DOWNEY FINANCIAL CORP
Form 10-Q
August 03, 2005
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UNITED STATES
SECURITITES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **June 30, 2005**

OR

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

For the transition period from __________ to __________

Commission File Number **1-13578**

DOWNEY FINANCIAL CORP.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**33-0633413** (I.R.S. Employer Identification No.)
3501 Jamboree Road, Newport Beach, CA (Address of principal executive office)	**92660** (Zip Code)
Registrant s telephone number, including area code	**(949) 854-0300**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes **X** No__

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes **X** No__

At June 30, 2005, 27,853,783 shares of the Registrant s Common Stock, $0.01 par value were outstanding.

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DOWNEY FINANCIAL CORP.

JUNE 30, 2005 QUARTERLY REPORT ON FORM 10-Q

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in Thousands, Except Per Share Data)	*June 30, 2005*	*December 31, 2004*	*June 30, 2004*
Assets			
Cash	$ 128,670	$ 119,502	$ 126,361
Federal funds	30,001	-	-
Cash and cash equivalents	158,671	119,502	126,361
U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value	504,965	497,009	630,785
Loans held for sale, at lower of cost or fair value	914,277	1,118,475	661,481
Mortgage-backed securities available for sale, at fair value	292	304	321
Loans held for investment	14,528,766	13,458,713	12,343,385
Allowance for loan losses	(36,380)	(34,714)	(33,450)
Loans held for investment, net	14,492,386	13,423,999	12,309,935
Investments in real estate and joint ventures	58,941	55,411	31,517
Real estate acquired in settlement of loans	2,201	2,555	2,424
Premises and equipment	105,230	106,238	107,277
Federal Home Loan Bank stock, at cost	265,849	243,613	167,797
Investment in Downey Financial Capital Trust I	-	-	3,711
Mortgage servicing rights, net	16,833	17,964	92,049
Other assets	92,482	63,738	88,689
	$ 16,612,127	$ 15,648,808	$ 14,222,347
Liabilities and Stockholders Equity			
Deposits	$ 11,042,072	$ 9,657,978	$ 8,948,238
Securities sold under agreements to repurchase	-	-	239,688
Federal Home Loan Bank advances	4,002,757	4,559,622	3,556,087
Senior notes	198,004	197,924	198,179
Junior subordinated debentures	-	-	123,711
Accounts payable and accrued liabilities	126,521	108,217	88,608
Deferred income taxes	126,628	117,416	125,384
Total liabilities	15,495,982	14,641,157	13,279,895

Stockholders equity			
Preferred stock, par value of $0.01 per share; authorized 5,000,000 shares;			
outstanding none	-	-	-
Common stock, par value of $0.01 per share; authorized 50,000,000 shares;			
issued 28,235,022 shares at June 30, 2005, December 31, 2004 and			
June 30, 2004; outstanding 27,853,783 shares at both June 30, 2005 and			
December 31, 2004 and 27,968,283 shares at June 30, 2004	282	282	282
Additional paid-in capital	93,792	93,792	93,792
Accumulated other comprehensive income (loss)	(1,427)	318	(5,745)
Retained earnings	1,040,290	930,051	864,704
Treasury stock, at cost, 381,239 shares at both June 30, 2005 and			
December 31, 2004 and 266,739 shares at June 30, 2004	(16,792)	(16,792)	(10,581)
Total stockholders equity	1,116,145	1,007,651	942,452
	$ 16,612,127	$ 15,648,808	$ 14,222,347

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Income

(Dollars in Thousands, Except Per Share Data)	*Three Months Ended June 30,* 2005	*Three Months Ended June 30,* 2004	*Six Months Ended June 30,* 2005	*Six Months Ended June 30,* 2004
Interest income				
Loans	$ 189,641	$ 123,313	$ 362,648	$ 238,843
U.S. Treasury securities and agency obligations	5,029	6,332	9,867	10,396
Mortgage-backed securities	3	3	6	6
Other investments	3,120	1,594	5,658	2,792
Total interest income	197,793	131,242	378,179	252,037
Interest expense				
Deposits	60,962	34,662	109,985	67,262
Federal Home Loan Bank advances and other borrowings	39,572	16,543	73,552	32,248
Senior notes	3,296	292	6,591	292
Junior subordinated debentures	-	3,134	-	6,268
Total interest expense	103,830	54,631	190,128	106,070
Net interest income	93,963	76,611	188,051	145,967
Provision for loan losses	583	1,458	2,621	3,262
Net interest income after provision for loan losses	93,380	75,153	185,430	142,705
Other income, net				
Loan and deposit related fees	25,645	14,419	45,152	26,875
Real estate and joint ventures held for investment, net	1,728	7,048	4,308	7,974
Secondary marketing activities:				
Loan servicing income (loss), net	(2,529)	13,786	(1,045)	(459)
Net gains on sales of loans and mortgage-backed securities	48,848	15,675	79,463	17,047
Net gains on sales of mortgage servicing rights	-	-	981	-
Net gains (losses) on sales of investment securities	1	(21,271)	28	(19,159)
Litigation award	1,767	-	1,767	-
Other	339	523	859	855
Total other income, net	75,799	30,180	131,513	33,133

