

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

DOWNEY FINANCIAL CORP
Form 10-Q
October 31, 2002

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended SEPTEMBER 30, 2002

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

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

Title of each class -----	Name of each exchange on which registered -----
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

At September 30, 2002, 28,022,722 shares of the Registrant's Common Stock, \$0.01 par value were outstanding.

DOWNEY FINANCIAL CORP.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

SEPTEMBER 30, 2002 QUARTERLY REPORT ON FORM 10-Q

TABLE OF CONTENTS

PART I

ITEM 1. FINANCIAL INFORMATION.....	1
Consolidated Balance Sheets.....	1
Consolidated Statements of Income.....	2
Consolidated Statements of Comprehensive Income.....	3
Consolidated Statements of Cash Flows.....	4
Notes To Consolidated Financial Statements.....	6
ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.....	13
ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.....	42
ITEM 4. CONTROLS AND PROCEDURES.....	42

PART II

ITEM 1. LEGAL PROCEEDINGS.....	43
ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.....	43
ITEM 3. DEFAULTS UPON SENIOR SECURITIES.....	43
ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.....	43
ITEM 5. OTHER INFORMATION.....	43
ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.....	43
SIGNATURES	45

i

PART I

ITEM 1. - FINANCIAL INFORMATION

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Dollars in Thousands, Except Per Share Data)	September 30, 2002

ASSETS	
Cash	\$ 135,493
Federal funds	16,702

Cash and cash equivalents	152,195

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value	267,243
Municipal securities held to maturity, at amortized cost (estimated fair value of \$6,372 at September 30, 2002, \$6,373 at December 31, 2001 and \$6,533 at September 30, 2001)	6,387
Loans held for sale, at lower of cost or fair value	665,587
Mortgage-backed securities available for sale, at fair value	1,019,030
Loans receivable held for investment	10,000,420
Investments in real estate and joint ventures	40,371
Real estate acquired in settlement of loans	15,441
Premises and equipment	113,258
Federal Home Loan Bank stock, at cost	116,041
Mortgage servicing rights, net	46,912
Other assets	75,197
	\$ 12,518,082
=====	
LIABILITIES AND STOCKHOLDERS' EQUITY	
Deposits	\$ 9,056,932
Federal Home Loan Bank advances and other borrowings	1,869,789
Accounts payable and accrued liabilities	618,068
Deferred income taxes	62,680
	11,607,469

Company obligated mandatorily redeemable capital securities of subsidiary trust holding solely junior subordinated debentures of the Company ("Capital Securities")	120,000
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 September 30, 2002 and 28,213,048 shares at December 31, 2001 and September 30, 2001	282
Additional paid-in capital	93,792
Accumulated other comprehensive income (loss)	274
Retained earnings	704,978
Treasury stock, at cost, 212,300 shares at September 30, 2002	(8,713)
	790,613

	\$ 12,518,082
=====	

See accompanying notes to consolidated financial statements.

1

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended September 30,	
	2002	2001

(Dollars in Thousands, Except Per Share Data)	2002	2001

INTEREST INCOME		

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Loans receivable	\$ 150,987	\$ 187,867
U.S. Treasury securities and agency obligations	2,190	3,727
Mortgage-backed securities	287	62
Other investments	1,460	2,040
<hr/>		
Total interest income	154,924	193,696
<hr/>		
INTEREST EXPENSE		
Deposits	59,598	107,033
Borrowings	15,314	10,176
Capital securities	3,040	3,040
<hr/>		
Total interest expense	77,952	120,249
<hr/>		
NET INTEREST INCOME	76,972	73,447
PROVISION FOR LOAN LOSSES	471	791
<hr/>		
Net interest income after provision for loan losses	76,501	72,656
<hr/>		
OTHER INCOME, NET		
Loan and deposit related fees	11,848	13,274
Real estate and joint ventures held for investment, net	2,407	746
Secondary marketing activities:		
Loan servicing loss, net	(18,963)	(11,771)
Net gains (losses) on sales of loans and mortgage-backed securities	(971)	4,234
Net gains on sales of mortgage servicing rights	--	87
Net gains on sales of investment securities	--	3
Other	913	497
<hr/>		
Total other income (loss), net	(4,766)	7,070
<hr/>		
OPERATING EXPENSE		
Salaries and related costs	29,067	24,943
Premises and equipment costs	7,916	6,628
Advertising expense	1,066	939
Professional fees	91	2,432
SAIF insurance premiums and regulatory assessments	765	786
Other general and administrative expense	7,474	5,981
<hr/>		
Total general and administrative expense	46,379	41,709
<hr/>		
Net operation of real estate acquired in settlement of loans	110	110
Amortization of excess cost over fair value of branch acquisitions	111	116
<hr/>		
Total operating expense	46,600	41,935
<hr/>		
INCOME BEFORE INCOME TAXES	25,135	37,791
Income taxes	10,631	16,025
<hr/>		
NET INCOME	\$ 14,504	\$ 21,766
<hr/>		
PER SHARE INFORMATION		
BASIC	\$ 0.52	\$ 0.77
<hr/>		
DILUTED	\$ 0.52	\$ 0.77
<hr/>		
CASH DIVIDENDS DECLARED AND PAID	\$ 0.09	\$ 0.09
<hr/>		
Weighted average diluted shares outstanding	28,132,199	28,278,485
<hr/>		

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

See accompanying notes to consolidated financial statements.

2

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In Thousands)	Three Months Ended September 30,	
	2002	2001
NET INCOME	\$ 14,504	\$ 21,766
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	104	973
Mortgage-backed securities available for sale, at fair value	774	9
Less reclassification of realized gains included in net income	--	(2)
Unrealized gains (losses) on cash flow hedges:		
Net derivative instruments	(3,383)	(3,052)
Less reclassification of realized losses included in net income ...	2,543	575
Total other comprehensive income (loss), net of income taxes (benefits)	38	(1,497)
COMPREHENSIVE INCOME	\$ 14,542	\$ 20,269

See accompanying notes to consolidated financial statements.

3

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	\$
Adjustments to reconcile net income to net cash used for operating activities:	
Depreciation and amortization	
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	
Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, investment securities, real estate and other assets	
Interest capitalized on loans (negative amortization)	
Federal Home Loan Bank stock dividends	
Loans originated for sale	(4
Proceeds from sales of loans held for sale, including those sold via mortgage-backed securities	4

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

(Increase) decrease in other, net	

Net cash provided by (used for) operating activities	

CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales of:	
U.S. Treasury securities, agency obligations and other investment securities available for sale	
Wholly owned real estate and real estate acquired in settlement of loans	
Proceeds from maturities of U.S. Treasury securities, agency obligations and other investment securities available for sale	
Purchase of:	
U.S. Treasury securities, agency obligations and other investment securities available for sale	
Mortgage-backed securities available for sale	
Loans receivable held for investment	
Premises and equipment	
Originations of loans receivable held for investment (net of refinances of \$606,919 for the nine months ended September 30, 2002 and \$557,183 for the nine months ended	
September 30, 2001)	(2
Principal payments on loans receivable held for investment and mortgage-backed securities available for sale	2
Net change in undisbursed loan funds	
Investments in real estate held for investment	
Other, net	

Net cash provided by (used for) investing activities	

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

(In Thousands)	Nine Month September	2002

CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	\$	437,366
Proceeds from Federal Home Loan Bank advances and other borrowings		4,325,258
Repayments of Federal Home Loan Bank advances and other borrowings		(3,978,181)
Purchase of treasury stock		(8,713)
Proceeds from exercise of stock options		392
Cash dividends		(7,602)

Net cash provided by (used for) financing activities		768,520

Net increase (decrease) in cash and cash equivalents		9,115
Cash and cash equivalents at beginning of period		143,080

CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$	152,195
=====		
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Interest	\$	243,440	\$
Income taxes		21,992	
Supplemental disclosure of non-cash investing:			
Loans transferred to held for investment from held for sale		2,475	
Loans transferred from held for investment to wholly owned real estate		--	
Mortgage-backed securities available for sale, purchased and not settled ..		510,224	
Loans exchanged for mortgage-backed securities		3,401,952	
Real estate acquired in settlement of loans		20,245	
Loans to facilitate the sale of real estate acquired in settlement of loans		10,778	

See accompanying notes to consolidated financial statements.

5

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE (1) - BASIS OF FINANCIAL STATEMENT PRESENTATION

In the opinion of Downey Financial Corp. and subsidiaries ("Downey," "we," "us" and "our"), the accompanying consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation of Downey's financial condition as of September 30, 2002, December 31, 2001 and September 30, 2001, the results of operations and comprehensive income for the three months and nine months ended September 30, 2002 and 2001, and changes in cash flows for the nine months ended September 30, 2002 and 2001. 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 accounting principles generally accepted in the United States of America 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 following information under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations is written with the presumption 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, 2001, 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, 2001 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) - EARNINGS PER SHARE

Earnings per share is calculated on both a basic and diluted basis. 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 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.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Three Months Ended September				
2002				
(Dollars in Thousands, Except Per Share Data)	Net Income	Weighted Average Shares Outstanding	Per Share Amount	Net Income
Basic earnings per share	\$14,504	28,092,920	\$0.52	\$21,766
Effect of dilutive stock options	--	39,279	--	--
Diluted earnings per share	\$14,504	28,132,199	\$0.52	\$21,766

Nine Months Ended September				
2002				
(Dollars in Thousands, Except Per Share Data)	Net Income	Weighted Average Shares Outstanding	Per Share Amount	Net Income
Basic earnings per share	\$72,127	28,179,585	\$2.56	\$81,085
Effect of dilutive stock options	--	49,703	--	--
Diluted earnings per share	\$72,127	28,229,288	\$2.56	\$81,085

6

NOTE (3) - BUSINESS SEGMENT REPORTING

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

(In Thousands)	Banking	Real Estate Investment	Elimination
THREE MONTHS ENDED SEPTEMBER 30, 2002			
Net interest income	\$ 76,960	\$ 12	\$ --
Provision for loan losses	471	--	--
Other income (loss)	(7,507)	2,741	--
Operating expense	46,439	161	--
Net intercompany income (expense)	100	(100)	--
Income before income taxes	22,643	2,492	--
Income taxes	9,607	1,024	--
Net income	\$ 13,036	\$ 1,468	\$ --
AT SEPTEMBER 30, 2002			
Assets:			
Loans and mortgage-backed securities	\$ 11,685,037	\$ --	\$ --
Investments in real estate and joint ventures	--	40,371	--
Other	828,500	4,090	(39,916)

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total assets	12,513,537	44,461	(39,916)
Equity	\$ 790,613	\$ 39,916	\$ (39,916)
THREE MONTHS ENDED SEPTEMBER 30, 2001			
Net interest income (loss)	\$ 73,473	\$ (26)	\$ --
Provision for loan losses	791	--	--
Other income	5,987	1,083	--
Operating expense	40,071	1,864	--
Net intercompany income (expense)	92	(92)	--
Income (loss) before income taxes (benefit)	38,690	(899)	--
Income taxes (benefit)	16,389	(364)	--
Net income (loss)	\$ 22,301	\$ (535)	\$ --
AT SEPTEMBER 30, 2001			
Assets:			
Loans and mortgage-backed securities	\$ 9,912,489	\$ --	\$ --
Investments in real estate and joint ventures	--	38,043	--
Other	797,775	1,629	(33,642)
Total assets	10,710,264	39,672	(33,642)
Equity	\$ 698,475	\$ 33,642	\$ (33,642)

(In Thousands)	Banking	Real Estate Investment	Elimination
NINE MONTHS ENDED SEPTEMBER 30, 2002			
Net interest income	\$ 232,015	\$ 30	\$ --
Provision for loan losses	812	--	--
Other income	23,358	7,331	--
Operating expense	136,338	627	--
Net intercompany income (expense)	279	(279)	--
Income before income taxes	118,502	6,455	--
Income taxes	50,185	2,645	--
Net income	\$ 68,317	\$ 3,810	\$ --
NINE MONTHS ENDED SEPTEMBER 30, 2001			
Net interest income	\$ 225,843	\$ 12	\$ --
Provision for loan losses	1,274	--	--
Other income	31,943	3,423	--
Operating expense	115,924	3,402	--
Net intercompany income (expense)	273	(273)	--
Income (loss) before income taxes (benefit)	140,861	(240)	--
Income taxes (benefit)	59,632	(96)	--
Net income (loss)	\$ 81,229	\$ (144)	\$ --

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

The following table summarizes the activity in our mortgage servicing rights and related allowance for the periods indicated and other related financial data.

