliance with the OTS capital standards to seek an exemption from penalties or sanctions for noncompliance. The OTS will grant an exemption only if the savings association meets strict requirements. In addition, the OTS must deny the exemption in some circumstances. If the OTS does grant an exemption, the savings association still may be exposed to enforcement actions for other violations of law or unsafe or unsound practices or conditions.

Prompt Corrective Action. The OTS's prompt corrective action regulation requires the OTS to take mandatory actions and authorizes the OTS to take discretionary actions against a savings association that falls within undercapitalized capital categories specified in the regulation.

The regulation establishes five categories of capital classification:

- o "well capitalized;"
- o "adequately capitalized;"
- o "undercapitalized;"
- o "significantly undercapitalized;" and
- o "critically undercapitalized."

The regulation uses an institution's risk-based capital, leverage capital and tangible capital ratios to determine the institution's capital classification. At December 31, 2000, the Bank exceeded the capital requirements of a well capitalized institution under applicable OTS regulations.

Loans-to-One-Borrower. Savings associations generally are subject to the lending limits applicable to national banks. With limited exceptions, the maximum amount that a savings association or a national bank may lend to any borrower, including some related entities of the borrower, at one time may not exceed:

- 15% of the unimpaired capital and surplus of the institution, plus
- an additional 10% of unimpaired capital and surplus if the loans are fully secured by readily marketable collateral.

Savings associations are additionally authorized to make loans to one borrower, for any purpose:

- in an amount not to exceed $500,000; or
- by order of the Director of OTS, in an amount not to exceed the lesser of $30,000,000 or 30% of unimpaired capital and surplus to develop residential housing, provided:
  - the purchase price of each single-family dwelling in the development does not exceed $500,000;

  - the savings association is in compliance with its capital requirements;
  - the loans comply with applicable loan-to-value requirements; and
  - the aggregate amount of loans made under this authority does not exceed 15% of unimpaired capital and surplus.

At December 31, 2000, the Bank's loans-to-one-borrower limit was $112 million based upon the 15% of unimpaired capital and surplus measurement.

Qualified Thrift Lender Test. The OTS requires savings associations to meet a qualified thrift lender test. The qualified thrift lender test may be met either by maintaining a specified level of assets in qualified thrift investments as specified in the Home Owners' Loan Act or by meeting the definition of a "domestic building and loan association." Qualified thrift investments are primarily residential mortgages and related investments, including some mortgage-related securities. The required percentage of investments under the Home Owners' Loan Act is 65% of assets while the Internal Revenue Code requires investments of 60% of assets. An association must be in compliance with the qualified thrift lender test or the definition of domestic building and loan association on a monthly basis in nine out of every 12 months. Associations failing to meet the qualified thrift lender test are generally allowed only to engage in activities permitted for both national banks and savings associations.

The FHLB also relies on the qualified thrift lender test. A savings association will only enjoy full borrowing privileges from an FHLB if the savings association is a qualified thrift lender. As of December 31, 2000, the Bank was in compliance with its qualified thrift lender test requirement and met the definition of a domestic building and loan association.

Affiliate Transactions. Transactions between a savings association and its "affiliates" are quantitatively and qualitatively restricted under the Federal Reserve Act. Affiliates of a savings association include, among other entities, the savings association's holding company and companies that are under common control with the savings association.

In general, a savings association or its subsidiaries are limited in their ability to engage in "covered transactions" with affiliates:

- to an amount equal to 10% of the association's capital and surplus, in the case of covered transactions with any one affiliate; and

- to an amount equal to 20% of the association's capital and surplus, in the case of covered transactions with all affiliates.

In addition, a savings association and its subsidiaries may engage in covered transactions and other specified transactions only on terms and under circumstances that are substantially the same, or at least as favorable to the savings association or its subsidiary, as those prevailing at the time for comparable transactions with nonaffiliated companies. A "covered transaction" includes:

- a loan or extension of credit to an affiliate;

- a purchase of investment securities issued by an affiliate;

- a purchase of assets from an affiliate, with some exceptions;

- the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any party; or

- the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate.