Operating expense				
Salaries and related costs	39,042	37,575	78,197	73,144
Premises and equipment costs	7,891	8,200	15,891	16,408
Advertising expense	1,551	1,165	2,901	2,873
SAIF insurance premiums and regulatory assessments	927	744	1,854	1,501
Professional fees	345	356	681	724
Other general and administrative expense	8,605	9,432	16,997	17,914
Total general and administrative expense	58,361	57,472	116,521	112,564
Net operation of real estate acquired in settlement of loans	(79)	(237)	(15)	(309)
Total operating expense	58,282	57,235	116,506	112,255
Income before income taxes	110,897	48,098	200,437	63,583
Income taxes	46,827	20,277	84,628	26,850
Net income	$ 64,070	$ 27,821	$ 115,809	$ 36,733
Per share information				
Basic	$ 2.30	$ 0.99	$ 4.16	$ 1.31
Diluted	$ 2.29	$ 0.99	$ 4.15	$ 1.31
Cash dividends declared and paid	$ 0.10	$ 0.10	$ 0.20	$ 0.20
Weighted average shares outstanding				
Basic	27,853,783	27,962,031	27,853,783	27,953,219
Diluted	27,884,276	27,990,588	27,883,058	27,985,565

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(In Thousands)	*Three Months Ended June 30,* 2005	2004	*Six Months Ended June 30,* 2005	2004
Net income	$ 64,070	$ 27,821	$ 115,809	$ 36,733
Other comprehensive income (loss), net of income taxes (benefits)				
Unrealized gains (losses) on securities available for sale:				
U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value	728	(5,962)	(1,715)	(6,272)
Mortgage-backed securities available for sale, at fair value	1	-	1	(1)
Reclassification of realized amounts included in net income	-	158	(17)	158
Unrealized gains (losses) on cash flow hedges:				
Net derivative instruments	23	1,869	(55)	2,507
Reclassification of realized amounts included in net income	(228)	(3,563)	41	(2,944)
Total other comprehensive income (loss), net of income taxes (benefits)	524	(7,498)	(1,745)	(6,552)
Comprehensive income	$ 64,594	$ 20,323	$ 114,064	$ 30,181

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In Thousands)	*Six Months Ended June 30,* 2005	2004
Cash flows from operating activities		
Net income	$ 115,809	$ 36,733
Adjustments to reconcile net income to net cash used for operating activities:		
Depreciation and amortization	46,148	42,168
Provision for losses on loans, real estate acquired in settlement of loans, investments in real estate and joint ventures, mortgage servicing rights and other assets	4,018	1,937
Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, investment securities, real estate and other assets	(83,141)	(4,579)
Interest capitalized on loans (negative amortization)	(47,860)	(4,965)
Federal Home Loan Bank stock dividends	(4,875)	(2,399)
Loans originated and purchased for sale	(4,947,439)	(2,206,985)
Proceeds from sales of loans held for sale, including those sold as mortgage-backed securities	5,200,591	1,822,422
Other, net	(61,312)	(48,685)
Net cash provided by (used for) operating activities	221,939	(364,353)
Cash flows from investing activities		
Proceeds from sales of:		
U.S. Treasury securities, agency obligations and other investment securities available for sale	-	1,259,216
Wholly owned real estate and real estate acquired in settlement of loans	1,752	10,446
Proceeds from maturities of U.S. Treasury securities, agency obligations and other investment securities available for sale	26,555	383,746
Purchase of:		
U.S. Treasury securities, agency obligations and other investment securities available for sale	(37,528)	(1,613,453)
Loans held for investment	(29,675)	(142,995)
Federal Home Loan Bank stock	(17,361)	(42,309)
Premises and equipment	(7,673)	(5,189)
Originations of loans held for investment (net of refinances of $336,310 for the six months ended June 30, 2005 and $329,019 for the six months ended June 30, 2004)	(3,068,844)	(4,146,060)
Principal payments on loans held for investment and mortgage-backed securities available for sale	2,092,954	2,029,626
Net change in undisbursed loan funds	33,621	132,137

Investments in real estate held for investment	(869)	(2,916)
Other, net	2,559	922
Net cash used for investing activities	(1,004,509)	(2,136,829)