	Three Months Ended		
(Dollars in Thousands)	September 30, 2002	June 30, 2002	March 31, 2002
Gross balance at beginning of period	\$ 81,100	\$ 74,914	\$ 65,630
Additions	9,304	10,156	14,997
Amortization	(4,120)	(3,253)	(2,916)
Sales of mortgage servicing rights	--	--	(35)
Impairment write-down	(2,579)	(717)	(2,762)
Gross balance at end of period	83,705	81,100	74,914
Allowance balance at beginning of period	21,329	6,333	8,735
Provision for (reduction of) impairment	18,043	15,713	360
Impairment write-down	(2,579)	(717)	(2,762)
Allowance balance at end of period	36,793	21,329	6,333
Total mortgage servicing rights, net	\$ 46,912	\$ 59,771	\$ 68,581
Estimated fair value (1)	\$ 46,986	\$ 59,771	\$ 70,532
Weighted average expected life (in months)	39	61	87
Custodial account earnings rate	2.06%	3.82%	4.61%
Weighted average discount rate	8.19	9.10	9.13
AT PERIOD END			
Mortgage loans serviced for others:			
Total	\$ 7,502,157	\$ 6,962,403	\$ 6,408,812
With capitalized mortgage servicing rights:(1)			
Amount	7,355,700	6,807,306	6,196,137
Weighted average interest rate	6.71%	6.80%	6.85%
Custodial escrow balances	\$ 21,628	\$ 13,044	\$ 6,103

	Nine Months Ended September 30,	
(In Thousands)	2002	2001
Gross balance at beginning of period	\$ 65,630	\$ 46,214
Additions	34,457	29,091
Amortization	(10,289)	(6,857)
Sales of mortgage servicing rights	(35)	(2,910)
Impairment write-down	(6,058)	(3,887)
Gross balance at end of period	83,705	61,651
Allowance balance at beginning of period	8,735	5,483
Provision for impairment	34,116	22,548
Impairment write-down	(6,058)	(3,887)
Allowance balance at end of period	36,793	24,144

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total mortgage servicing rights, net	\$ 46,912	\$ 37,507
--	-----------	-----------

Key assumptions, which vary due to changes in market interest rates and are used to determine the fair value of our mortgage servicing rights, include: expected prepayment speeds, which impact the average life of the portfolio; the earnings rate on custodial accounts, which impact the value of custodial accounts; and the discount rate used in valuing future cash flows. The following table summarizes the estimated changes in the fair value of our 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. Also summarized is the earnings impact associated with provisions to or reductions in the valuation allowance for mortgage servicing rights. Impairment is measured on a disaggregated basis based upon the predominant risk

8

characteristics of the underlying mortgage loans such as term and coupon. Certain stratum may have impairment, while other stratum may not. Therefore, changes in overall fair value may not equal provisions to or reductions in 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	Value of Custodial Accounts	Discount Rate	Com
Increase rates 100 basis points:				
Increase (decrease) in fair value (1)	\$ 38,181	\$ 2,435	\$ (1,150)	\$
Reduction of (increase in) valuation allowance	36,793	2,509	(1,076)	
Decrease rates 100 basis points:				
Increase (decrease) in fair value (2)	(19,849)	(2,435)	1,209	
Reduction of (increase in) valuation allowance	(19,775)	(2,361)	1,283	

The following table presents a breakdown of the components of our loan servicing income (loss) during the periods indicated.

(In Thousands)	Three Months Ended			
	September 30, 2002	June 30, 2002	March 31, 2002	December 2001

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Income from servicing operations	\$ 3,200	\$ 3,349	\$ 2,688	\$ 2,4
Amortization of MSR's	(4,120)	(3,253)	(2,916)	(2,9
(Provision for) reduction of impairment ...	(18,043)	(15,713)	(360)	11,9

Total loan servicing income (loss), net	\$ (18,963)	\$ (15,617)	\$ (588)	\$ 11,4
=====				

	Nine Months Ended September 30,	

(In Thousands)	2002	2001

Income from servicing operations	\$ 9,237	\$ 6,551
Amortization of MSR's	(10,289)	(6,857)
Provision for impairment	(34,116)	(22,548)

Total loan servicing loss, net	\$ (35,168)	\$ (22,854)
=====		

NOTE (5) - ACCOUNTING FOR DERIVATIVES AND HEDGING ACTIVITIES

DERIVATIVES

We offer short-term interest rate lock commitments to help us attract potential home loan borrowers. The commitments guarantee a specified interest rate for a loan if our underwriting standards are met, but do not obligate the potential borrower. Accordingly, a certain number of commitments never become loans and merely expire. The residential one-to-four unit rate lock commitments we ultimately expect 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

9

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 September 30, 2002, we had a notional amount of expected rate lock commitments identified to sell as part of our secondary marketing activities of \$892 million, with an estimated fair value gain of \$12.1 million, of which \$6.9 million was associated with mortgage servicing rights.

HEDGING ACTIVITIES

As part of our secondary marketing activities, we typically utilize 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 our residential one-to-four unit expected rate lock commitments and loans held for sale. We do not generally enter into derivative transactions for purely speculative purposes. Contracts designated to loans held for sale 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

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

the hedge is established at the inception of the hedge. Changes in fair value of the notional amount of forward sale contracts not designated to loans held for sale 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 fair value of the notional amount of forward sale contracts designated as cash flow hedges for 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 in fair value of the notional amount of forward sale contracts 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. We estimate 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 September 30, 2002, the notional amount of forward sale contracts amounted to \$1.7 billion, with an estimated fair value loss of \$15.7 million, of which \$659 million were designated as cash flow hedges. The notional amount of forward purchase contracts amounted to \$165 million, with an estimated fair value gain of \$0.7 million that partially offsets the loss on our forward sale contracts not designated to loans held for sale.

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

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. Also shown is the notional amount of expected rate lock commitment derivatives for loans originated for sale, loans held for sale and the notional amounts for their associated hedging derivatives (i.e., forward sale contracts).

(In Thousands)	September 30, 2002	June 30, 2002	Three Months ended Mar 2002
Net gains (losses) on non-qualifying hedge transactions	\$ (2,663)	\$ (390)	\$
Net losses on qualifying cash flow hedge transactions:			
Unrealized hedge ineffectiveness	--	--	
Less reclassification of realized hedge ineffectiveness ...	--	--	

Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	(2,663)	(390)	
Other comprehensive income (loss)	(840)	(1,138)	
=====			
NOTIONAL AMOUNT AT PERIOD END			
Non-qualifying hedge transactions:			
Expected rate lock commitments	\$ 892,429	\$ 503,359	\$ 23
Associated forward sale contracts	1,024,586	501,292	23
Associated forward purchase contracts	165,000	3	
Qualifying cash flow hedge transactions:			
Loans held for sale, at lower of cost or fair value	665,587	381,465	38
Associated forward sale contracts	659,305	378,238	39
=====			

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

10

(In Thousands)	Nine Months Ended September 30,	
	2002	2001
Net gains (losses) on non-qualifying hedge transactions	\$ 1,811	\$ (2,130)
Net losses on qualifying cash flow hedge transactions:		
Unrealized hedge ineffectiveness	--	(467)
Less reclassification of realized hedge ineffectiveness ...	--	467
Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	1,811	(2,130)
Other comprehensive loss	(623)	(1,228)

NOTE (6) - 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 and state taxing authorities have examined Downey's tax returns for all tax years through 1997. Tax years subsequent to 1997 remain open to review. Downey's management believes it has adequately provided for potential exposure to issues that may be raised in the years open to review.

NOTE (7) - CURRENT ACCOUNTING ISSUES

Statement of Financial Accounting Standards No. 142. Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142"), applies to all acquired intangible assets whether acquired singularly, as part of a group, or in a business combination. SFAS 142 supersedes APB Opinion No. 17, "Intangible Assets," and carries forward provisions in Opinion 17 related to internally developed intangible assets. SFAS 142 changes the accounting for goodwill from an amortization method to an impairment-only approach. Goodwill should no longer be amortized, but instead tested for impairment at least annually at the reporting unit level. The accounting provisions are effective for fiscal years beginning after December 31, 2001. Our intangible assets and goodwill are related to branch acquisitions and not within the scope of SFAS 142. We recognized an unidentified intangible asset for branch acquisitions because the fair value of the liabilities assumed exceeded the fair value of the assets acquired. However, Statement of Financial Accounting Standards No. 147, "Acquisitions of Certain Financial Institutions, an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9," which was issued on October 1, 2002, states that assets of this nature which meet the definition of a business combination will be accounted for using the impairment-only approach (see discussion below).

Statement of Financial Accounting Standards No. 143. Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" ("SFAS 143"), addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 is effective for financial statements issued for fiscal years beginning after June 15, 2002. It is anticipated that the financial impact of SFAS 143 will not have a material effect on Downey.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Statement of Financial Accounting Standards No. 144. Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), addresses financial accounting and reporting for the impairment or disposal of long-lived assets. SFAS 144 supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations--Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," for the disposal of a business segment. SFAS 144 also eliminates the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of SFAS 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The provisions of SFAS 144 generally are to be applied prospectively.

Statement of Financial Accounting Standards No. 145. Statement of Financial Accounting Standards No. 145, "Rescission of SFAS Statements No. 4, 44, and 64, Amendment of SFAS Statement No. 13, and Technical Corrections" ("SFAS 145"), updates, clarifies and simplifies existing accounting pronouncements. SFAS 145 rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt." SFAS 145 amends SFAS No. 13, "Accounting for Leases," to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. The provisions of SFAS 145 related to SFAS No. 4 and SFAS No. 13 are effective for fiscal years beginning and transactions occurring after

11

May 15, 2002, respectively. It is anticipated that the financial impact of SFAS 145 will not have a material effect on Downey.

Statement of Financial Accounting Standards No. 146. Statement of Financial Accounting Standards No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" ("SFAS 146"), requires Downey to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS 146 replaces Emerging Issues Task Force ("EITF") Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The provisions of SFAS 146 are to be applied prospectively to exit or disposal activities initiated after December 31, 2002.

Statement of Financial Accounting Standards No. 147. Statement of Financial Accounting Standards No. 147, "Acquisitions of Certain Financial Institutions, an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9" ("SFAS 147"), addresses the financial accounting and reporting for the acquisition of all or part of a financial institution, except for a transaction between two or more mutual enterprises. SFAS 147 removes acquisitions of financial institutions, other than transactions between two or more mutual enterprises, from the scope of Statement of Financial Accounting Standards No. 72, "Accounting for Certain Acquisitions of Banking or Thrift Institutions," ("SFAS 72"), and Financial Accounting Standards Board Interpretation No. 9, "Applying APB Opinions No. 16 and 17 When a Savings and Loan Association or a Similar Institution Is Acquired in a Business Combination Accounted for by the Purchase Method," and requires that those transactions be accounted for in accordance with Statement of Financial Accounting Standards No. 141, "Business Combinations," and SFAS 142. Thus, the requirement in SFAS 72 to recognize, and subsequently amortize, any excess of the fair value of liabilities assumed over the fair value of tangible and identifiable intangible assets acquired as an unidentifiable intangible asset no longer applies to acquisitions within the scope of SFAS 147. Consequently, Downey will cease amortizing the remaining

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

excess cost over fair value of branch acquisitions and subject this asset to annual impairment testing. Downey will also restate previously issued financial statements back to January 1, 2002, when SFAS 142 was applied. For the third quarter of 2002, our amortization of excess cost over fair value of branch acquisitions was \$0.1 million and as of September 30, 2002, this asset totaled \$3 million. For the first nine months of 2002, our amortization was \$0.3 million.

SFAS 147 also provides guidance on the accounting for the impairment or disposal of acquired long-term customer-relationship intangible assets of financial institutions such as depositor- and borrower-relationship intangible assets and credit cardholder intangible assets. Those intangible assets are subject to the same undiscounted cash flow recoverability test and impairment loss recognition and measurement provisions that SFAS 144 requires for other long-lived assets that are held and used. The provisions of SFAS 147 are effective on October 1, 2002.

The following table shows the impact to net income on both an absolute and per share basis for the restatement that will be made in fourth quarter 2002 pursuant to SFAS 147.

(In Thousands, Except Per Share Data)	Three Months Ended			Nine Mon
	September 30, 2002	June 30, 2002	March 31, 2002	Septem 200
<hr style="border-top: 1px dashed black;"/>				
NET INCOME AS ORIGINALLY REPORTED				
Amount	\$ 14,504	\$ 20,309	\$ 37,314	\$ 72
Basic earnings per share	0.52	0.72	1.32	
Diluted earnings per share ..	0.52	0.72	1.32	
<hr style="border-top: 1px dashed black;"/>				
NET INCOME RESTATED FOR SFAS 147				
Amount	\$ 14,568	\$ 20,375	\$ 37,378	\$ 72
Basic earnings per share	0.52	0.72	1.32	
Diluted earnings per share ..	0.52	0.72	1.32	
<hr style="border-top: 1px dashed black;"/>				

12

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. 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.