In addition, under the OTS regulations:

- a savings association may not make a loan or extension of credit to an affiliate unless the affiliate is engaged only in activities permissible for bank holding companies;

- a savings association may not purchase or invest in securities of an affiliate other than shares of a subsidiary;

- a savings association and its subsidiaries may not purchase a low-quality asset from an affiliate;

- covered transactions and other specified transactions between a savings association or its subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices; and

- with some exceptions, each loan or extension of credit by a savings association to an affiliate must be secured by collateral with a market value ranging from 100% to 130%, depending on the type of collateral, of the amount of the loan or extension of credit.

The OTS regulations generally exclude all non-bank and non-savings association subsidiaries of savings associations from treatment as affiliates, except to the extent that the OTS or the Federal Reserve decides to treat these subsidiaries as affiliates. The regulations also require savings associations to make and retain records that reflect affiliate transactions in reasonable detail and provides that specified classes of savings associations may be required to give the OTS prior notice of affiliate transactions.

Capital Distribution Limitations. OTS regulations impose limitations upon all capital distributions by savings associations, like cash dividends, payments to repurchase or otherwise acquire its shares, payments to shareholders of another institution in a cash-out merger and other distributions charged against capital. The OTS recently adopted an amendment to these capital distribution limitations. Under the new rule, a savings association in some circumstances may:

- be required to file an application and await approval from the OTS before it makes a capital distribution;
- be required to file a notice 30 days before the capital distribution; or
- be permitted to make the capital distribution without notice or application to the OTS.

The OTS regulations require a savings association to file an application if:

- it is not eligible for expedited treatment of its other applications under OTS regulations;
- the total amount of all of capital distributions, including the proposed capital distribution, for the applicable calendar year exceeds its retained net income for that year to date plus retained net income for the preceding two years;
- it would not be at least adequately capitalized, under the prompt corrective action regulations of the OTS following the distribution; or
- the association's proposed capital distribution would violate a prohibition contained in any applicable statute, regulation or agreement between the savings association and the OTS, or the FDIC, or violate a condition imposed on the savings association in an OTS-approved application or notice.

In addition, a savings association must give the OTS notice of a capital distribution if the savings association is not required to file an application, but:

- would not be well capitalized under the prompt corrective action regulations of the OTS following the distribution;
- the proposed capital distribution would reduce the amount of or retire any part of the savings association's common or preferred stock or retire any part of debt instruments like notes or debentures

  included in capital, other than regular payments required under a debt instrument approved by the OTS; or
- the savings association is a subsidiary of a savings and loan holding company.

If neither the savings association nor the proposed capital distribution meet any of the above listed criteria, the OTS does not require the savings association to submit an application or give notice when making the proposed capital distribution. The OTS may prohibit a proposed capital distribution that would otherwise be permitted if the OTS determines that the distribution would constitute an unsafe or unsound practice.

Privacy. Under the Financial Services Modernization Act, federal banking regulators are required to adopt rules that will limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Federal banking regulators issued final rules on May 10, 2000. Pursuant to those rules, financial institutions must provide:

- initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- annual notices of their privacy policies to current customers; and
- a reasonable method for customers to "opt out" of disclosures to nonaffiliated third parties.

The rules were effective November 13, 2000, but compliance is optional until July 1, 2001. These privacy provisions will affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. Although it is not possible at this time to assess the impact of the privacy provisions on our financial condition or results of operations, we do not believe that the Privacy provisions will have a material adverse impact on our operations in the near term.