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Continued)

	Six Months Ended June 30,	
(In Thousands)	*2005*	*2004*
Cash flows from financing activities		
Net increase in deposits	$ 1,384,094	$ 654,480
Proceeds from Federal Home Loan Bank advances and other borrowings	19,078,375	7,815,383
Repayments of Federal Home Loan Bank advances and other borrowings	(19,632,875)	(6,134,856)
Proceeds from the issuance of senior notes	-	198,182
Proceeds from reissuance of treasury stock and exercise of stock options	-	843
Cash dividends	(5,570)	(5,590)
Other, net	(2,285)	(14,066)
Net cash provided by financing activities	821,739	2,514,376
Net increase in cash and cash equivalents	39,169	13,194
Cash and cash equivalents at beginning of period	119,502	113,167
Cash and cash equivalents at end of period	$ 158,671	$ 126,361
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 183,597	$ 105,500
Income taxes	81,426	4,987
Supplemental disclosure of non-cash investing:		
Loans transferred to held for investment from held for sale	19,814	3,940
Loans transferred from held for investment to held for sale	106	283
Loans exchanged for mortgage-backed securities	480,497	1,153,683
Real estate acquired in settlement of loans	1,141	2,508
Loans to facilitate the sale of real estate acquired in settlement of loans	65	98

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE (1) Basis of Financial Statement Presentation

In the opinion of Downey Financial Corp. and subsidiaries (Downey, we, us and our), the accompanying consolidated financial statemen contain all adjustments (consisting of normal recurring accruals unless otherwise disclosed in this Form 10-Q) necessary for a fair presentation of Downey s financial condition as of June 30, 2005, December 31, 2004 and June 30, 2004, the results of operations and comprehensive income for the three months and six months ended June 30, 2005 and 2004, and changes in cash flows for the six months ended June 30, 2005 and 2004. Certain prior period amounts have been reclassified to conform to the current period presentation.

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

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

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

	Three Months Ended				
(Dollars in Thousands)	*June 30, 2005*	*March 31, 2005*	*December 31, 2004*	*September 30, 2004*	*June 30, 2004*
Gross balance at beginning of period	$ 20,834	$ 20,502	$ 99,127	$ 95,813	$ 91,766
Additions	1,217	1,609	1,835	12,114	12,074
Amortization	(1,398)	(1,160)	(2,998)	(5,190)	(4,082)
Sales	-	(14)	(61,663)	-	-
Impairment write-down	(27)	(103)	(15,799)	(3,610)	(3,945)
Gross balance at end of period	20,626	20,834	20,502	99,127	95,813
Allowance balance at beginning of period	1,224	2,538	16,832	3,764	22,045
Provision for (reduction of) impairment	2,596	(1,211)	1,505	16,678	(14,336)
Impairment write-down	(27)	(103)	(15,799)	(3,610)	(3,945)
Allowance balance at end of period	3,793	1,224	2,538	16,832	3,764
Total mortgage servicing rights, net	$ 16,833	$ 19,610	$ 17,964	$ 82,295	$ 92,049
As a percentage of associated mortgage loans	0.75 %	0.89 %	0.86 %	0.82 %	1.00 %
Estimated fair value [(a)]	$ 16,863	$ 19,665	$ 17,968	$ 82,401	$ 92,483
Weighted average expected life (in months)	40	54	53	57	67

Custodial account earnings rate	3.45 %	3.21 %	2.69 %	2.24 %	2.10 %
Weighted average discount rate	9.12	9.13	9.03	9.27	8.97
At period end					
Mortgage loans serviced for others:					
Total	$ 10,287,991	$ 8,043,655	$ 6,672,984	$ 10,568,339	$ 9,279,359
With capitalized mortgage servicing rights:[(a)]					
Amount	2,249,030	2,207,403	2,100,452	10,075,028	9,242,641
Weighted average interest rate	5.57 %	5.57 %	5.59 %	5.52 %	5.61 %
Total loans sub-serviced without mortgage					
servicing rights:[(b)]					
Term less than six months	$ 315,448	$ 475,327	$ 610,263	$ -	$ -
Term indefinite	7,698,176	5,332,613	3,931,483	459,307	-
Custodial account balances	$ 237,722	$ 157,624	$ 143,765	$ 229,704	$ 238,914

[(a)] The estimated fair value may exceed book value for certain asset strata and excluded loans sold or securitized prior to 1996 and loans sub-serviced without capitalized MSRs.
[(b)] Servicing is performed for a fixed fee per loan each month.