OVERVIEW

Our net income for the third quarter of 2002 totaled \$14.5 million or \$0.52 per share on a diluted basis, compared to \$21.8 million or \$0.77 per share in the third quarter of 2001. During the current quarter, 212,300 shares of common stock were repurchased at an average price per share of \$41.04, leaving \$41 million of the \$50 million authorization available for future share repurchases.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

The decline in our net income between third quarters was primarily due to a larger addition to the valuation allowance for mortgage servicing rights. The addition was reflected within the category of loan servicing loss and was necessary due to an approximate 120 basis point decline in long-term interest rates, which resulted in an increase in the projected rate at which loans serviced for others are expected to prepay, thereby shortening their expected average life. In addition, the decline in long-term interest rates also reduced the expected value of associated custodial accounts. The pre-tax addition during the third quarter was \$18.0 million, up from \$11.9 million in the year-ago third quarter. Excluding the valuation allowances, our net income in the current quarter would have been \$24.9 million, down \$3.7 million or 12.9% from the adjusted year-ago level. This decline reflected a decrease of \$5.7 million in adjusted net income from our banking operations, partially offset by a \$2.0 million increase in net income from real estate investment activities which benefited from higher gains from sales. The decline in our adjusted net income from banking operations was primarily due to the following:

- o a \$7.3 million or 40.9% decline in other income primarily due to:
 - o a \$5.3 million unfavorable change in net gains from the sales of loans and mortgage servicing rights and
 - o a \$1.4 million decline in loan and deposit related fees due primarily to lower loan prepayment fees; and
- o a \$6.4 million or 15.9% increase in operating expense due to higher costs associated with the increased number of branch locations and higher loan origination activity.

These items were partially offset by a \$3.5 million or 4.7% increase in net interest income, due to higher interest-earning assets, and a \$0.3 million decline in provision for loan losses.

For the first nine months of 2002, our net income totaled \$72.1 million or \$2.56 per share on a diluted basis, compared to \$81.1 million or \$2.86 per share for the first nine months of 2001. The decline between nine-month periods reflected lower net income from our banking operations and was primarily due to higher valuation provisions associated with mortgage servicing rights.

For the third quarter of 2002, our return on average assets was 0.51% and our return on average equity was 7.41%. For the first nine months of 2002, our return on average assets was 0.87% and our return on average equity was 12.51%.

Our single family loan originations totaled a record \$2.832 billion in the third quarter of 2002, up 42.4% from the \$1.988 billion we originated in the third quarter of 2001 and 29.9% above the \$2.179 billion we originated in the previous quarter. Of the current quarter total, \$1.032 billion represented originations of loans for portfolio, of which \$150 million represented subprime credits. In addition to single family loans, we originated \$43 million of other loans in the quarter.

At quarter end, our assets totaled \$12.5 billion, up 16.8% from a year ago. Included in the total were \$1.0 billion of 30-year fixed rate mortgage-backed securities purchased in late September, of which about half were funded by quarter end with short-term borrowings, while the other half settles in mid-October. These securities were purchased due to a net interest spread of over 3% given the steepness in the yield curve. However, these securities were sold in early October due to interest rate volatility and the potential adverse impact market interest rate changes could have on the carrying value of the investment. Approximately \$1.0 million was earned on these securities while owned, virtually all of which will be recognized in the fourth quarter.

Our deposits totaled \$9.1 billion, up 2.1% from a year ago. During the quarter, we opened one new traditional and seven new in-store branches, bringing our total branches at quarter end to 156, of which 85 were in-store. A year ago, branches totaled 134, of which 67 were in-store.

Our non-performing assets increased \$5 million during the quarter to \$89 million or 0.71% of total assets (0.77% excluding the previously mentioned mortgage-backed securities purchased in late September but sold in early October). Residential non-performers increased \$9 million during the quarter, of which \$6 million was associated with subprime loans. That increase was partially offset by a \$4 million decline in commercial real estate non-performers due to a short-pay that was accepted in full consideration of the loan obligation.

At September 30, 2002, our primary subsidiary, Downey Savings and Loan Association, F.A. (the "Bank") exceeded all regulatory capital tests, with capital-to-asset ratios of 6.36% for both tangible and core capital and 13.65% for risk-based capital. These capital levels are significantly above the "well capitalized" standards defined by the federal banking regulators of 5% for core and tangible capital and 10% for risk-based capital.

CRITICAL ACCOUNTING POLICIES

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey's Annual Report on Form 10-K for the year ended December 31, 2001. Certain accounting policies require us to make significant estimates and assumptions which have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and our results of operations for the reporting periods.

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

- o Allowance for losses on loans and real estate. For further information, see Financial Condition--Problem Loans and Real Estate--Allowance for Losses on Loans and Real Estate on page 36.
- o Valuation of mortgage servicing rights. For further information, see Note 4 on page 8 of Notes to Consolidated Financial Statements.

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.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Our net interest income totaled \$77.0 million in the third quarter of 2002, up \$3.5 million or 4.8% from the same period last year. The increase between third quarters reflected higher interest-earning asset levels. Our interest-earning assets averaged \$10.9 billion during the quarter, up 5.6% from the year-ago level. The effective interest rate spread averaged 2.83% in the current quarter, slightly below 2.85% a year ago.

For the first nine months of 2002, net interest income totaled \$232.0 million, up \$6.2 million or 2.7% from a year ago. The increase reflected both a higher effective interest rate spread and higher interest-earning asset levels.

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

- o interest income from average interest-earning assets and the resultant yields; and
- o 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 quarter using the average of each month's daily average balance during the periods indicated.

	Three Months Ended Sept			
	2002			
(Dollars in Thousands)	Average Balance	Interest	Average Yield/ Rate	Ave Bal
Interest-earning assets:				
Loans	\$ 10,475,813	\$ 150,987	5.77%	\$ 9,
Mortgage-backed securities	32,601	287	3.52	
Investment securities	387,325	3,650	3.74	
Total interest-earning assets	10,895,739	154,924	5.69	10,
Non-interest-earning assets	392,952			

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total assets	\$ 11,288,691			\$ 10,
Transaction accounts:				
Non-interest-bearing checking	\$ 301,169	\$ --	-- %	\$
Interest-bearing checking (a)	414,909	323	0.31	
Money market	114,544	487	1.69	
Regular passbook	3,222,127	18,566	2.29	1,
Total transaction accounts	4,052,749	19,376	1.90	1,
Certificates of deposit	4,766,674	40,222	3.35	6,
Total deposits	8,819,423	59,598	2.68	8,
Borrowings	1,396,414	15,314	4.35	
Capital securities	120,000	3,040	10.14	
Total deposits, borrowings and capital securities	10,335,837	77,952	2.99	9,
Other liabilities	169,552			
Stockholders' equity	783,302			
Total liabilities and stockholders' equity	\$ 11,288,691			\$ 10,
Net interest income/interest rate spread		\$ 76,972	2.70%	
Excess of interest-earning assets over deposits, borrowings and capital securities	\$ 559,902			\$
Effective interest rate spread			2.83	

(Dollars in Thousands)	Nine Months Ended Septe			
	2002			
	Average Balance	Interest	Average Yield/ Rate	Ave Bal
Interest-earning assets:				
Loans	\$ 10,161,564	\$ 459,712	6.03%	\$ 10,
Mortgage-backed securities	73,283	2,503	4.55	
Investment securities	412,504	12,532	4.06	
Total interest-earning assets	10,647,351	474,747	5.95	10,
Non-interest-earning assets	394,442			
Total assets	\$ 11,041,793			\$ 10,
Transaction accounts:				
Non-interest-bearing checking	\$ 293,964	\$ --	-- %	\$
Interest-bearing checking (a)	421,894	1,065	0.34	
Money market	112,830	1,497	1.77	
Regular passbook	2,875,959	52,502	2.44	
Total transaction accounts	3,704,647	55,064	1.99	1,
Certificates of deposit	4,929,779	133,290	3.61	6,
Total deposits	8,634,426	188,354	2.92	8,
Borrowings	1,373,979	45,226	4.40	1,
Capital securities	120,000	9,122	10.14	
Total deposits, borrowings and capital securities	10,128,405	242,702	3.20	10,
Other liabilities	144,425			
Stockholders' equity	768,963			

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total liabilities and stockholders' equity	\$ 11,041,793		\$ 10,
Net interest income/interest rate spread		\$ 232,045	2.75%
Excess of interest-earning assets over deposits, borrowings and capital securities	\$ 518,946		\$
Effective interest rate spread			2.91

16

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

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

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

(In Thousands)	Three Months Ended September 30, 2002 Versus 2001 Changes Due To				Volume
	Volume	Rate	Rate/ Volume	Net	
Interest income:					
Loans	\$ 11,059	\$ (45,274)	\$ (2,665)	\$ (36,880)	\$ 7,075
Mortgage-backed securities	346	(18)	(103)	225	3,039
Investment securities	(457)	(1,803)	143	(2,117)	(1,719)
Change in interest income	10,948	(47,095)	(2,625)	(38,772)	8,395
Interest expense:					
Transaction accounts:					
Interest-bearing checking (1) ..	10	(184)	(4)	(178)	72
Money market	147	(251)	(57)	(161)	460
Regular passbook	16,222	(2,603)	(4,479)	9,140	47,959
Total transaction accounts ..	16,379	(3,038)	(4,540)	8,801	48,491
Certificates of deposit	(30,102)	(37,990)	11,856	(56,236)	(90,490)
Total interest-bearing deposits	(13,723)	(41,028)	7,316	(47,435)	(41,999)
Borrowings	7,418	(1,348)	(932)	5,138	5,052
Capital securities	--	--	--	--	--

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Change in interest expense	(6,305)	(42,376)	6,384	(42,297)	(36,947)
Change in net interest income	\$ 17,253	\$ (4,719)	\$ (9,009)	\$ 3,525	\$ 45,342

PROVISION FOR LOAN LOSSES

Provision for loan losses totaled \$0.5 million in the current quarter, down \$0.3 million from the year-ago third quarter. The allowance for loan losses was \$35 million at September 30, 2002, compared to \$36 million at year-end 2001. Net charge-offs totaled \$1.4 million in the third quarter of 2002, compared to less than \$0.1 million a year ago. The increase from a year ago primarily reflects a \$1.2 million charge-off in the current quarter of a commercial real estate loan for which a short-pay was accepted in full consideration of the loan.

For the first nine months of 2002, provision for loan losses was \$0.8 million and net charge-offs were \$2.1 million. That compares to a provision for loan losses of \$1.3 million and net charge-offs of \$0.7 million in the year-ago period. For further information regarding our allowance for loan losses, see Financial Condition--Problem Loans and Real Estate--Allowance for Losses on Loans and Real Estate on page 36.

17

OTHER INCOME

A loss of \$4.8 million was recognized in our total other income for the third quarter of 2002, compared to income of \$7.1 million in the year-ago third quarter. The \$11.8 million unfavorable change between third quarters primarily reflected:

- o a \$7.2 million increase in the loss on our loan servicing activity due primarily to a larger addition to the valuation allowance for mortgage servicing rights, as the fair value of those rights dropped in the current quarter due to an approximate 120 basis point decline in long-term interest rates;
- o a \$5.3 million unfavorable change in net gains (losses) on sales of loans and mortgage-backed securities and mortgage servicing rights; and
- o a \$1.4 million decline in loan and deposit related fees, due primarily to a \$2.9 million decline in loan prepayment fees.

Partially offsetting those declines was a \$1.7 million increase in income from real estate held for investment due to higher gains from sales.

For the first nine months of 2002, total other income was \$30.7 million, down \$4.7 million from a year ago, primarily reflecting a \$12.3 million increase in the loss from loan servicing and a \$2.9 million decrease in loan and deposit related fees. Those items were partially offset by a \$6.3 million increase in net gains (losses) on sales of loans and mortgage-backed securities and mortgage servicing rights, and a \$4.0 million increase in income from real estate and joint ventures held for investment. Below is a further discussion of the major other income categories.

LOAN AND DEPOSIT RELATED FEES

Loan and deposit related fees totaled \$11.8 million in the third quarter of

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

2002, down \$1.4 million from a year ago. Our loan related fees were down \$2.8 million between third quarters, due primarily to a decline in loan prepayment fees. This decline was partially offset by a \$1.3 million or 28.6% increase in our deposit related fees, primarily due to higher fees from our checking accounts.

The following table presents a breakdown of loan and deposit related fees during the quarterly periods indicated.