Consumer Protection Rules - Sale of Insurance Products. In December 2000, pursuant to the requirements of the Financial Services Modernization Act, the federal bank and thrift regulatory agencies adopted consumer protection rules for the sale of insurance products by depository institutions. The rule is effective on April 1, 2001. The final rule applies to any depository institution or any person selling, soliciting, advertising or offering insurance products or annuities to a consumer at an office of the institution or on behalf of the institution. Before an institution can complete the sale of an insurance product or annuity, the regulation requires oral and written disclosure that such product:

- is not a deposit or other obligation of, or guaranteed by, the depository institution or its affiliate;
- is not insured by the FDIC or any other agency of the United States, the depository institution or its affiliate; and
- has certain risks in investment, including the possible loss of value.

Finally, the depository institution may not condition an extension of credit:

- on the consumer's purchase of an insurance product or annuity from the depository institution or from any of its affiliates, or
- on the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity.

The rule also requires formal acknowledgement from the consumer that disclosures were received.

In addition, to the extent practicable, a depository institution must keep insurance and annuity sales activities physically segregated from the areas where retail deposits are routinely accepted from the general public.

Safeguarding Confidential Customer Information. In January 2000, the banking agencies adopted guidelines requiring financial institutions to establish an information security program to:

- identify and assess the risks that may threaten customer information;
- develop a written plan containing policies and procedures to manage and control these risks;
- implement and test the plan; and
- adjust the plan on a continuing basis to account for changes in technology, the sensitivity of customer information, and internal or external threats to information security.

Each institution may implement a security program appropriate to its size and complexity and the nature and scope of its operations.

The guidelines outline specific security measures that institutions should consider in implementing a security program. A financial institution must adopt those security measures determined to be appropriate. The guidelines require the board of directors to oversee an institution's efforts to develop, implement and maintain an effective information security program and approve written information security policies and programs. The guidelines are effective July 1, 2001.

Activities of Subsidiaries. A savings association seeking to establish a new subsidiary, acquire control of an existing company or conduct a new activity through a subsidiary must provide 30 days prior notice to the FDIC and the OTS and conduct any activities of the subsidiary in compliance with regulations and orders of the OTS. The OTS has the power to require a savings association to divest any subsidiary or terminate any activity conducted by a subsidiary that the OTS determines to pose a serious threat to the financial safety, soundness or stability of the savings association or to be otherwise inconsistent with sound banking practices.

Community Reinvestment Act and the Fair Lending Laws. Savings associations have a responsibility under the Community Reinvestment Act and related regulations of the OTS to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. An institution's failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in regulatory restrictions on its activities and the denial of applications. In addition, an institution's failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in the OTS, other federal regulatory agencies as well as the Department of Justice taking enforcement actions.

Federal Home Loan Bank System. The Bank is a member of the FHLB system. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB.

As an FHLB member, the Bank is required to own capital stock in an FHLB in an amount equal to the greater of:

- 1% of its aggregate outstanding principal amount of its residential mortgage loans, home purchase contracts and similar obligations at the beginning of each calendar year;

- o 5% of its FHLB advances or borrowings; or
- o $500.

The Bank's required investment in FHLB stock, based on December 31, 2000 financial data, was $99 million. At December 31, 2000, the Bank had $106 million of FHLB stock.

Liquidity Requirements. Under OTS regulations, a savings association is required to maintain an average daily balance of liquid assets. These liquid assets include cash, some time deposits and savings accounts, bankers' acceptances, some government obligations and other investments. The OTS requires a savings association to maintain an average daily balance of liquid assets in each calendar quarter of not less than 4% of either:

- o its liquidity base, which consists of some net withdrawable accounts plus short-term borrowings, as of the end of the preceding calendar quarter; or
- o the average daily balance of its liquidity base during the preceding quarter.

The OTS may change this liquidity requirement from time to time to any amount between 4% and 10%, depending upon factors, including economic conditions and savings flows of all savings associations. The Bank maintains liquid assets in compliance with these regulations. The OTS may impose monetary penalties upon an institution for violations of liquidity requirements.