(Dollars in Thousands)	*Six Months Ended June 30,* 2005	2004
Gross balance at beginning of period	$ 20,502	$ 95,183
Additions	2,826	18,042
Amortization	(2,558)	(9,601)
Sales	(14)	-
Impairment write-down	(130)	(7,811)
Gross balance at end of period	20,626	95,813
Allowance balance at beginning of period	2,538	13,008
Provision for (reduction of) impairment	1,385	(1,433)
Impairment write-down	(130)	(7,811)
Allowance balance at end of period	3,793	3,764
Total mortgage servicing rights, net	$ 16,833	$ 92,049

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

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

(Dollars in Thousands)	*Expected Prepayment Speeds*	*Custodial Accounts Rate*	*Discount Rate*	*Combination*
Increase rates 100 basis points: [a]				
Increase (decrease) in fair value	$ 4,141	$ 1,101	$ (550)	$ 4,539
Reduction of (increase in) valuation allowance	3,062	1,073	(541)	3,461
Decrease rates 100 basis points: [b]				
Increase (decrease) in fair value	(7,028)	(1,141)	537	(8,249)
Reduction of (increase in) valuation allowance	(6,998)	(1,117)	528	(8,219)

[(a)] *The weighted-average expected life of the MSRs portfolio is 57 months.*
[(b)] *The weighted-average expected life of the MSRs portfolio is 12 months.*

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

	Three Months Ended				
(In Thousands)	*June 30, 2005*	*March 31, 2005*	*December31, 2004*	*September 30, 2004*	*June 30, 2004*
Net cash servicing fees	$ 1,753	$ 1,627	$ 3,595	$ 6,031	$ 5,615
Payoff and curtailment interest cost [(a)]	(288)	(194)	(968)	(1,053)	(2,083)
Amortization of mortgage servicing rights	(1,398)	(1,160)	(2,998)	(5,190)	(4,082)
(Provision for) reduction of impairment of mortgage servicing rights	(2,596)	1,211	(1,505)	(16,678)	14,336
Total loan servicing income (loss), net	$ (2,529)	$ 1,484	$ (1,876)	$ (16,890)	$ 13,786

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

(In Thousands)	*Six Months Ended June 30,* 2005	2004
Net cash servicing fees	$ 3,380	$ 11,319
Payoff and curtailment interest cost [a]	(482)	(3,610)
Amortization of mortgage servicing rights	(2,558)	(9,601)
(Provision for) reduction of impairment of mortgage servicing rights	(1,385)	1,433
Total loan servicing loss, net	$ (1,045)	$ (459)

[a] *Represents the difference between the contractual obligation to pay interest to the investor for an entire month and the actual interest received when a loan prepays prior to the end of the month. This does not include the benefit of the use of repaid loan funds to increase net interest income.*

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

Derivatives

Downey offers short-term interest rate lock commitments to help attract potential home loan borrowers. The commitments guarantee a specified interest rate for a loan if underwriting standards are met, but do not obligate the potential borrower. Accordingly, some commitments never become loans and merely expire. The residential one-to-four unit rate lock commitments Downey ultimately expects to result in loans and sell in the secondary market are treated as derivatives. Consequently, as derivatives, the hedging of the expected rate lock commitments do not qualify for hedge accounting. Associated fair value adjustments to the notional amount of the expected rate lock commitments are recorded in current earnings under net gains (losses) on sales of loans and mortgage-backed securities with an offset to the balance sheet in either other assets, or accounts payable and accrued liabilities. Fair values for the notional amount of expected rate lock commitments are based on observable market prices acquired from third parties. The carrying amount of loans held for sale includes a basis adjustment to the loan balance at funding resulting from the change in fair value of the rate lock derivative from the date of commitment to the date of funding. At June 30, 2005, Downey had a notional amount of expected rate lock commitments identified to sell as part of its secondary marketing activities of $625 million, with a change in fair value resulting in a gain of $0.1 million.