(In Thousands)	Three Months Ended			
	September 30, 2002	June 30, 2002	March 31, 2002	December 31, 2001

Loan related fees:				
Prepayment fees	\$ 3,523	\$ 4,140	\$ 4,686	\$ 5,475
Other fees	2,366	1,992	2,167	2,477
Deposit related fees:				
Automated teller machine fees	2,051	1,668	1,543	1,670
Other fees	3,908	3,596	3,122	3,224

Total loan and deposit related fees	\$11,848	\$11,396	\$11,518	\$12,846
=====				

18

For the nine months of 2002, loan and deposit related fees totaled \$34.8 million, down \$2.9 million from the same period of 2001. The decrease reflected a \$6.0 million decline in loan prepayment fees, as deposit related fees were up \$2.9 million.

The following table presents a breakdown of loan and deposit related fees during the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001

Loan related fees:		
Prepayment fees	\$12,349	\$18,364
Other fees	6,525	6,287
Deposit related fees:		
Automated teller machine fees	5,262	4,854
Other fees	10,626	8,135

Total loan and deposit related fees	\$34,762	\$37,640
=====		

REAL ESTATE AND JOINT VENTURES HELD FOR INVESTMENT

Income from our real estate and joint ventures held for investment totaled \$2.4 million in the third quarter of 2002, up \$1.7 million from a year ago. The favorable change reflected increases of \$1.7 million in net gains from sales.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

The gains primarily related to joint venture projects and were reported in the category of equity in net income from joint ventures.

The following table sets forth the key components comprising our income from real estate and joint venture operations during the quarterly periods indicated.

(In Thousands)	Three Months End			
	September 30, 2002	June 30, 2002	March 31, 2002	De
Rental operations, net of expenses	\$ 269	\$ 521	\$ 823	\$
Equity in net income from joint ventures	1,634	1,001	745	
Interest from joint venture advances	306	304	111	
Net gains on sales of wholly owned real estate	99	8	--	
(Provision for) reduction of losses on real estate and joint ventures	99	(818)	1,318	
Total income from real estate and joint ventures held for investment, net	\$ 2,407	\$ 1,016	\$ 2,997	\$

For the first nine months of 2002, income from real estate and joint ventures held for investment totaled \$6.4 million, up \$4.0 million from the same period of 2001 due primarily to sales activity.

The following table sets forth the key components comprising our income from real estate and joint venture operations during the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001
Rental operations, net of expenses	\$1,613	\$1,219
Equity in net income from joint ventures	3,380	524
Interest from joint venture advances	721	385
Net gains on sales of wholly owned real estate	107	2
Reduction of losses on real estate and joint ventures	599	308
Total income from real estate and joint ventures held for investment, net	\$6,420	\$2,438

SECONDARY MARKETING ACTIVITIES

A loss of \$19.0 million was recorded in loan servicing from our portfolio of loans serviced for others during the third quarter of 2002, \$7.2 million higher than the loss of \$11.8 million in the year-ago period. The higher loss primarily reflected a larger addition to the valuation allowance for mortgage servicing rights, \$18.0 million in the current quarter, compared to \$11.9

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

million a year ago. The current quarter valuation addition was associated with the deterioration in fair value of our mortgage servicing rights due to the approximate 120 basis point decline in long-term interest rates, which resulted in an increase in the projected rate at which loans serviced for others are expected to prepay, thereby shortening their expected average life. In addition, the decline in long-term interest rates also reduced the expected value of custodial accounts. At September 30, 2002, we serviced loans for others of \$7.5 billion, compared to \$5.8 billion at December 31, 2001, and \$5.5 billion at September 30, 2001.

The following table presents a breakdown of the components of our loan servicing income (loss) during the quarterly periods indicated.

(In Thousands)	Three Months Ended		
	September 30, 2002	June 30, 2002	March 31, 2002
Income from servicing operations	\$ 3,200	\$ 3,349	\$ 2,688
Amortization of MSR's	(4,120)	(3,253)	(2,916)
(Provision for) reduction of impairment ...	(18,043)	(15,713)	(360)
Total loan servicing income (loss), net	\$(18,963)	\$(15,617)	\$ (588)

For the first nine months of 2002, a loss of \$35.2 million was recorded in loan servicing, compared to a loss of \$22.9 million from the same period of 2001, due to a larger addition to the valuation allowance for mortgage servicing rights.

The following table presents a breakdown of the components of our loan servicing loss during the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001
Income from servicing operations .	\$ 9,237	\$ 6,551
Amortization of MSR's	(10,289)	(6,857)
Provision for impairment	(34,116)	(22,548)
Total loan servicing loss, net	\$(35,168)	\$(22,854)

For further information regarding mortgage servicing rights, see Notes To Consolidated Financial Statements--Note (4)--Mortgage Servicing Rights on page 8.

Sales of loans and mortgage-backed securities increased in the third quarter of 2002 to a record \$1.564 billion from \$1.120 billion a year ago. A loss of \$1.0 million was recognized in the current quarter, compared to income

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

of \$4.2 million a year ago. Included in the current quarter loss was a \$2.7 million loss associated with the SFAS 133 impact of valuing derivatives associated with the sale of loans. Excluding the SFAS 133 loss, a gain of \$1.7 million or 0.11% of loans sold was realized. This result is below recent quarters due, in part, to lower values of mortgage servicing rights being recognized on loans sold servicing retained, given the decline that occurred in long-term interest rates between the time the fixed rate was committed to the borrower and when we sold the loan. Net losses in the current quarter included the capitalization of mortgage servicing rights totaling \$9.3 million, compared to \$10.3 million a year ago.

The following table presents a breakdown of the components of our net gains (losses) on sales of loans and mortgage-backed securities during the quarterly periods indicated.

(In Thousands)	Three Months Ended		
	September 30, 2002	June 30, 2002	March 31, 2002
Mortgage servicing rights	\$ 9,304	\$10,156	\$14,997
All other components excluding SFAS 133	(7,612)	(2,870)	(3,660)
SFAS 133	(2,663)	(390)	4,864
Total net gains (losses) on sales of loans and mortgage-backed securities	\$ (971)	\$ 6,896	\$16,201
Total as percent of loans and mortgage-backed securities sold	(0.06)%	0.63%	1.17%

For the first nine months of 2002, net gains on sales of loans and mortgage-backed securities totaled \$22.1 million, up \$6.7 million from the same period of 2001.

The following table presents a breakdown of the components of our net gains on sales of loans and mortgage-backed securities during the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001
Mortgage servicing rights	\$ 34,457	\$ 29,091
All other components excluding SFAS 133	(14,142)	(11,578)
SFAS 133	1,811	(2,130)
Total net gains on sales of loans and mortgage-backed securities ..	\$ 22,126	\$ 15,383
Total as percent of loans and mortgage-backed securities sold ...	0.55%	0.50%

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

OPERATING EXPENSE

Our operating expense totaled \$46.6 million in the current quarter, up \$4.7 million or 11.1% from the third quarter of 2001. That increase was due primarily to higher general and administrative costs associated with an increased number of branch locations and higher loan origination activity.

The following table presents a breakdown of key components comprising operating expense during the quarterly periods indicated.

(In Thousands)	Three Months Ended			
	September 30, 2002	June 30, 2002	March 31, 2002	December 31, 2001
Salaries and related costs	\$29,067	\$28,315	\$29,437	\$27,075
Premises and equipment costs	7,916	7,754	7,133	7,303
Advertising expense	1,066	1,582	1,044	1,168
Professional fees	91	233	564	839
SAIF insurance premiums and regulatory assessments	765	762	786	792
Other general and administrative expense ...	7,474	6,350	6,211	6,339
Total general and administrative expense	46,379	44,996	45,175	43,516
Net operation of real estate acquired in settlement of loans	110	27	(58)	237
Amortization of excess cost over fair value of branch acquisitions	111	114	111	113
Total operating expense	\$46,600	\$45,137	\$45,228	\$43,866

For the first nine months of 2002, operating expenses totaled \$137.0 million, up \$17.6 million or 14.8% from the same period of 2001, and also reflected higher costs associated with the increased number of branch locations and higher loan origination activity.

The following table presents a breakdown of key components comprising operating expense during the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001
Salaries and related costs	\$ 86,819	\$ 72,860
Premises and equipment costs	22,803	18,713
Advertising expense	3,692	3,242
Professional fees	888	4,613
SAIF insurance premiums and regulatory assessments	2,313	2,259
Other general and administrative expense	20,035	17,293

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total general and administrative expense	136,550	118,980
Net operation of real estate acquired in settlement of loans	79	2
Amortization of excess cost over fair value of branch acquisitions	336	344
<hr/>		
Total operating expense	\$136,965	\$119,326
<hr/> <hr/>		

PROVISION FOR INCOME TAXES

Income taxes for the third quarter totaled \$10.6 million, resulting in an effective tax rate of 42.3%, compared to \$16.0 million and 42.4% for the like quarter of a year ago. Our effective tax rate was 42.3% for the first nine months of both 2002 and 2001. For further information regarding income taxes, see Notes to Consolidated Financial Statements--Note (6)--Income Taxes on page 11.

22

BUSINESS SEGMENT REPORTING

The previous discussion and analysis of the Results of Operations pertained to our consolidated results. This section discusses and analyzes the results of operations of our two business segments--banking and real estate investment. For further information regarding business segments, see Notes To Consolidated Financial Statements--Note (3)--Business Segment Reporting on page 7.

The following table presents by business segment our net income for the periods indicated.

(In Thousands)	Three Months Ended			
	September 30, 2002	June 30, 2002	March 31, 2002	Decem 2
Banking net income	\$13,036	\$19,724	\$35,557	\$3
Real estate investment net income (loss)	1,468	585	1,757	
Total net income	\$14,504	\$20,309	\$37,314	\$3
<hr/>				
	Nine Months Ended September 30,			
	2002	2001		
Banking net income	\$68,317	\$81,229		
Real estate investment net income (loss)	3,810	(144)		
Total net income	\$72,127	\$81,085		
<hr/> <hr/>				

BANKING

Net income from our banking operations for the third quarter of 2002 totaled \$13.0 million, down \$9.3 million or 41.5% from \$22.3 million in the third quarter of 2001. The decrease between third quarters primarily reflected a

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

larger addition to the valuation allowance for mortgage servicing rights. The addition was reflected within the category of loan servicing loss and was necessary due to the approximate 120 basis point decline in long-term interest rates, which resulted in an increase in the projected rate at which loans serviced for others are expected to prepay, thereby shortening their expected average life. In addition, the decline in long-term interest rates also reduced the expected value of associated custodial accounts. The pre-tax addition during the third quarter was \$18.0 million, up from \$11.9 million in the year-ago third quarter. Excluding the valuation allowances, our net income from banking operations in the current quarter would have been \$23.4 million, down \$5.7 million or 19.6% from the adjusted year-ago level. The decline in our adjusted net income from banking operations was primarily due to the following:

- o a \$7.3 million or 40.9% decrease in other income primarily due to:
 - o a \$5.3 million unfavorable change in net gains from the sales of loans and mortgage servicing rights and
 - o a \$1.4 million decrease in loan and deposit related fees due primarily to lower loan prepayment fees; and
- o a \$6.4 million or 15.9% increase in operating expense due to higher costs associated with the increased number of branch locations and higher loan origination activity.

These items were partially offset by a \$3.5 million or 4.7% increase in net interest income due to higher interest-earning assets, and a \$0.3 million decline in provision for loan losses.

23

The following table sets forth our banking operational results and selected financial data for the quarterly periods indicated.

(In Thousands)	Three Months Ended			
	September 30, 2002	June 30, 2002	March 31, 2002	Dece
Net interest income	\$ 76,960	\$ 75,115	\$ 79,940	\$ 7
Provision for (reduction of) loan losses	471	(1,106)	1,447	
Other income (loss)	(7,507)	2,803	28,062	3
Operating expense	46,439	44,893	45,006	4
Net intercompany income	100	86	93	
Income before income taxes	22,643	34,217	61,642	6
Income taxes	9,607	14,493	26,085	2
Net income	\$ 13,036	\$ 19,724	\$ 35,557	\$ 3
=====				
AT PERIOD END				
Assets:				
Loans and mortgage-backed securities	\$ 11,685,037	\$ 10,286,033	\$ 10,088,113	\$ 10,13
Other	828,500	840,416	819,407	96
Total assets	12,513,537	11,126,449	10,907,520	11,09
Equity	\$ 790,613	\$ 787,306	\$ 767,622	\$ 73
=====				

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

For the first nine months of 2002, our net income from banking operations totaled \$68.3 million, down \$12.9 million from the same period a year ago due primarily to the larger addition to the valuation allowance for mortgage servicing rights.