Federal Reserve System. The Federal Reserve requires all depository institutions to maintain non- interest-bearing reserves at specified levels against their transaction accounts and non-personal time deposits. These transaction accounts include checking, NOW and Super NOW checking accounts. The balances a savings association maintains to meet the reserve requirements imposed by the Federal Reserve may be used to satisfy the liquidity requirements that are imposed by the OTS. At December 31, 2000, the Bank was in compliance with these requirements.

REGULATION OF DSL SERVICE COMPANY

DSL Service Company is licensed as a real estate broker under the California Real Estate Law and as a contractor with the Contractors State License Board. Thus, the real estate investment activities of DSL Service Company, including development, construction and property management activities relating to its portfolio of projects, are governed by a variety of laws and regulations. Changes in the laws and regulations or their interpretation by agencies and the courts occur frequently. DSL Service Company must comply with various federal, state and local laws, ordinances, rules and regulations concerning zoning, building design, construction, hazardous waste and similar matters. Environmental laws and regulations also affect the operations of DSL Service Company, including regulations pertaining to availability of water, municipal sewage treatment capacity, land use, protection of endangered species, population density and preservation of the natural terrain and coastlines. These and other requirements could become more restrictive in the future, resulting in additional time and expense in connection with DSL Service Company's real estate activities.

With regard to environmental matters, the construction products industry is regulated by federal, state and local laws and regulations pertaining to several areas including human health and safety and environmental compliance. The Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended by the Superfund Amendments and Reauthorization Act of 1986, as well as analogous laws in some states, create joint and several liability for the cost of cleaning up or correcting releases to the environment of designated hazardous substances. Among those who may be held jointly and severally liable are:

- those who generated the waste;
- those who arranged for disposal;
- those who owned or operated the disposal site or facility at the time of disposal; and
- current owners.

In general, this liability is imposed in a series of governmental proceedings initiated by the government's identification of a site for initial listing as a "Superfund site" on the National Priorities List or a similar state list and the government's identification of potentially responsible parties who may be liable for cleanup costs. None of the DSL Service Company's project sites are listed as a "Superfund site."

In addition, California courts have imposed warranty-like responsibility upon developers of new housing for defects in structure and the housing site, including soil conditions. This responsibility is not necessarily dependent upon a finding that the developer was negligent.

As a licensed entity, DSL Service Company is also examined and supervised by the California Department of Real Estate and the Contractors State License Board.

TAXATION

Federal. A savings institution is taxed like other corporations for federal income tax purposes, though savings institutions have historically enjoyed favorable treatment under the Internal Revenue Code in determining their deductions for bad debts.

Savings institutions are required to comply with income tax statutes and regulations similar to those applicable to large commercial banks. The Bank's bad debt deduction is determined under the specific charge-off method, which allows the Bank to take an income tax deduction for these loans only when they have been determined to be wholly or partially worthless.

In addition to the regular corporate income tax, corporations might be required to pay an alternative minimum tax. This tax is computed at 20% of the corporation's regular taxable income, after taking some adjustments into account. This alternative tax applies to corporations to the extent that it exceeds a corporation's regular tax liability.

A corporation that incurs alternative minimum tax generally is entitled to take this tax as a credit against its regular tax in later years to the extent that the corporation's regular tax liability in these later years exceeds the corporation's alternative minimum tax.

State. The Bank uses California's financial corporation income tax rate to compute its California franchise tax liability. This rate is higher than the California non-financial corporation income tax rate because the financial corporation income tax rate reflects an amount "in lieu" of local personal property and business license taxes that are paid by non-financial corporations, but not by banks or other financial corporations. The financial corporation income tax rate was 10.84% for both 2000 and 1999.

The Bank files a California franchise tax return on a combined reporting basis. Other state income and franchise tax returns are filed on a separate-entity basis in Arizona, Colorado, Idaho, Oregon and Utah. The Bank anticipates that additional state income and franchise tax returns will be required in future years as its lending business is expanded nationwide.