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

Hedging Activities

As part of secondary marketing activities, Downey typically utilizes short-term forward sale and purchase contracts derivatives that mature in less than one year to offset the impact of changes in market interest rates on the value of residential one-to-four unit expected rate lock commitments and loans held for sale. In general, rate lock commitments associated with fixed rate loans require a higher percentage of forward sale contracts to mitigate interest rate risk than those associated with adjustable rate loans. Contracts designated as hedges for the forecasted sale of loans from the held for sale portfolio are accounted for as cash flow hedges because these contracts have a high correlation to the price movement of the loans being hedged (within a range of 80% - 125%). The measurement approach for determining the ineffective aspects of the hedge is established at the inception of the hedge. Changes in fair value of the notional amount of forward sale contracts not designated as cash flow hedges and the ineffectiveness of hedge transactions that are not perfectly correlated are recorded in net gains (losses) on sales of loans and mortgage-backed securities. Changes in expected future cash flows related to the fair value of the notional amount of forward sale contracts designated as cash flow hedges for the forecasted sale of loans held for sale are recorded in other comprehensive income, net of tax, provided cash flow hedge requirements are met. The offset to these changes are recorded in the balance sheet as either other assets, or accounts payable and accrued liabilities. The amounts recorded in accumulated other comprehensive income will be recognized in the income statement when the hedged forecasted transactions settle. Downey estimates that all of the related unrealized gains or losses in accumulated other comprehensive income will be reclassified into earnings within the next three months. Fair values for the notional amount of forward sale contracts are based on observable market prices acquired from third parties. At June 30, 2005, the notional amount of forward sale contracts amounted to $1.478 billion, with a change in fair value resulting in a loss of less than $0.1 million related to undesignated contracts and a gain of $0.7 million related to designated cash flow hedges with a notional amount of $905 million. There were no forward purchase contracts at June 30, 2005.

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

In connection with its interest rate risk management, Downey from time-to-time enters into interest rate exchange agreements ("swap contracts") with certain national investment banking firms or the Federal Home Loan Bank ("FHLB") under terms that provide mutual payment of interest on the outstanding notional amount of swap contracts. These swap contracts help Downey manage the effects of adverse changes in interest rates on net interest income. Downey has interest rate swap contracts on which Downey pays variable interest based on the 3-month London Inter-Bank Offered Rate ("LIBOR") while receiving fixed interest. The swaps were designated as a hedge of changes in the fair value of certain FHLB fixed rate advances due to changes in market interest rates. The payment and maturity dates of the swap contracts match those of the advances. This hedge effectively converts fixed interest rate advances into debt that adjusts quarterly to movements in 3-month LIBOR. Because the terms of the swap contracts match those of the advances, the hedge has no ineffectiveness and results are reported in interest expense. The fair value of interest rate swap contracts is based on observable market prices acquired from third parties and represents the estimated amount Downey would receive or pay upon terminating the contracts, taking into consideration current interest rates and the remaining contract terms. The fair value of the swap contracts is recorded on the balance sheet in either other assets or accounts payable and accrued liabilities. With no ineffectiveness, the recorded swap contract values will essentially act as fair value adjustments to the advances being hedged. At June 30, 2005, swap contracts with a notional amount totaling $430 million were outstanding and had a fair value loss of $10.8 million recorded on the balance sheet in accounts payable and accrued liabilities and as a decrease to the advances being hedged.

The following table summarizes Downey s interest rate swap contracts at June 30, 2005:

(Dollars in Thousands)		*Notional Amount*	*Weighted Average Interest Rate*	*Term*	
Pay	Variable (3-month LIBOR)	$ (100,000)	3.32 %	March 2004	October 2008
Receive	Fixed	100,000	3.20		
Pay	Variable (3-month LIBOR)	(130,000)	3.32	March 2004	October 2008
Receive	Fixed	130,000	3.21		
Pay	Variable (3-month LIBOR)	(100,000)	3.32	March 2004	November 2008
Receive	Fixed	100,000	3.26		
Pay	Variable (3-month LIBOR)	(100,000)	3.32	March 2004	November 2008
Receive	Fixed	100,000	3.27		

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

	Three Months Ended				
(In Thousands)	*June 30, 2005*	*March 31, 2005*	*December 31, 2004*	*September 30, 2004*	*June 30, 2004*
Net gains (losses) on non-qualifying hedge transactions	$ 1,258	$ 2,913	$ (5,030)	$ 2,595	$ 3,352
Net gains (losses) on qualifying cash flow hedge transactions:					
Unrealized hedge ineffectiveness	-	-	-	-	-
Less reclassification of realized hedge ineffectiveness	-	-	-	-	-

Total net gains (losses) recognized in sales of loans and					
mortgage-backed securities (SFAS 133 effect)	1,258	2,913	(5,030)	2,595	3,352
Other comprehensive income (loss)	(205)	191	(293)	822	(1,694)
Notional amount or balance at period end					
Non-qualifying hedge transactions:					
Expected rate lock commitments	$ 624,604	$ 727,899	$ 367,650	$ 462,441	$ 541,358
Associated forward sale contracts	572,977	633,031	368,822	448,999	374,462
Associated forward purchase contracts	-	-	-	-	-
Qualifying cash flow hedge transactions:					
Loans held for sale, at lower of cost or fair value	914,277	1,255,104	1,118,475	845,913	661,481
Associated forward sale contracts	905,373	1,247,969	1,115,636	838,567	652,796
Qualifying fair value hedge transactions:					
Designated FHLB advances pay-fixed	430,000	430,000	430,000	430,000	430,000
Associated interest rate swap contracts					
pay-variable, receive-fixed	430,000	430,000	430,000	430,000	430,000