The following table sets forth our banking operational results for the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001
Net interest income	\$232,015	\$225,843
Provision for loan losses	812	1,274
Other income	23,358	31,943
Operating expense	136,338	115,924
Net intercompany income ..	279	273
Income before income taxes	118,502	140,861
Income taxes	50,185	59,632
Net income	\$ 68,317	\$ 81,229

24

REAL ESTATE INVESTMENT

Net income from our real estate investment operations totaled \$1.5 million in the third quarter of 2002, compared to a net loss of \$0.5 million in the year-ago quarter. The favorable change was primarily attributed to higher gains from sales, which increased \$1.7 million, and lower operating expenses, as the year-ago quarter included expense pertaining to litigation matters associated with certain joint venture partners.

The following table sets forth real estate investment operational results and selected financial data for the quarterly periods indicated.

(In Thousands)	Three Months Ended			
	September 30, 2002	June 30, 2002	March 31, 2002	Decem 20
Net interest income (expense)	\$ 12	\$ 13	\$ 5	\$ (
Other income	2,741	1,299	3,291	1,7
Operating expense	161	244	222	1
Net intercompany expense	100	86	93	
Income (loss) before income taxes (benefit) ...	2,492	982	2,981	1,4
Income taxes (benefit)	1,024	397	1,224	6
Net income (loss)	\$ 1,468	\$ 585	\$ 1,757	\$ 8

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

=====
 AT PERIOD END

Assets:

Investment in real estate and joint ventures	\$ 40,371	\$ 40,283	\$ 26,384	\$ 38,1
Other	4,090	1,919	4,060	2,0

Total assets	44,461	42,202	30,444	40,1

Equity	\$ 39,916	\$ 38,448	\$ 24,963	\$ 34,5
=====				

For the first nine months of 2002, our net income from real estate investment operations totaled \$3.8 million, a favorable change from a loss of \$0.1 million from the same period a year ago due primarily to sales activity and lower operating expenses, as the year-ago quarter included expense pertaining to litigation matters associated with certain joint venture partners.

The following table sets forth our real estate investment operational results for the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001

Net interest income	\$ 30	\$ 12
Other income	7,331	3,423
Operating expense	627	3,402
Net intercompany expense	279	273

Income (loss) before income taxes (benefit)	6,455	(240)
Income taxes (benefit)	2,645	(96)

Net income (loss)	\$ 3,810	\$ (144)
=====		

Our investment in real estate and joint ventures amounted to \$40 million at September 30, 2002, compared to \$38 million at both December 31, 2001 and September 30, 2001.

For information on valuation allowances associated with real estate and joint venture loans, see Financial Condition--Problem Loans and Real Estate--Allowances for Losses on Loans and Real Estate on page 36.

FINANCIAL CONDITION

LOANS AND MORTGAGE-BACKED SECURITIES

Total loans and mortgage-backed securities, including those we hold for sale, increased \$1.4 billion during the third quarter to a total of \$11.7 billion or 93.3% of assets at September 30, 2002. The increase primarily resulted from the purchase of \$1.0 billion of 30-year fixed rate mortgage-backed securities available for sale purchased in late September, of which about half were funded by quarter end with short-term borrowings, while the other half settles in mid-October. These securities were purchased due to a net interest

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

spread of over 3% given the steepness in the yield curve. However, these securities were sold in early October due to interest rate volatility and the potential adverse impact market interest rate changes could have on the carrying value of the investment. Also contributing to the increase in loans and mortgage-backed securities was a higher level of loans held for investment in the residential one-to-four units adjustable category. Given the continued low interest rate environment and borrower preference for fixed rate loans, our annualized prepayment speed in the current quarter remained high at 36%, compared to 39% a year ago and 38% during the previous quarter.

The following table sets forth loans originated, including purchases, for investment and for sale during the periods indicated.

(In Thousands)	Three Months Ended			---
	September 30, 2002	June 30, 2002	September 30, 2001	---

Loans originated for investment:				
Residential one-to-four units:				
Adjustable	\$1,028,635	\$1,109,982	\$ 867,271	\$3,
Fixed	3,473	3,940	4,445	
Other	42,576	119,970	56,554	

Total loans originated for investment	1,074,684	1,233,892	928,270	3,
Loans originated for sale (1)	1,799,673	1,065,360	1,116,589	4,

Total loans originated	\$2,874,357	\$2,299,252	\$2,044,859	\$7,

Originations of residential one-to-four unit loans totaled a record \$2.832 billion in the third quarter of 2002, of which \$1.032 billion or 36% were for portfolio, with the balance for sale in the secondary market. This was 29.9% higher than the \$2.179 billion we originated in the second quarter of 2002, and 42.4% higher than the \$1.988 billion we originated in the year-ago third quarter. Of the current quarter originations for portfolio, \$150 million represented originations of subprime credits as part of our continuing strategy to enhance the portfolio's net yield. During the current quarter, 78% of our residential one-to-four unit originations represented refinancing transactions. This is up from the previous quarter level of 67% and the year-ago third quarter level of 72%. In addition to single family loans, we originated \$43 million of other loans in the current quarter.

During the current quarter, loan originations for investment consisted primarily of adjustable rate mortgages which provide for negative amortization and are tied to COFI or the 12-month moving average of the annual yields on actively traded U.S. Treasury securities adjusted to a constant maturity of one year ("MTA"), indexes which lag behind the movement in market interest rates. For the quarter, 52% of portfolio originations represented monthly adjusting COFI rate mortgages, 23% represented monthly adjusting MTA rate mortgages, while 20% represented adjustable rate loans where the initial rate is fixed for the first three years.

Our adjustable rate mortgages:

- o generally begin with an incentive interest rate, which is an interest rate below the current market rate, that adjusts to the applicable

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

index plus a defined spread, subject to periodic and lifetime caps, after one, three, six or twelve months;

- o generally 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
- o limit interest rate adjustments, for loans that adjust both the interest rate and payment amount simultaneously, to 1% per adjustment period for those that adjust semi-annually and 2% per adjustment period for those that adjust annually.

26

Most of our adjustable rate mortgages adjust the interest rate monthly and the payment amount annually. These monthly adjustable rate mortgages:

- o have a lifetime interest rate cap, but no specified periodic interest rate adjustment cap;
- o have a periodic cap on changes in required monthly payments; and
- o allow for negative amortization, which is the addition to loan principal of accrued interest that exceeds the required monthly loan payments.

If a loan incurs significant negative amortization, the loan-to-value ratio could increase which creates an increased risk that the fair value of the underlying collateral on the loan would be insufficient to satisfy fully the outstanding principal and interest. A loan-to-value ratio is the ratio of the principal amount of the loan to the lower of the sales price or appraised value of the property securing the loan at origination. We currently impose a limit on the amount of negative amortization. The principal plus the negative amortization cannot exceed 125% of the original loan amount, except for subprime loans and loans with loan-to-value ratios of greater than 80% wherein the borrower has obtained private mortgage insurance to reduce the effective loan-to-value ratio to between 67% and 80%. In those two instances, the principal plus negative amortization cannot exceed 110% of the original loan amount.

At September 30, 2002, \$7.3 billion or 77% of the adjustable rate mortgages in our loan portfolio were subject to negative amortization, of which \$128 million represented the amount of negative amortization included in the loan balance. The amount of negative amortization is \$18 million or 12.3% below the June 30, 2002 level.

We also continue to originate residential fixed interest rate mortgage loans to meet consumer demand, but we intend to sell the majority of these loans. We sold through our secondary marketing activities a record \$1.564 billion of loans and mortgage-backed securities in the third quarter of 2002, compared to \$1.093 billion in the previous quarter and \$1.120 billion in the third quarter of 2001. All were secured by residential one-to-four unit property, and at September 30, 2002, loans held for sale totaled \$666 million.

At September 30, 2002, our unfunded loan application pipeline totaled \$2.9 billion. Within that pipeline, we had commitments to borrowers for short-term interest rate locks of \$1.3 billion, of which \$1.2 billion were related to residential one-to-four unit loans being originated for sale in the secondary market. Furthermore, at September 30, 2002, we had commitments to purchase loans of \$294 million, loans in process of \$92 million and undrawn lines and letters of credit of \$92 million. We believe our current sources of funds will enable us

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

to meet these obligations.

27

The following table sets forth the origination, purchase and sale activity relating to our loans and mortgage-backed securities during the quarterly periods indicated.

(In Thousands)	September 30, 2002	June 30, 2002	Three Ma
INVESTMENT PORTFOLIO			
Loans originated:			
Loans secured by real estate:			
Residential one-to-four units:			
Adjustable	\$ 675,280	\$ 868,022	\$
Adjustable - subprime	123,263	148,876	
Adjustable - fixed for 3-5 years	181,439	85,679	
Adjustable - fixed for 3-5 years - subprime	24,851	133	

Total adjustable residential one-to-four units	1,004,833	1,102,710	
Fixed	3,373	3,940	
Fixed - subprime	--	--	
Residential five or more units	--	--	

Total residential	1,008,206	1,106,650	
Commercial real estate	557	--	
Construction	17,418	65,030	
Land	--	37,820	
Non-mortgage:			
Commercial	8,000	600	
Automobile	64	329	
Other consumer	16,537	16,191	

Total loans originated	1,050,782	1,226,620	1,
Real estate loans purchased:			
One-to-four units	21,485	6,459	
One-to-four units - subprime	2,417	813	
Other (1)	--	--	

Total real estate loans purchased	23,902	7,272	

Total loans originated and purchased	1,074,684	1,233,892	1,
Loan repayments	(927,653)	(950,438)	(
Other net changes (2)	6,943	(45,850)	

Net increase (decrease) in loans held for investment	153,974	237,604	

SALE PORTFOLIO			
Residential one-to-four units:			
Originated whole loans	1,792,091	1,060,399	1,
Loans purchased	7,582	4,961	
Loans transferred to the investment portfolio	(460)	(1,401)	
Originated whole loans sold	(280,786)	(132,614)	(
Loans exchanged for mortgage-backed securities	(1,232,826)	(943,883)	(1,
Other net changes	(3,105)	(594)	
Capitalized basis adjustment (3)	1,626	6,129	

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Net increase (decrease) in loans held for sale	284,122	(7,003)	(
Mortgage-backed securities, net:			
Received in exchange for loans	1,232,826	943,883	1,
Sold	(1,283,100)	(960,840)	(1,
Purchased	1,014,098	--	
Repayments	(4,258)	(18,950)	
Other net changes	1,342	3,226	
Net increase (decrease) in mortgage-backed securities available for sale	960,908	(32,681)	
Net increase (decrease) in loans held for sale and mortgage-backed securities available for sale	1,245,030	(39,684)	(
Total net increase (decrease) in loans and mortgage-backed securities	\$ 1,399,004	\$ 197,920	\$

28

The following table sets forth the composition of our loan and mortgage-backed securities portfolio at the quarter ends indicated.

(In Thousands)	September 30, 2002	June 30, 2002	March 2002
INVESTMENT PORTFOLIO			
Loans secured by real estate:			
Residential one-to-four units:			
Adjustable	\$ 6,746,906	\$ 6,590,943	\$ 6,279,
Adjustable - subprime	1,345,644	1,357,098	1,365,
Adjustable - fixed for 3-5 years	1,313,391	1,271,031	1,294,
Adjustable - fixed for 3-5 years - subprime	64,808	48,835	57,
Fixed	225,701	260,934	295,
Fixed - subprime	9,629	11,982	13,
Total residential one-to-four units	9,706,079	9,540,823	9,306,
Residential five or more units:			
Adjustable	4,693	4,952	5,
Fixed	3,737	3,775	4,
Commercial real estate:			
Adjustable	39,553	40,200	40,
Fixed	38,112	41,522	69,
Construction	110,125	124,318	78,
Land	53,885	62,182	36,
Non-mortgage:			
Commercial	17,792	17,371	21,
Automobile	14,475	17,667	20,
Other consumer	54,779	50,101	48,
Total loans held for investment	10,043,230	9,902,911	9,631,
Increase (decrease) for:			
Undisbursed loan funds	(99,309)	(106,557)	(65,
Net deferred costs and premiums	91,379	85,926	80,
Allowance for losses	(34,880)	(35,834)	(37,

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total loans held for investment, net	10,000,420	9,846,446	9,608,
SALE PORTFOLIO, NET			
Loans held for sale:			
Residential one-to-four units	662,292	379,796	392,
Capitalized basis adjustment (1)	3,295	1,669	(4,
Total loans held for sale	665,587	381,465	388,
Mortgage-backed securities available for sale:			
Adjustable	3,385	58,122	73,
Fixed	1,015,645	--	17,
Total mortgage-backed securities available for sale	1,019,030	58,122	90,
Total loans held for sale and mortgage-backed securities available for sale	1,684,617	439,587	479,
Total loans and mortgage-backed securities	\$11,685,037	\$10,286,033	\$10,088,

We carry loans for sale at the lower of cost or fair value. At September 30, 2002, no valuation allowance was required as the fair value exceeded book value on an aggregate basis.