The Internal Revenue Service and state taxing authorities have examined our tax returns for all tax years through 1995 and are currently reviewing returns filed for the 1996 tax year. The Bank made a payment of $10.7 million during 2000 to settle federal tax claims related to the sale and leaseback of computer equipment in 1990. This amount had been previously reflected in the Bank's tax accrual, and therefore had no adverse impact upon current year earnings. In addition, the Bank's management believes it has adequately provided for potential exposure with regard to other issues in the years currently under examination. Our tax years subsequent to 1996 remain open to review by federal and state tax authorities.

FACTORS THAT MAY AFFECT FUTURE RESULTS

The following discusses certain factors which may affect our financial results and operations and should be considered in evaluating Downey.

Economic Conditions and Geographic Concentrations. Downey is headquartered in and its operations are concentrated in California. As a result of this geographic concentration, our results depend largely upon economic conditions in the state. Leading business forecasters and economists predict that economic growth may slow substantially from 2000. A significant contributor to the projected 2001 slowdown is California's current energy crisis. The expected hike in energy rates could impede growth by reducing business investment and consumer spending within the state. Other issues facing the state's economy are potential job losses as California "dot.com" companies continue to reduce their workforce. A deterioration in economic conditions could have a material adverse impact on the quality of our loan and real estate portfolios and the demand for our products and services.

Interest Rates. We anticipate that short-term interest rate levels will likely decline in 2001, and if interest rates vary substantially from present levels, our results may differ materially from current levels. Changes in interest rates will influence the growth of loans, investments and deposits and affect the rates received on loans and investment securities and paid on deposits. Changes in interest rates also affect the value of our recorded

mortgage servicing rights on loans we service for others, generally increasing in value as interest rates rise and declining as interest rates fall. If interest rates were to increase significantly, the economic feasibility of real estate investment activities also could be adversely affected.

Government Regulation and Monetary Policy. The financial services industry is subject to extensive federal and state supervision and regulation. Significant new laws or changes in, or repeals of, existing laws may cause our results to differ materially. Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects credit conditions for Downey, primarily through open market operations in United States government securities, the discount rate for borrowings and reserve requirements, and a material change in these conditions would be likely to have a material impact on our results.

Competition. The banking and financial services business in our market areas is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the accelerating pace of consolidation among financial services providers. Our results may differ if circumstances affecting the nature or level of competition change.

Credit Quality. A significant source of risk arises from the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. We have adopted prudent underwriting and loan quality monitoring systems, procedures and credit policies, including the establishment and review of the allowance for loan losses, that management believes are appropriate to minimize this risk by tracking loan performance, assessing the likelihood of nonperformance and diversifying our loan portfolio. Such policies and procedures, however, may not prevent unexpected losses that could materially adversely affect our results.

ITEM 2. PROPERTIES

BRANCHES

The corporate offices of Downey, the Bank and DSL Service Company are located at 3501 Jamboree Road, Newport Beach, California 92660. Part of that corporate facility houses a branch office of the Bank. Certain departments (warehousing, record retention, etc.) are located in other owned and leased facilities in Orange County, California. The majority of our administrative operations, however, are located in our corporate headquarters.

At December 31, 2000, we had 114 branches. We owned the building and land occupied by 56 of our branches and we owned one branch building on leased land. We operate branches in 57 locations (including 49 in-store locations) with leases or licenses expiring at various dates through October 2010, with options to extend the term.

The net book value of our owned branches, including the one on leased land, totaled $82 million at December 31, 2000 and the net book value of our leased branch offices totaled $2 million at December 31, 2000. The net book value of our furniture and fixtures, including electronic data processing equipment, was $20 million at December 31, 2000.

For additional information regarding our offices and equipment, see Note 1 on page 69 and Note 9 on page 85 of Notes to Consolidated Financial Statements.

ELECTRONIC DATA PROCESSING

We utilize a mainframe computer system with use of various third-party vendors' software for retail deposit operations, loan servicing, accounting and loan origination functions, including our operations conducted over the Internet. The net book value of our electronic data processing equipment, including personal computers and software, was $12 million at December 31, 2000.