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	Six Months Ended June 30,	
(In Thousands)	*2005*	*2004*
Net gains on non-qualifying hedge transactions	$ 4,171	$ 70
Net gains on qualifying cash flow hedge transactions:		
Unrealized hedge ineffectiveness	-	-
Less reclassification of realized hedge ineffectiveness	-	-
Total net gains recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	4,171	70
Other comprehensive loss	(14)	(437)

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

Financial Instruments with Off-Balance Sheet Risk

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

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

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

(In Thousands)	*June 30, 2005*	*March 31, 2005*	*December 31, 2004*	*September 30, 2004*	*June 30, 2004*
Commitments to originate loans held for investment:					
Adjustable	$ 228,310	$ 241,414	$ 738,102	$ 683,429	$ 479,968
Undisbursed loan funds and unused lines of credit	491,375	494,210	457,815	426,055	372,464
Commitments to invest in community development funds [(a)]	1,832	5,445	5,129	5,771	5,226

[a] *At June 30, 2005, outstanding commitments to invest in community development funds totaled $5.9 million. Of this amount, $4.1 million was related to projects with disbursements that are likely to occur and are therefore placed on the balance sheet and recorded in other assets and other liabilities.*

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

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

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Other Contractual Obligations

Downey sells all loans without recourse. When a loan sold to an investor without recourse fails to perform according to the contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred and whether such defects give rise to a violation of a representation or warranty made to the investor in connection with the sale. If such a defect is identified, Downey may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, Downey has no commitment to repurchase the loan. During the first six months of 2005, Downey recorded less than a $1 million repurchase loss related to defects in the origination process. These loan and servicing sale contracts typically contain provisions to refund sales price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Downey had a reserve of $1 million at June 30, 2005, $7 million at December 31, 2004 and less than $1 million at June 30, 2004 to cover the estimated loss exposure related to early payoffs.

Through the normal course of business, Downey has entered into certain contractual obligations generally related to the funding of operations through deposits and borrowings, as well as leases for premises and equipment. Downey has obligations under long-term operating leases, principally for building space and land. Lease terms generally cover a five-year period, with options to extend, and are non-cancelable. Downey also has vendor contractual relationships, but the contracts are not considered to be material.

At June 30, 2005, scheduled maturities of certificates of deposit, FHLB advances, senior notes and future operating minimum lease commitments were as follows:

(In Thousands)	*Within 1 Year*	*1 3 Years*	*4 5 Years*	*Over 5 Years*	*Total Balance*
Certificates of deposit	$ 6,387,443	$ 907,441	$ 213,752	$ -	$ 7,508,636
FHLB advances and other borrowings	3,417,457	126,300	430,000	29,000	4,002,757
Senior notes	-	-	-	198,004	198,004
Operating leases	4,004	7,796	4,256	2,445	18,501
Total other contractual obligations	$ 9,808,904	$ 1,041,537	$ 648,008	$ 229,449	$ 11,727,898

Litigation

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

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

NOTE (4) Income Taxes

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

NOTE (5) Employee Stock Option Plans

Downey has a Long Term Incentive Plan (the LTIP), which provides for the granting of stock appreciation rights, restricted stock, performance awards and other awards. The LTIP specifies an authorization of 434,110 shares (adjusted for stock dividends and splits) of common stock to be available for issuance, of which 131,851 shares are available for future grants. Under the LTIP, options are exercisable over vesting periods specified in each grant and, unless exercised, the options terminate in five or ten years from the date of the grant. Further, under the LTIP, the option price shall at least equal or exceed the fair market value of such shares on the date the options are granted. No shares have been granted under the LTIP since 1998. At June 30, 2005, Downey had 381,239 shares of treasury stock that may be used to satisfy the exercise of options or for payment of other awards. No other stock-based compensation plan exists.

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

NOTE (6) Earnings Per Share

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

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

	Three Months Ended June 30,					
	2005			*2004*		
(Dollars in Thousands, Except Per Share Data)	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*
Basic earnings per share	$ 64,070	27,853,783	$ 2.30	$ 27,821	27,962,031	$ 0.99
Effect of dilutive stock options	-	30,493	0.01	-	28,557	-
Diluted earnings per share	$ 64,070	27,884,276	$ 2.29	$ 27,821	27,990,588	$ 0.99

	Six Months Ended June 30,					
	2005			*2004*		
(Dollars in Thousands, Except Per Share Data)	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*	*Net Income*	*Weighted Average Shares Outstanding*	*Per Share Amount*