At September 30, 2002, our residential one-to-four units subprime portfolio consisted of approximately 85% "A-" credit, 13% "B" credit and 2% "C" credit loans. At September 30, 2002, the average loan-to-value ratio at origination for these loans was approximately 75%.

We carry mortgage-backed securities available for sale at fair value which, at September 30, 2002, reflected an unrealized gain of \$1.6 million. The current quarter-end unrealized gain, less the associated tax effect, is reflected within a separate component of other comprehensive income until realized.

29

DEPOSITS

At September 30, 2002, our deposits totaled \$9.1 billion, up \$188 million or 2.1% from the year-ago level, and up \$366 million or 4.2% from the previous quarter. Compared to the year-ago period, our lower-rate transaction accounts--i.e., checking, money market and regular passbook--increased \$2.1 billion, almost double the year-ago level, which was partially offset by a decrease in our certificates of deposit of \$1.9 billion or 28.6%. As depositors seemed more interested in liquidity given the relatively low level of interest rates, they moved monies from certificates of deposit to transaction accounts, primarily regular passbook accounts. At September 30, 2002, the average deposit size of our traditional branches was \$105 million, while the average size of our in-store branches was \$19 million, or \$21 million excluding the 18 new in-store branches opened within the past 12 months.

The following table sets forth information concerning our deposits and weighted average rates paid at the quarter ends indicated.

September 30, 2002	June 30, 2002	March 31, 2002	December 31,
Weighted	Weighted	Weighted	Weighted

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

(Dollars in Thousands)	Average Rate	Amount	Average Rate	Amount	Average Rate	Amount	Average Rate	Amount
Transaction accounts:								
Non-interest-bearing								
checking	-- %	\$ 312,338	-- %	\$ 295,788	-- %	\$ 312,962	-- %	\$ 26
Interest-bearing								
checking (1)	0.25	410,095	0.25	418,310	0.25	436,612	0.35	42
Money market	1.64	113,746	1.80	114,618	1.82	112,646	2.01	10
Regular passbook	2.04	3,413,891	2.42	3,082,356	2.57	2,789,500	2.46	2,13

Total transaction								
accounts	1.71	4,250,070	1.99	3,911,072	2.05	3,651,720	1.92	2,92
Certificates of deposit:								
Less than 3.00%	2.36	1,942,296	2.50	1,764,986	2.45	1,467,532	2.41	97
3.00-3.49	3.36	1,213,176	3.33	1,258,969	3.29	1,080,673	3.20	45
3.50-3.99	3.88	664,344	3.84	588,142	3.84	527,613	3.84	53
4.00-4.49	4.25	376,386	4.25	563,298	4.23	830,142	4.22	89
4.50-4.99	4.80	492,254	4.80	456,618	4.76	495,530	4.76	55
5.00-5.99	5.41	66,452	5.43	74,154	5.21	356,605	5.30	92
6.00 and greater	6.26	51,954	6.26	73,319	6.32	189,075	6.37	1,36

Total certificates of								
deposit	3.30	4,806,862	3.41	4,779,486	3.66	4,947,170	4.54	5,69

Total deposits	2.55%	\$9,056,932	2.77%	\$8,690,558	2.98%	\$8,598,890	3.65%	\$8,61

BORROWINGS

During the current quarter, our borrowings increased \$456 million to \$1.9 billion, due to increases in FHLB advances of \$274 million and securities sold under agreements to repurchase of \$182 million. This increased level of borrowing was used to purchase approximately one-half of the \$1.0 billion of mortgage-backed securities, which were purchased late in September but sold in early October.

The following table sets forth information concerning our FHLB advances and other borrowings at the quarter ends indicated.

(Dollars in Thousands)	September 30, 2002	June 30, 2002	March 31, 2002
Federal Home Loan Bank advances	\$1,687,431	\$ 1,413,607	\$ 1,320,386
Securities sold under agreements to repurchase .	182,358	--	--
Other borrowings	--	--	--

Total borrowings	\$1,869,789	\$ 1,413,607	\$ 1,320,386
=====			
Weighted average rate on borrowings during			
the period	4.35%	4.59%	4.28%
Total borrowings as a percentage of total assets	14.94	12.70	12.10
=====			

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

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. Interest expense on our capital securities, including the amortization of deferred issuance costs, was \$3.0 million for the third quarter of 2002, and \$9.1 million for the first nine months of 2002.

ASSET/LIABILITY MANAGEMENT AND MARKET RISK

Market risk is the risk of loss from adverse changes in market prices and interest rates. Our market risk arises primarily from interest rate risk in our lending and deposit taking activities. This interest rate risk primarily occurs to the degree that our interest-bearing liabilities reprice or mature on a different basis--generally more rapidly--than our interest-earning assets. Since our earnings depend primarily on our net interest income, which is the difference between the interest and dividends earned on interest-earning assets and the interest paid on interest-bearing liabilities, one of our principal objectives is to actively monitor and manage the effects of adverse changes in interest rates on net interest income while maintaining asset quality. Our primary strategy to manage interest rate risk is to emphasize the origination of adjustable rate mortgages or loans with relatively short maturities. Interest rates on adjustable rate mortgages are primarily tied to COFI and MTA.

In addition to the market risk associated with our lending and deposit taking activities, we also have market risk associated with our secondary marketing activities. Changes in mortgage interest rates, primarily fixed rate mortgages, impact the fair value of loans held for sale as well as our off-balance sheet commitments where we have committed to an interest rate with a potential borrower for a loan we intend to sell (known as an interest rate lock commitment derivative). Our objective is to hedge against fluctuations in interest rates through use of forward sale and purchase contracts with government-sponsored enterprises and whole loan sale contracts with various parties. These contracts are typically obtained at the time the interest rate lock commitments are made. Therefore, as interest rates fluctuate, the changes in the fair value of our interest rate lock commitments and loans held for sale tend to be offset by changes in the fair value of the hedge contracts. Although we continue to hedge as previously done, SFAS 133, as applied to our risk management strategies, may increase or decrease reported net income and stockholders' equity, depending on levels of interest rates and other variables affecting the fair values of derivative instruments and hedged items, but will have no effect on the overall economics of the transactions. We currently do not enter into hedging contracts for speculative purposes.

Changes in mortgage interest rates also impact the value of our mortgage servicing rights. Rising interest rates typically result in slower prepayment speeds on the loans being serviced for others which increase the value of mortgage servicing rights. Declining interest rates typically result in faster prepayment speeds which decrease the value of mortgage servicing rights. Currently, we do not hedge our mortgage servicing rights against that risk.

There has been no significant change in our market risk since December 31, 2001.

One measure of our exposure to differential changes in interest rates between assets and liabilities is shown in the following table, which sets forth the repricing frequency of our major asset and liability categories as of September 30, 2002, as well as other information regarding the repricing and

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

maturity differences between our interest-earning assets and total deposits, borrowings and capital securities in future periods. We refer to these differences as "gap." We have determined the repricing frequencies by reference to projected maturities, based upon contractual maturities as adjusted for scheduled repayments and "repricing mechanisms"--provisions for changes in the interest and dividend rates of assets and liabilities. We assume prepayment rates on substantially all of our loan portfolio based upon our historical loan prepayment experience and anticipated future prepayments. Repricing mechanisms on a number of our assets are subject to limitations, such as caps on the amount that interest rates and payments on our loans may adjust, and accordingly, these assets do not normally respond to changes in market interest rates as completely or rapidly as our liabilities. The interest rate sensitivity of our assets and liabilities illustrated in the following table would vary substantially if we used different assumptions or if actual experience differed from the assumptions set forth.

(Dollars in Thousands)	September 30,			
	Within 6 Months	7 - 12 Months	1 - 5 Years	6 - Ye
Interest-earning assets:				
Investment securities and FHLB stock(1)	\$ 241,988	\$ 45,819	\$ 113,490	\$
Loans and mortgage-backed securities:(2)				
Loans secured by real estate:				
Residential:				
Adjustable	8,451,276	297,630	841,852	
Fixed	687,370	49,348	107,514	
Commercial real estate	37,312	3,726	17,407	1
Construction	45,379	--	--	
Land	23,369	9	66	
Non-mortgage loans:				
Commercial	9,422	--	--	
Consumer	57,271	3,120	7,690	
Mortgage-backed securities	1,019,030	--	--	
Total loans and mortgage-backed securities	10,330,429	353,833	974,529	2
Total interest-earning assets	\$10,572,417	\$ 399,652	\$1,088,019	\$ 2
Transaction accounts:				
Non-interest-bearing checking	\$ 312,338	\$ --	\$ --	\$
Interest-bearing checking	410,095	--	--	
Money market	113,746	--	--	
Regular passbook	3,413,891	--	--	
Total transaction accounts	4,250,070	--	--	
Certificates of deposit	2,419,199	1,103,111	1,284,552	
Total deposits	6,669,269	1,103,111	1,284,552	
Borrowings	729,439	69,700	611,650	45
Capital securities	--	--	--	
Total deposits, borrowings and capital securities	\$ 7,398,708	\$ 1,172,811	\$1,896,202	\$ 45
Excess (shortfall) of interest-earning assets over deposits, borrowings and capital securities ...	\$ 3,173,709	\$ (773,159)	\$ (808,183)	\$ (43)
Cumulative gap	3,173,709	2,400,550	1,592,367	1,16

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Cumulative gap - as a percent of total assets:

September 30, 2002	25.35%	19.18%	12.72%
December 31, 2001	12.01	4.76	7.91
September 30, 2001	17.55	7.07	8.93

32

Our six-month gap at September 30, 2002 was a positive 25.35%. This means that more interest-earning assets mature or reprice within six months than total deposits, borrowings and capital securities. This compares to a positive six-month gap of 12.01% at December 31, 2001 and 17.55% at September 30, 2001.

We continue to pursue our strategy of emphasizing the origination of adjustable rate mortgages. For the twelve months ended September 30, 2002, we originated and purchased for investment \$4.3 billion of adjustable rate loans which represented virtually all of the loans we originated and purchased for investment during the period.

At September 30, 2002 and 2001, essentially all of our interest-earning assets mature, reprice or are estimated to prepay within five years, compared to 99% at December 31, 2001. At September 30, 2002, loans held for investment with adjustable interest rates represented 92% of the portfolio. During the third quarter of 2002, we continued to offer residential fixed rate loan products to our customers primarily for sale in the secondary market. We price and originate fixed rate mortgage loans for sale into the secondary market to increase opportunities to originate adjustable rate mortgages and to generate fees and servicing income. We also originate fixed rate loans for portfolio to facilitate the sale of real estate acquired in settlement of loans and which meet specific yield and other approved guidelines.

At September 30, 2002, \$9.8 billion or 92% of our total loan portfolio, consisted of adjustable rate loans, construction loans, and loans with a due date of five years or less, compared to \$9.3 billion or 91% at December 31, 2001, and \$9.1 billion or 92% at September 30, 2001.

The following table sets forth the interest rate spread between our interest-earning assets and interest-bearing liabilities at the quarter ends indicated.

	September 30, 2002	June 30, 2002	March 31, 2002	December 31, 2001

Weighted average yield:				
Loans and mortgage-backed securities	6.00%	6.01%	6.45%	7.15%
Federal Home Loan Bank stock	2.87	5.56	5.30	5.31
Investment securities	3.12	3.44	3.43	3.54

Interest-earning assets yield	5.90	5.93	6.35	6.98

Weighted average cost:				
Deposits	2.55	2.77	2.98	3.65
Borrowings:				
Federal Home Loan Bank advances ..	3.95	4.32	4.63	3.73
Other borrowings	2.02	--	--	7.88

Total borrowings	3.76	4.32	4.63	3.73

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Capital securities	10.00	10.00	10.00	10.00

Combined funds cost	2.84	3.07	3.28	3.74

Interest rate spread	3.06%	2.86%	3.07%	3.24%
=====				

The period-end weighted average yield on our loan portfolio declined to 6.00% at September 30, 2002, down from 7.15% at December 31, 2001 and 7.68% at September 30, 2001. At September 30, 2002, our adjustable rate mortgage portfolio of single family residential loans, including mortgage-backed securities, totaled \$9.6 billion with a weighted average rate of 5.94%, compared to \$9.0 billion with a weighted average rate of 7.11% at December 31, 2001, and \$8.8 billion with a weighted average rate of 7.68% at September 30, 2001.