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SHAREHOLDERS

No matters were submitted to shareholders during the fourth quarter of 2000.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is traded on the New York Stock Exchange ("NYSE") and the Pacific Exchange ("PCX") with the trading symbol "DSL." At February 28, 2001, we had approximately 873 stockholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 28,211,048 outstanding shares of common stock.

The following table sets forth for the quarters indicated the range of high and low sale prices per share of our common stock as reported on the NYSE Composite Tape.

	2000				1999			
	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter	4th Quarter	3rd Quarter	2nd Quarter	1st Quarter
High	$60.88	$40.94	$33.00	$21.44	$22.94	$24.13	$23.00	$25.75
Low	33.13	29.94	20.44	18.75	19.06	19.81	18.13	18.25
End of period	55.00	39.50	28.98	21.25	20.19	20.13	21.94	18.31

During 2000, we paid quarterly cash dividends totaling $0.36 per share, aggregating $10.1 million compared to $0.35 per share, aggregating $9.9 million during 1999. On February 23, 2001, we paid a $0.09 per share quarterly cash dividend, aggregating $2.5 million.

We may pay additional dividends out of funds legally available therefor at such times as the Board of Directors determines that dividend payments are appropriate. The Board of Directors' policy is to consider the declaration of dividends on a quarterly basis.

The payment of dividends by the Bank to Downey is subject to OTS regulations. For further information regarding these regulations see Business--Regulation--Regulation of the Bank--Capital Distribution Limitations on page 16.

ITEM 6. SELECTED FINANCIAL DATA

(Dollars in Thousands, Except Per Share Amounts)	2000	1999	
INCOME STATEMENT DATA:			
Total interest income	$ 784,360	$ 533,751	$ 4
Total interest expense	521,885	326,273	2
Net interest income	262,475	207,478	1
Provision for loan losses	3,251	11,270	
Net interest income after provision for loan losses	259,224	196,208	1
Other income, net:			
Loan and deposit related fees	30,089	20,097	
Real estate and joint ventures held for investment, net	8,798	19,302	
Secondary marketing activities:			
Loan servicing fees	(3,628)	1,672	
Net gains on sales of loans and mortgage-backed securities	3,297	14,806	
Net gains (losses) on sales of investment securities	(106)	288	
Gain on sale of subsidiary (1)	9,762	--	
Other	2,342	3,113	
Total other income, net	50,554	59,278	
Operating expense:			
General and administrative expense	136,189	144,382	1
SAIF special assessment (2)	--	--	
Net operation of real estate acquired in settlement of loans	818	19	
Amortization of excess of cost over fair value of net assets acquired...	462	474	
Total operating expense	137,469	144,875	1
Net income (1) (2)	$ 99,251	$ 63,804	$
PER SHARE DATA:			
Earnings per share--Basic (1) (2)	$ 3.52	$ 2.27	$
Earnings per share--Diluted (1) (2)	3.51	2.26	
Book value per share at end of period	22.15	18.91	
Stock price at end of period	55.00	20.19	
Cash dividends paid	0.36	0.35	
SELECTED FINANCIAL RATIOS:			
Effective interest rate spread	2.66%	2.88%	
Return on average assets (1) (2)	0.97	0.85	
Return on average equity (1) (2)	17.17	12.70	
Dividend payout ratio	10.22	15.44	
LOAN ACTIVITY:			
Loans originated	$ 5,218,368	$7,132,486	$4,0
Loans and mortgage-backed securities purchased	18,828	49,669	
Loans and mortgage-backed securities sold	1,662,600	2,386,958	1,7
BALANCE SHEET SUMMARY (END OF PERIOD):			
Total assets	$10,893,863	$9,407,540	$6,2
Loans and mortgage-backed securities	10,084,353	8,746,063	5,7
Investments and cash equivalents	439,968	299,698	2
Deposits	8,082,689	6,562,761	5,0
Borrowings	1,978,572	2,122,780	7
Capital securities	120,000	120,000	