Basic earnings per share	$ 115,809	27,853,783	$ 4.16	$ 36,733	27,953,219	$ 1.31
Effect of dilutive stock options	-	29,275	0.01	-	32,346	-
Diluted earnings per share	$ 115,809	27,883,058	$ 4.15	$ 36,733	27,985,565	$ 1.31

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

NOTE (7) Business Segment Reporting

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

(In Thousands)	*Banking*	*Real Estate Investment*	*Elimination*	*Totals*
Three months ended June 30, 2005				
Net interest income	$ 93,853	$ 110	$ -	$ 93,963
Provision for loan losses	583	-	-	583
Other income	73,768	2,031	-	75,799
Operating expense	58,030	252	-	58,282
Net intercompany income (expense)	(39)	39	-	-
Income before income taxes	108,969	1,928	-	110,897
Income taxes	46,037	790	-	46,827
Net income	$ 62,932	$ 1,138	$ -	$ 64,070
At June 30, 2005				
Assets:				
Loans and mortgage-backed securities, net	$ 15,406,955	$ -	$ -	$ 15,406,955
Investments in real estate and joint ventures	-	58,941	-	58,941
Other	1,196,756	17,833	(68,358)	1,146,231
Total assets	16,603,711	76,774	(68,358)	16,612,127
Equity	$ 1,116,145	$ 68,358	$ (68,358)	$ 1,116,145
Three months ended June 30, 2004				
Net interest income (expense)	$ 76,842	$ (231)	$ -	$ 76,611
Provision for loan losses	1,458	-	-	1,458
Other income	22,724	7,456	-	30,180
Operating expense	56,908	327	-	57,235
Net intercompany income (expense)	(43)	43	-	-
Income before income taxes	41,157	6,941	-	48,098
Income taxes	17,431	2,846	-	20,277
Net income	$ 23,726	$ 4,095	$ -	$ 27,821
At June 30, 2004				
Assets:				
	$ 12,971,737	$ -	$ -	$ 12,971,737

Loans and mortgage-backed securities, net				
Investments in real estate and joint ventures	-	31,517	-	31,517
Other	1,239,475	11,845	(32,227)	1,219,093
Total assets	14,211,212	43,362	(32,227)	14,222,347
Equity	$ 942,452	$ 32,227	$ (32,227)	$ 942,452

(In Thousands)	*Banking*	*Real Estate Investment*	*Elimination*	*Totals*
Six months ended June 30, 2005				
Net interest income	$ 187,838	$ 213	$ -	$ 188,051
Provision for loan losses	2,621	-	-	2,621
Other income	126,666	4,847	-	131,513
Operating expense	115,888	618	-	116,506
Net intercompany income (expense)	(77)	77	-	-
Income before income taxes	195,918	4,519	-	200,437
Income taxes	82,776	1,852	-	84,628
Net income	$ 113,142	$ 2,667	$ -	$ 115,809
Six months ended June 30, 2004				
Net interest income (expense)	$ 146,286	$ (319)	$ -	$ 145,967
Provision for loan losses	3,262	-	-	3,262
Other income	24,415	8,718	-	33,133
Operating expense	111,607	648	-	112,255
Net intercompany income (expense)	(81)	81	-	-
Income before income taxes	55,751	7,832	-	63,583
Income taxes	23,638	3,212	-	26,850
Net income	$ 32,113	$ 4,620	$ -	$ 36,733

NOTE (8) Current Accounting Issues

Statement of Financial Accounting Standards No. 123R

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

Statement of Financial Accounting Standards No. 153

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

Statement of Financial Accounting Standards No. 154

Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), replaces APB No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Changes in Interim Financial Statements. APB No. 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. SFAS 154 changes the accounting for, and reporting of, a change in accounting principle. SFAS 154 requires retrospective application to prior period s financial statements of voluntary changes in accounting principle and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005, though early adoption is permitted as of the date this Statement was issued, which was May of 2005. SFAS 154 is not expected to have a material financial impact on Downey.

Emerging Issues Task Force Issue No. 03-1

In March of 2004, the Emerging Issues Task Force ("EITF") reached consensus on the guidance provided in EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments." Among other investments, this guidance is applicable to debt and equity securities that are within the scope of Statement No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Paragraph 10 of EITF 03-1 specifies that an impairment would be considered other-than-temporary unless (a) the investor has the ability and intent to hold an investment for a reasonable period of time sufficient for the recovery of the fair value up to (or beyond) the cost of the investment and (b) evidence indicating that the cost of the investment is recoverable within a reasonable period of time outweighs evidence to the contrary. A company s liquidity and capital requirements should be considered when assessing its intent and ability to hold an investment for a reasonable period of time that would allow the fair value of the investment to recover up to or beyond its cost. A pattern of selling investments prior to the forecasted fair value recovery may call into question a company s intent. In addition, the severity and duration of the impairment should also be considered when determining whether the impairment is other-than-temporary. This guidance was effective for reporting periods beginning after June 15, 2004 with the exception of paragraphs 10 - 20 of EITF 03-1, which was to be deliberated further.