PROBLEM LOANS AND REAL ESTATE

NON-PERFORMING ASSETS

Non-performing assets consist of loans on which we have ceased accruing interest (which we refer to as non-accrual loans), loans restructured at a below market rate, real estate acquired in settlement of loans and repossessed automobiles. Our non-performing assets increased \$5 million during the quarter to \$89 million or 0.71% of total assets (0.77% excluding the mortgage-backed securities of \$1.0 billion purchased in late September but were sold in early October). Residential non-performers increased \$9 million during the quarter, of which \$6 million was associated with subprime loans. That increase was partially offset by a \$4 million decline in commercial real estate non-performers due to a short-pay that was accepted in full consideration of the loan.

33

The following table summarizes our non-performing assets at the quarter ends indicated.

(Dollars in Thousands)	September 30, 2002	June 30, 2002	March 31, 2002	De

Non-accrual loans:				
Residential one-to-four units	\$36,068	\$33,827	\$43,934	
Residential one-to-four units - subprime	36,304	31,540	33,169	
Other	823	4,305	4,589	

Total non-accrual loans	73,195	69,672	81,692	
Troubled debt restructure - below market rate (1) ...	203	203	203	
Real estate acquired in settlement of loans	15,441	13,528	11,917	
Repossessed automobiles	15	16	19	

Total non-performing assets	\$88,854	\$83,419	\$93,831	
=====				
Allowance for loan losses:				
Amount	\$34,880	\$35,834	\$37,307	
As a percentage of non-performing loans	47.52%	51.28%	45.55%	
Non-performing assets as a percentage of total assets	0.71	0.75	0.86	
=====				

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

DELINQUENT LOANS

Loans delinquent 30 days or more as a percentage of total loans declined slightly during the quarter to 0.90% at September 30, 2002, from 0.91% at June 30, 2002, and 0.96% a year ago. In our 60-89 non-mortgage commercial category, we had an increase of \$1.2 million due to one loan, which paid-off after September 30, 2002.

34

The following table indicates the amounts of our past due loans at the quarter ends indicated.

(Dollars in Thousands)	September 30, 2002				
	30-59 Days	60-89 Days	90+ Days (1)	Total	30-59 Days
Loans secured by real estate:					
Residential:					
One-to-four units	\$17,835	\$10,454	\$25,487	\$ 53,776	\$20,531
One-to-four units - subprime	11,606	6,565	22,275	40,446	10,694
Five or more units	--	--	--	--	--
Commercial real estate	--	--	--	--	--
Construction	--	--	--	--	--
Land	--	--	--	--	--
Total real estate loans	29,441	17,019	47,762	94,222	31,225
Non-mortgage:					
Commercial	--	1,235	548	1,783	--
Automobile	126	9	26	161	190
Other consumer	147	36	249	432	314
Total delinquent loans	\$29,714	\$18,299	\$48,585	\$ 96,598	\$31,729
Delinquencies as a percentage of total loans	0.28%	0.17%	0.45%	0.90%	0.31%

(Dollars in Thousands)	March 31, 2002				
	30-59 Days	60-89 Days	90+ Days (1)	Total	30-59 Days
Loans secured by real estate:					
Residential:					
One-to-four units	\$19,454	\$ 6,360	\$34,724	\$ 60,538	\$19,170
One-to-four units - subprime	13,653	4,175	25,797	43,625	13,159
Five or more units	--	--	--	--	--
Commercial real estate	--	--	--	--	--
Construction	--	--	--	--	--
Land	--	--	--	--	--
Total real estate loans	33,107	10,535	60,521	104,163	32,329
Non-mortgage:					
Commercial	--	--	637	637	--
Automobile	138	14	79	231	174
Other consumer	142	57	185	384	356
Total delinquent loans	\$33,387	\$10,606	\$61,422	\$105,415	\$32,859

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Delinquencies as a percentage of total loans	0.33%	0.11%	0.61%	1.05%	0.33%
=====					
September 30, 2001					

Loans secured by real estate:					
Residential:					
One-to-four units	\$18,515	\$ 8,165	\$25,131	\$ 51,811	
One-to-four units - subprime	11,212	8,569	21,649	41,430	
Five or more units	--	--	--	--	
Commercial real estate	--	--	--	--	
Construction	--	--	--	--	
Land	--	--	--	--	

Total real estate loans	29,727	16,734	46,780	93,241	
Non-mortgage:					
Commercial	--	--	1,290	1,290	
Automobile	269	54	80	403	
Other consumer	253	38	264	555	

Total delinquent loans	\$30,249	\$16,826	\$48,414	\$ 95,489	
=====					
Delinquencies as a percentage of total loans	0.30%	0.17%	0.49%	0.96%	
=====					

ALLOWANCE FOR LOSSES ON LOANS AND REAL ESTATE

We maintain a valuation allowance for losses on loans and real estate to provide for losses inherent in those portfolios. The adequacy of the allowance is evaluated quarterly by management to maintain the allowance at levels sufficient to provide for inherent losses.

We adhere to an internal asset review system and loss allowance methodology designed to provide for timely recognition of problem assets and an adequate valuation allowance to cover asset losses. The amount of the allowance is based upon the summation of general valuation allowances, allocated allowances and an unallocated allowance. General valuation allowances relate to assets with no well-defined deficiency or weakness and takes into consideration loss that is imbedded within the portfolio but has not yet been realized. Allocated allowances relate to assets with well-defined deficiencies or weaknesses. Included in both these allowances are those amounts associated with assets where it is probable that the recorded value of the asset has declined and the loss can be reasonably estimated. If we determine the carrying value of our asset exceeds its net fair value and no alternative payment source exists, then a specific allowance is recorded for the amount of that difference. The unallocated allowance is more subjective and is reviewed quarterly to take into consideration estimation errors and economic trends that are not necessarily captured in determining the general valuation and allocated allowances.

Allowances for losses on all assets were \$37 million at September 30, 2002, compared to \$39 million at December 31, 2001, and \$38 million at September 30, 2001.

In the current quarter, our provision for loan losses totaled \$0.5 million and net loan charge-offs totaled \$1.4 million, resulting in a decrease in the allowance for loan losses to \$35 million at September 30, 2002. The current quarter decline in the allowance reflected a decrease of \$1.5 million in

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

allocated allowances to \$5.4 million due primarily to a \$1.2 million charge-off of a commercial real estate loan for which a short-pay was accepted in full consideration of the loan. General valuation allowances increased \$0.5 million and there was no change in our unallocated allowance of \$2.8 million.

The following table summarizes the activity in our allowance for loan losses during the quarterly periods indicated.

(In Thousands)	Three Months Ended			
	September 30, 2002	June 30, 2002	March 31, 2002	De
Balance at beginning of period	\$35,834	\$37,307	\$36,120	
Provision (reduction)	471	(1,106)	1,447	
Charge-offs	(1,450)	(387)	(276)	
Recoveries	25	20	16	
Balance at end of period	\$34,880	\$35,834	\$37,307	

Since year-end 2001, our allowance for loan losses declined by \$1.2 million, as general valuation allowances declined by \$1.1 million and allocated allowances declined by \$0.1 million.

The following table summarizes the activity in our allowance for loan losses during the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001
Balance at beginning of period	\$ 36,120	\$ 34,452
Provision	812	1,274
Charge-offs	(2,113)	(1,032)
Recoveries	61	349
Balance at end of period	\$ 34,880	\$ 35,043

The following table presents gross charge-offs, gross recoveries and net charge-offs by category of loan during the periods indicated.

(Dollars in Thousands)	Three Months Ended				
	September 30, 2002	June 30, 2002	March 31, 2002	December 31, 2001	September 2001

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

GROSS LOAN CHARGE-OFFS

Loans secured by real estate:

Residential:

One-to-four units	\$ 113	\$ 197	\$ 125	\$ 108	\$ 25
One-to-four units - subprime	69	63	17	70	60
Five or more units	--	--	--	--	--
Commercial real estate	1,188	--	--	--	--
Construction	--	--	--	--	--
Land	--	--	--	--	--

Non-mortgage:

Commercial	--	--	--	--	--
Automobile	3	33	52	51	26
Other consumer	77	94	82	87	87

Total gross loan charge-offs	1,450	387	276	316	198
------------------------------	-------	-----	-----	-----	-----

GROSS LOAN RECOVERIES

Loans secured by real estate:

Residential:

One-to-four units	--	--	9	1	86
One-to-four units - subprime	--	--	--	100	61
Five or more units	--	--	--	--	--
Commercial real estate	--	--	--	--	--
Construction	--	--	--	--	--
Land	--	--	--	--	--

Non-mortgage:

Commercial	--	--	--	--	--
Automobile	21	16	5	--	--
Other consumer	4	4	2	2	2

Total gross loan recoveries	25	20	16	103	149
-----------------------------	----	----	----	-----	-----

NET LOAN CHARGE-OFFS

Loans secured by real estate:

Residential:

One-to-four units	113	197	116	107	(61)
One-to-four units - subprime	69	63	17	(30)	(1)
Five or more units	--	--	--	--	--
Commercial real estate	1,188	--	--	--	--
Construction	--	--	--	--	--
Land	--	--	--	--	--

Non-mortgage:

Commercial	--	--	--	--	--
Automobile	(18)	17	47	51	26
Other consumer	73	90	80	85	85

Total net loan charge-offs	\$ 1,425	\$ 367	\$ 260	\$ 213	\$ 49
----------------------------	----------	--------	--------	--------	-------

Net loan charge-offs as a percentage of average loans	0.05%	0.01%	0.01%	0.01%	-- %
---	-------	-------	-------	-------	------

The following table indicates our allocation of the allowance for loan losses to the various categories of loans at the quarter ends indicated.

September 30, 2002

June 30, 2002

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

(Dollars in Thousands)	Allowance	Gross Loan Portfolio Balance	Allowance Percentage to Loan Balance	Allowance	Gross Loan Portfolio Balance	Allowance Percentage to Loan Balance
Loans secured by real estate:						
Residential:						
One-to-four units	\$17,951	\$ 8,285,998	0.22%	\$17,291	\$8,122,908	0.21
One-to-four units - subprime	8,873	1,420,081	0.62	8,697	1,417,915	0.61
Five or more units	63	8,430	0.75	65	8,727	0.74
Commercial real estate	1,448	77,665	1.86	2,905	81,722	3.55
Construction	1,292	110,125	1.17	1,459	124,318	1.17
Land	665	53,885	1.23	769	62,182	1.24
Non-mortgage:						
Commercial	634	17,792	3.56	596	17,371	3.43
Automobile	127	14,475	0.88	250	17,667	1.42
Other consumer	1,027	54,779	1.87	1,002	50,101	2.00
Not specifically allocated	2,800	--	--	2,800	--	--
Total loans held for investment	\$34,880	\$10,043,230	0.35%	\$35,834	\$9,902,911	0.36

	December 31, 2001			September 30, 2001		
Loans secured by real estate:						
Residential:						
One-to-four units	\$19,033	\$7,699,061	0.25%	\$16,598	\$7,567,462	0.22
One-to-four units - subprime	9,633	1,506,719	0.64	10,385	1,605,994	0.65
Five or more units	84	11,179	0.75	86	11,489	0.75
Commercial real estate	1,848	112,509	1.64	2,262	142,480	1.59
Construction	1,005	84,942	1.18	1,164	99,161	1.17
Land	274	22,028	1.24	262	21,121	1.24
Non-mortgage:						
Commercial	573	22,017	2.60	650	22,762	2.86
Automobile	277	24,529	1.13	196	29,109	0.67
Other consumer	593	50,908	1.16	640	53,243	1.20
Not specifically allocated	2,800	--	--	2,800	--	--
Total loans held for investment	\$36,120	\$9,533,892	0.38%	\$35,043	\$9,552,821	0.37

At September 30, 2002, the recorded investment in loans for which we recognized impairment totaled \$13 million, unchanged from December 31, 2001, but down from \$15 million at September 30, 2001. The allowance for losses related to these loans was \$1 million at September 30, 2002, December 31, 2001 and September 30, 2001. During the third quarter of 2002, total interest recognized on the impaired loan portfolio was \$0.3 million.

The following table summarizes the activity in our allowance for loan losses associated with impaired loans during the quarterly periods indicated.

(In Thousands)	Three Months Ended		
	September 30, 2002	June 30, 2002	March 31, 2002

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Balance at beginning of period	\$ 2,203	\$ 2,356	\$ 759
Provision (reduction)	(268)	(153)	1,597
Charge-offs	(1,188)	--	--
Recoveries	--	--	--
Balance at end of period	\$ 747	\$ 2,203	\$ 2,356

For the first nine months of 2002, total interest recognized on the impaired loan portfolio was \$1.0 million.