Stockholders' equity	624,636	532,418	4
Loans serviced for others	3,964,462	2,923,778	1,0
AVERAGE BALANCE SHEET DATA:			
Assets	$10,217,371	$7,501,228	$5,9
Loans	9,514,978	6,937,342	5,3
Deposits	7,290,850	5,697,292	5,1
Stockholders' equity	577,979	502,412	4

ITEM 6. SELECTED FINANCIAL DATA (CONTINUED)

(Dollars in Thousands, Except Per Share Amounts)	2000	1999	
CAPITAL RATIOS:			
Average stockholders' equity to average assets	5.66%	6.70%	
Bank only--end of period (3):			
Core and tangible capital	6.42	6.27	
Risk-based capital	12.94	12.14	
SELECTED ASSET QUALITY DATA (END OF PERIOD):			
Total non-performing assets	$ 54,974	$ 39,194	$ 2
Non-performing assets as a percentage of total assets	0.50%	0.42%	
Allowance for loan losses:			
Amount	$ 34,452	$ 38,342	$ 3
As a percentage of non-performing loans	76.63%	116.25%	1

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Certain statements under this caption constitute "forward-looking statements" under the Private Securities Litigation Reform Act of 1995 which involve risks and uncertainties. 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. For additional information concerning these factors, see Business--Factors that May Affect Future Results on page 20.

OVERVIEW

Our net income for 2000 totaled a record $99.2 million or $3.51 per share on a diluted basis. Included in the results was a $5.6 million after-tax gain from the sale of our indirect automobile finance subsidiary in February 2000. Excluding the gain, our net income for the year would have been $93.6 million or $3.32 per share on a diluted basis, up 46.8% from $63.8 million or $2.26 per share in 1999.

The increase in our adjusted net income between years was due to higher net income from our banking operations, as net income from our real estate investment activities declined $5.6 million to $4.4 million due primarily to lower net gains from sales of properties. On an adjusted basis, net income from our banking operations increased $35.4 million or 65.8% to $89.2 million due to the following:

- net interest income increased $54.4 million or 26.2% due to an increase in average interest-earning assets as our effective interest rate spread declined;

- provision for loan losses declined by $8.0 million due primarily to lower growth in our loan portfolio than a year ago and the sale of our indirect automobile finance subsidiary; and

- operating expense declined by $7.1 million due to lower general and administrative costs primarily associated with residential lending activities and the sale of our indirect automobile finance subsidiary. Our efficiency ratio (the percentage of our net interest income and other income excluding income from real estate investment activities and investment securities gains or losses used to cover our general and administrative costs) improved from 58.4% in 1999 to 46.2% in 2000.

Those favorable items were partially offset by a $8.1 million decline in other income, as an increase of $10.0 million in loan and deposit related fees were unable to offset the following:

- a $11.5 million decline in net gains on sales of loans and mortgage-backed securities due to a lower volume of loans being sold; and

- a $3.6 million loss in loan servicing fees compared to income of $1.7 million in 1999. Our current year loss resulted from a $6.1 million addition to the valuation allowance for mortgage servicing rights due to an increase in expected prepayments from the drop in late 2000 in mortgage interest rates.

For 2000, our return on average assets was 0.97% and our return on average equity was 17.17%. Excluding the gain on sale of subsidiary, our adjusted returns were 0.92% on average assets and 16.20% on average equity. Both these performance ratios compare favorably to 1999 when our return on average assets was 0.85% and our return on average equity was 12.70%.

Our assets increased $1.5 billion or 15.8% during 2000 to $10.9 billion at year-end, following a record 50.0% increase during 1999. Assets expanded in 2000 primarily from loan growth. Our single family loan originations decreased from $6.7 billion in 1999 to $5.0 billion in 2000, of which $1.7 billion were originated for sale in the secondary market. Of the current year's total, $405 million represented originations for portfolio of subprime credits as part of our continuing strategy to enhance the portfolio's net yield. In addition to single family loans, we originated $254 million of other loans during the year, including $115 million of construction and land loans and $57 million of automobile loans.