Subsequently, the Board decided not to provide additional guidance on the meaning of other-than-temporary impairment, but directed the staff to issue proposed FASB Staff Position (FSP) EITF 03-1a, Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1, as final. The final FSP (retitled FSP FAS 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments) will replace the guidance set forth in paragraphs 10-18 of Issue 03-1. FSP FAS 115-1 will clarify that an investor should recognize an impairment loss no later than when the impairment is deemed other than temporary, even if a decision to sell has not been made. The Board decided that FSP FAS 115-1 would be effective for other-than-temporary impairment analysis conducted in periods beginning after September 15, 2005. It is not expected to have a material financial impact on Downey.

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

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

OVERVIEW

Our net income for the second quarter of 2005 totaled $64.1 million or $2.29 per share on a diluted basis, up from $27.8 million or $0.99 per share in the second quarter of 2004.

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

- a $33.2 million increase in our net gains from sales of loans and mortgage-backed securities due to a higher volume and gain per dollar of loans sold;
- a $21.3 million favorable change associated with securities gains/losses, as the year-ago quarter included a loss associated with a partial economic hedge against value changes in mortgage servicing rights (MSRs);
- a $17.4 million or 22.6% increase in our net interest income reflecting growth in average interest-earning assets; and
- a $11.2 million increase in loan and deposit related fees primarily reflecting higher loan prepayment fees.

Those favorable factors were partially offset by:

- a $16.3 million unfavorable change in loan servicing activities, as the year-ago quarter included a $14.3 million recapture from the valuation allowance for MSRs compared to a $2.6 million provision in the current quarter; and
- a $5.3 million decline in our income from real estate and joint ventures held for investment due primarily to lower gains from sales.

For the first six months of 2005, our net income totaled $115.8 million or $4.15 per share on a diluted basis, more than triple the $36.7 million or $1.31 per share for the first six months of 2004. The increase primarily reflected higher gains from sales of loans and mortgage-backed securities, higher net interest income, a favorable change in securities gains/losses and an increase in loan and deposit related fees. Those favorable items were partially offset by higher operating expense and a decline in our income from real estate held for investment.

For the current quarter, our return on average assets was 1.51%, up from 0.83% a year ago, while our return on average equity was 23.62%, up from 11.95% a year ago. For the first six-month periods, our return on average assets increased from 0.58% a year ago to 1.40%, while our return on average equity increased from 7.94% to 21.90%.

Our loan originations (including purchases) totaled $4.133 billion in the current quarter, up 6.8% from $3.869 billion a year ago. Loans originated for sale increased $1.487 billion to $2.766 billion, while single family loans originated for portfolio declined by $1.117 billion to $1.272 billion. Of the current quarter total originated for portfolio, $133 million represented subprime credits. At quarter end, the subprime portfolio totaled $1.3 billion, with an average loan-to-value ratio at origination of 71% and, of the total, 96% represented "Alt. A and A-" credits. In addition to single family loans, $94 million of other loans were originated in the current quarter.

At quarter end, our assets totaled $16.612 billion, up $2.390 billion or 16.8% from a year ago and up $963 million or 6.2% from year-end 2004. During the current quarter, our assets declined $281 million due primarily to a $341 million decline in loans held for sale.

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At June 30, 2005, our deposits totaled $11.042 billion, up 23.4% from the year-ago level and $1.384 billion or 14.3% since year-end 2004. During the quarter, three new traditional branches were opened. This brings our total number of branches to 172, of which 92 were in-store and four were located in Arizona. A year ago, we had 167 branches, of which 95 were in-store and three were located in Arizona.

Our non-performing assets declined $4 million during the quarter to $25 million or 0.15% of total assets. The decrease occurred in our prime residential loan category, which was partially offset by an increase in our subprime residential loan category.

At June 30, 2005, Downey Savings and Loan Association, F.A. (the "Bank"), our primary subsidiary, exceeded all regulatory capital tests, with capital-to-asset ratios of 7.31% for both tangible and core capital and 14.11% for risk-based capital. These capital levels are significantly above the well capitalized standards defined by the federal banking regulators of 5% for core and tangible capital and 10% for risk-based capital.

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CRITICAL ACCOUNTING POLICIES

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey s Annual Report on Form 10-K for the year ended December 31, 2004. Certain accounting policies