38

The following table summarizes the activity in our allowance for loan losses associated with impaired loans during the year-to-date periods indicated.

(In Thousands)	Nine Months Ended September 30,	
	2002	2001
Balance at beginning of period	\$ 759	\$ 800
Provision	1,176	410
Charge-offs	(1,188)	--
Recoveries	--	--
Balance at end of period	\$ 747	\$ 1,210

The following table summarizes the activity in our allowance for real estate and joint ventures held for investment during the quarterly periods indicated.

(In Thousands)	Three Months Ended				
	September 30, 2002	June 30, 2002	March 31, 2002	December 31, 2001	September 30, 2001
Balance at beginning of period	\$ 1,851	\$ 1,033	\$ 2,690	\$ 2,689	\$ 3,000
Provision (reduction)	(99)	818	(1,318)	1	1
Charge-offs	--	--	(339)	--	--
Recoveries	--	--	--	--	--
Balance at end of period	\$ 1,752	\$ 1,851	\$ 1,033	\$ 2,690	\$ 2,990

The following table summarizes the activity in our allowance for real estate and joint ventures held for investment during the year-to-date periods indicated.

Nine Months Ended

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

(In Thousands)	September 30,	
	2002	2001
Balance at beginning of period	\$ 2,690	\$ 2,997
Reduction	(599)	(308)
Charge-offs	(339)	--
Recoveries	--	--
Balance at end of period	\$ 1,752	\$ 2,689

CAPITAL RESOURCES AND LIQUIDITY

Our sources of funds include deposits, advances from the FHLB and other borrowings; proceeds from the sale of loans, mortgage-backed securities and real estate; payments of loans and mortgage-backed securities and payments for and sales of loan servicing; and income from other investments. Interest rates, real estate sales activity and general economic conditions significantly affect repayments on loans and mortgage-backed securities and deposit inflows and outflows.

Our primary sources of funds generated in the third quarter of 2002 were from:

- o principal repayments--including prepayments, but excluding refinances of our existing loans--on loans and mortgage-backed securities of \$664 million;
- o a net increase in FHLB advances and other borrowings of \$456 million;
- o an increase in deposits of \$366 million; and
- o maturities of U.S. Treasury securities, agency obligations and other investment securities available for sale of \$157 million.

39

We used these funds for the following purposes:

- o to originate and purchase loans held for investment, excluding refinances of our existing loans, of \$780 million;
- o to purchase mortgage-backed securities available for sale of \$504 million;
- o to increase our loans held for sale a net \$284 million; and
- o to purchase U.S. Treasury securities, agency obligations and other investment securities available for sale of \$131 million.

Our principal source of liquidity is our ability to utilize borrowings, as needed. Our primary source of borrowings is the FHLB. At September 30, 2002, our FHLB borrowings totaled \$1.7 billion, representing 13.5% of total assets. We currently are approved by the FHLB to borrow up to 40% of total assets to the extent we provide qualifying collateral and hold sufficient FHLB stock. That approved limit would have permitted us, as of quarter end, to borrow an additional \$3.3 billion. To the extent deposit growth over the remainder of 2002 falls short of satisfying ongoing commitments to fund maturing and withdrawable deposits, repay maturing borrowings, fund existing and future loans, make

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

investments, and continue branch improvement programs, we will utilize our FHLB borrowing arrangement or possibly other sources. As of September 30, 2002, we had commitments to borrowers for short-term rate locks of \$1.3 billion, undisbursed loan funds and unused lines and letters of credit of \$184 million, and other contingent liabilities of \$3 million. We believe our current sources of funds enable us to meet our obligations while maintaining liquidity at appropriate levels.

Another measure of liquidity in the savings and loan industry is the ratio of cash and eligible investments to the sum of withdrawable savings and borrowings due within one year. The Bank's ratio was 4.6% at September 30, 2002, 4.3% at December 31, 2001 and 4.1% at September 30, 2001.

The holding company currently has liquid assets, including due from Bank--interest bearing balances, of \$67 million and can obtain further funds by means of dividends from subsidiaries, subject to certain limitations, or issuance of further debt or equity.

On July 24, 2002, the Board of Directors of Downey authorized a share repurchase program of up to \$50 million of Downey's common stock. To fund this program, the Bank paid a special \$50 million dividend during the third quarter to the holding company. The shares will be repurchased from time-to-time in open market transactions. The timing, volume and price of purchases will be made at the discretion of Downey, and will also be contingent upon Downey's overall financial condition, as well as market conditions in general. During the third quarter of 2002, 212,300 shares were repurchased at an average price of \$41.04.

Stockholders' equity totaled \$791 million at September 30, 2002, up from \$734 million at December 31, 2001 and \$698 million at September 30, 2001.

40

REGULATORY CAPITAL

Our core and tangible capital ratios were both 6.36% and our risk-based capital ratio was 13.65%. The Bank's capital ratios exceed the "well capitalized" standards of 5.00% for core capital and 10.00% for risk-based capital, as defined by regulation.

The following table is a reconciliation of the Bank's stockholder's equity to federal regulatory capital as of September 30, 2002.

(Dollars in Thousands)	Tangible Capital		Core Capital	
	Amount	Ratio	Amount	Ratio
Stockholder's equity	\$839,077		\$839,077	
Adjustments:				
Deductions:				
Investment in subsidiary, primarily real estate ..	(39,201)		(39,201)	
Excess cost over fair value of branch acquisitions	(2,814)		(2,814)	
Non-permitted mortgage servicing rights	(4,691)		(4,691)	
Additions:				
Unrealized losses on securities available for sale	(274)		(274)	
General loss allowance - investment in DSL				
Service Company	265		265	
Allowance for loan losses,				
net of specific allowances (1)	-		-	

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Regulatory capital	792,362	6.36%		792,362	6.36%
Well capitalized requirement	186,905	1.50	(2)	623,017	5.00
<hr style="border-top: 1px dashed black;"/>					
Excess	\$605,457	4.86%		\$169,345	1.36%
<hr style="border-top: 1px dashed black;"/>					

41

ITEM 3. - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For information regarding quantitative and qualitative disclosures about market risk see Financial Condition--Asset/Liability Management and Market Risk on page 31.

ITEM 4. - CONTROLS AND PROCEDURES

Within the 90 days prior to the date of this report, Downey carried out an evaluation, under the supervision and with the participation of Downey's management, including Downey's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Downey's disclosure controls and procedures pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that Downey's disclosure controls and procedures are effective in timely alerting them to material information relating to Downey required to be included in Downey's periodic Securities and Exchange Commission filings. There has been no significant changes in Downey's internal controls or in other factors that could significantly affect these controls subsequent to the evaluation date.

42

PART II - OTHER INFORMATION

ITEM 1 - 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 2 - CHANGES IN SECURITIES AND USE OF PROCEEDS

None.

ITEM 3 - DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5 - OTHER INFORMATION

None.

ITEM 6 - EXHIBITS AND REPORTS ON FORM 8-K

(A) Exhibits

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Exhibit Number -----	Description -----
3.1	(2) Certificate of Incorporation of Downey Financial Corp.
3.2	(1) Bylaws of Downey Financial Corp.
4.1	(4) Junior Subordinated Indenture dated as of July 23, 1999 between Downey Financial Corp. and Wilmington Trust Company as Indenture Trustee.
4.2	(4) 10% Junior Subordinated Debenture due September 15, 2029, Principal Amount \$123,711,350.
4.3	(4) Certificate of Trust of Downey Financial Capital Trust I, dated as of May 25, 1999.
4.4	(4) Trust Agreement of Downey Financial Capital Trust I, dated May 25, 1999.
4.5	(4) Amended and Restated Trust Agreement of Downey Financial Capital Trust I, between Downey Financial Corp., Wilmington Trust Company and the Administrative Trustees named therein, dated as of July 23, 1999.
4.6	(4) Certificate Evidencing Common Securities of Downey Financial Capital Trust I, 10% Common Securities.
4.7	(4) Certificate Evidencing Capital Securities of Downey Financial Capital Trust I, 10% Capital Securities (Global Certificate).
4.8	(4) Common Securities Guarantee Agreement of Downey Financial Corp. (Guarantor), dated July 23, 1999.
4.9	(4) Capital Securities Guarantee Agreement of Downey Financial Corp. and Wilmington Trust Company, dated as of July 23, 1999.
10.1	(3) Downey Savings and Loan Association, F.A. Employee Stock Purchase Plan (Amended and Restated as of January 1, 1996).

43

(A) Exhibits (Continued)

Exhibit Number -----	Description -----
10.2	(3) Amendment No. 1, Downey Savings and Loan Association, F.A. Employee Stock Purchase Plan. Amendment No. 1, Effective and Adopted January 22, 1997.
10.3	(3) Downey Savings and Loan Association, F.A. Employees' Retirement and Savings Plan (October 1, 1997 Restatement).
10.4	(3) Amendment No. 1, Downey Savings and Loan Association, F.A. Employees' Retirement and Savings Plan (October 1, 1997 Restatement) Amendment No. 1, Effective and Adopted January 28, 1998.
10.5	(3) Trust Agreement for Downey Savings and Loan Association, F.A. Employees' Retirement and Savings Plan, Effective October 1, 1997 between Downey Savings and Loan Association, F.A. and Fidelity Management Trust Company.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

- 10.6 (2) Downey Savings and Loan Association 1994 Long-Term Incentive Plan (as amended).
- 10.7 (1) Asset Purchase Agreement among Butterfield Savings and Loan Association, FSA, Mortgage Investment, Inc., Property Management Service, Inc. and Butterfield Capital Corporation, dated September 1, 1988.
- 10.8 (1) Assistance Agreement between and among the Federal Savings and Loan Insurance Corporation, Butterfield Savings and Loan Association, FSA and Downey Savings and Loan Association, dated September 29, 1988 (confidential treatment requested due to contractual prohibition against disclosure).
- 10.9 (1) Merger of Butterfield Savings and Loan Association, FSA, into Downey Savings and Loan Association, dated September 29, 1989.
- 10.10(1) Founder Retirement Agreement of Maurice L. McAlister, dated December 21, 1989.
- 10.11(5) Amendment No. 1, Founders Retirement Agreement of Maurice L. McAlister, dated December 21, 1989. Amendment No. 1, Effective and Adopted July 26, 2000.
- 10.12(1) Founder Retirement Agreement of Gerald H. McQuarrie, dated December 21, 1989.
- 10.13 (6) Deferred Compensation Program.
- 10.14 (6) Director Retirement Benefits.
- 99.1 Certification of Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
- 99.2 Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002.

- (1) Filed as part of Downey's Registration Statement on Form 8-B/A filed January 17, 1995.
- (2) Filed as part of Downey's Registration Statement on Form S-8 filed February 3, 1995.
- (3) Filed as part of Downey's report on Form 10-K filed March 16, 1998.
- (4) Filed as part of Downey's report on Form 10-Q filed November 2, 1999.
- (5) Filed as part of Downey's report on Form 10-Q filed August 2, 2000.
- (6) Filed as part of Downey's report on Form 10-K filed March 7, 2001.

We will furnish any or all of the non-confidential exhibits upon payment of a reasonable fee. Please send request for exhibits and/or fee information to:

44

Downey Financial Corp.
3501 Jamboree Road
Newport Beach, California 92660
Attention: Corporate Secretary

- (B) 1) Form 8-K filed July 8, 2002, with respect to the election of James H. Hunter as a new Board of Director.
- 2) Form 8-K filed July 17, 2002, with respect to a press release reporting its results of operations during the three and six months

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

- ended June 30, 2002.
- 3) Form 8-K filed August 16, 2002, with respect to a press release reporting monthly selected financial data for the thirteen months ended July 31, 2002.
 - 4) Form 8-K filed September 18, 2002, with respect to a press release reporting monthly selected financial data for the thirteen months ended August 31, 2002.

SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DOWNEY FINANCIAL CORP.

Date: October 31, 2002

/s/ Daniel D. Rosenthal

Daniel D. Rosenthal
President and Chief Executive Officer

Date: October 31, 2002

/s/ Thomas E. Prince

Thomas E. Prince
Executive Vice President and Chief Financial Officer

45

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Daniel D. Rosenthal, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Downey Financial Corp.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: October 31, 2002

/s/ Daniel D. Rosenthal

Daniel D. Rosenthal
President and Chief Executive Officer

46

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Thomas E. Prince, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Downey Financial Corp.;

2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors:

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: October 31, 2002

/s/ Thomas E. Prince

Thomas E. Prince
Executive Vice President and Chief Financial Officer