We funded our asset growth with deposits that increased 23.2% to $8.1 billion at December 31, 2000.

Non-performing assets totaled $55 million at December 31, 2000, up from $39 million a year ago. This increase was due primarily to a rise in residential non-performers, of which $11 million was in the subprime

category. When measured as a percentage of total assets, our non-performing assets rose from 0.42% at year-end 1999 to 0.50% at year-end 2000.

At December 31, 2000, the Bank exceeded all three regulatory capital tests, with capital-to-asset ratios of 6.42% in tangible and core capital and 12.94% in 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. For further information, see Business--Regulation--Regulation of the Bank--Insurance of Deposit Accounts on page 12, Financial Condition--Investments in Real Estate and Joint Ventures on page 39 and Financial Condition--Regulatory Capital Compliance on page 58.

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, borrowings and capital securities ("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 was $262.5 million in 2000, up $55.0 million or 26.5% from 1999 and $88.1 million or 50.5% greater than 1998. The 2000 improvement over 1999 primarily reflected an increase in average earning assets as our effective interest rate spread declined. Our average earning assets increased by $2.7 billion or 37.3% to $9.9 billion. Our effective interest rate spread averaged 2.66% in 2000, down from 2.88% in 1999 and 3.08% in 1998. The decline in the effective interest rate spread primarily reflected a higher proportion of earning assets in the current year being funded with higher cost certificates of deposit and borrowings thereby resulting in the cost of funds increasing more rapidly than the yield on earning assets. To a lesser extent, the sale of our indirect automobile lending subsidiary also contributed to the decline in the effective interest rate spread, as the loan yield on that portfolio was higher than the yield on our remaining loan portfolio.

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:

- o the difference between interest income on interest-earning assets and interest expense on interest-bearing liabilities, divided by

- o 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, borrowings and capital securities--for the periods 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 to the extent we believe we will recover the remaining principal balance of the loans. We computed average balances for the year using the average of each month's daily average balance during the periods indicated.

	2000			1999		
(Dollars in Thousands)	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Avera Yiel Rat
Interest-earning assets:						
Loans	$ 9,514,978	$760,538	7.99%	$6,937,342	$519,006	7.4
Mortgage-backed securities	15,959	1,060	6.64	26,361	1,638	6.2
Investment securities	346,192	22,762	6.57	232,746	13,107	5.6
Total interest-earning assets	9,877,129	784,360	7.94	7,196,449	533,751	7.4
Non-interest-earning assets	340,242			304,779		
Total assets	$10,217,371			$7,501,228		
Transaction accounts:						
Non-interest-bearing checking	$ 209,221	$ --	-- %	$ 165,271	$ --	--
Interest-bearing checking (1)	381,269	3,520	0.92	336,604	3,517	1.0
Money market	89,495	2,544	2.84	95,282	2,641	2.7
Regular passbook	796,212	27,841	3.50	767,238	26,224	3.4
Total transaction accounts	1,476,197	33,905	2.30	1,364,395	32,382	2.3
Certificates of deposit	5,814,653	345,398	5.94	4,332,897	224,382	5.1
Total deposits	7,290,850	379,303	5.20	5,697,292	256,764	4.5
Borrowings	2,118,497	130,419	6.16	1,175,704	64,161	5.4
Capital securities	120,000	12,163	10.14	52,903	5,348	10.1
Total deposits, borrowings and capital securities	9,529,347	521,885	5.48	6,925,899	326,273	4.7
Other liabilities	110,045			72,917		
Stockholders' equity	577,979			502,412		
Total liabilities and stockholders' equity	$10,217,371			$7,501,228		
Net interest income/interest rate spread		$262,475	2.46%		$207,478	2.7
Excess of interest-earning assets over						

deposits, borrowings and capital securities	$ 347,782		$ 270,550	
Effective interest rate spread		2.66		2.8