

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

DOWNEY FINANCIAL CORP  
Form 10-Q  
November 01, 2001

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, 2001

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, 2001, 28,213,048 shares of the Registrant's Common Stock, \$0.01 par value were outstanding.

DOWNEY FINANCIAL CORP.

SEPTEMBER 30, 2001 QUARTERLY REPORT ON FORM 10-Q

TABLE OF CONTENTS

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

PART I

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
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.....	11

PART II

OTHER INFORMATION.....	35
Item 6 Exhibits and Reports on Form 8-K.....	35

i

PART I - FINANCIAL INFORMATION

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in Thousands, Except Per Share Data)	September 30, 2001	D
-----		
ASSETS		
Cash .....	\$ 103,000	\$
Federal funds .....	2,401	
-----		
Cash and cash equivalents .....	105,401	
U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value .....	296,204	
Municipal securities held to maturity, at amortized cost (estimated market value of \$6,533 at September 30, 2001, \$6,534 at December 31, 2000 and \$6,709 at September 30, 2000) .....	6,549	
Loans held for sale, at lower of cost or market .....	373,489	
Mortgage-backed securities available for sale, at fair value .....	4,562	
Loans receivable held for investment .....	9,534,438	
Investments in real estate and joint ventures .....	38,043	
Real estate acquired in settlement of loans .....	11,870	
Premises and equipment .....	106,488	
Federal Home Loan Bank stock, at cost .....	111,649	
Mortgage servicing rights, net .....	37,507	
Other assets .....	90,094	
-----		
	\$10,716,294	\$
=====		
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits .....	\$ 8,868,782	\$
Federal Home Loan Bank advances .....	927,398	
Other borrowings .....	29	

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Accounts payable and accrued liabilities .....	67,392	
Deferred income taxes .....	34,218	
<hr/>		
Total liabilities .....	9,897,819	
<hr/>		
Company obligated mandatorily redeemable capital securities of subsidiary trust holding solely junior subordinated debentures of the Company ("Capital Securities") .....	120,000	
<hr/>		
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; outstanding 28,213,048 shares at September 30, 2001, 28,205,741 shares at December 31, 2000 and 28,201,606 shares at September 30, 2000 .....	282	
Additional paid-in capital .....	93,400	
Accumulated other comprehensive income (loss) .....	897	
Retained earnings .....	603,896	
<hr/>		
Total stockholders' equity .....	698,475	
<hr/>		
	\$10,716,294	\$
<hr/>		

See accompanying notes to consolidated financial statements.

1

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Income

	Three Months Ended September 30,	
	2001	2000
<hr/>		
(Dollars in Thousands, Except Per Share Data)		
<hr/>		
INTEREST INCOME		
Loans receivable .....	\$ 187,867	\$ 198,
U.S. Treasury securities and agency obligations .....	3,727	3,
Mortgage-backed securities .....	62	
Other investments .....	2,040	2,
<hr/>		
Total interest income .....	193,696	204,
<hr/>		
INTEREST EXPENSE		
Deposits .....	107,033	98,
Borrowings .....	10,176	35,
Capital securities .....	3,040	3,
<hr/>		
Total interest expense .....	120,249	137,
<hr/>		
NET INTEREST INCOME .....	73,447	67,
PROVISION FOR LOAN LOSSES .....	791	1,
<hr/>		
Net interest income after provision for loan losses .....	72,656	66,
<hr/>		
OTHER INCOME, NET		
Loan and deposit related fees .....	13,274	7,
Real estate and joint ventures held for investment, net:		
Operations, net .....	372	2,

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Net gains on sales of wholly owned real estate .....	--	1,
(Provision for) reduction of losses on real estate and joint ventures	374	
Secondary marketing activities:		
Loan servicing fees .....	(11,771)	
Net gains (losses) on sales of loans and mortgage-backed securities .	4,234	(
Net gains on sales of mortgage servicing rights .....	87	-
Net gains (losses) on sales of investment securities .....	3	
Gain on sale of subsidiary .....	--	
Other .....	497	
<hr/>		
Total other income, net .....	7,070	12,
<hr/>		
OPERATING EXPENSE		
Salaries and related costs .....	24,943	19,
Premises and equipment costs .....	6,628	5,
Advertising expense .....	939	
Professional fees .....	2,432	
SAIF insurance premiums and regulatory assessments .....	786	
Other general and administrative expense .....	5,981	4,
<hr/>		
Total general and administrative expense .....	41,709	32,
<hr/>		
Net operation of real estate acquired in settlement of loans .....	110	
Amortization of excess of cost over fair value of net assets acquired ..	116	
<hr/>		
Total operating expense .....	41,935	32,
<hr/>		
INCOME BEFORE INCOME TAXES .....	37,791	45,
Income taxes .....	16,025	19,
<hr/>		
Net income before cumulative effect of change in accounting principle ..	21,766	26,
Cumulative effect of change in accounting principle, net of taxes .....	--	-
<hr/>		
NET INCOME .....	\$ 21,766	\$ 26,
<hr/>		
PER SHARE INFORMATION		
Basic before cumulative effect of change in accounting principle .....	\$ 0.77	\$ 0
BASIC AFTER CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE .....	0.77	0
<hr/>		
Diluted before cumulative effect of change in accounting principle .....	\$ 0.77	\$ 0
DILUTED AFTER CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE .....	0.77	0
<hr/>		
CASH DIVIDENDS DECLARED AND PAID .....	\$ 0.09	\$ 0
<hr/>		
Weighted average diluted shares outstanding .....	28,278,485	28,247,
<hr/>		

See accompanying notes to consolidated financial statements.

2

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

	Three Months Ended	
	September 30,	
	<hr/>	
(In Thousands)	2001	2000
	<hr/>	

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

NET INCOME .....	\$ 21,766	\$ 26,33
-----		
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 .....	973	85
Mortgage-backed securities available for sale, at fair value .....	9	7
Less reclassification of realized (gains) losses included in net income .....	(2)	(1)
Unrealized gains (losses) on cash flow hedges:		
Net derivative instruments .....	(3,052)	--
Cumulative effect of change in accounting principle .....	--	--
Less reclassification of realized losses included in net income .....	575	--
-----		
Total other comprehensive income (loss), net of income taxes (benefits) ....	(1,497)	91
-----		
COMPREHENSIVE INCOME .....	\$ 20,269	\$ 27,25
=====		

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:	
Cumulative effect of change in accounting principle, net of income taxes .....	
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 .....	
Gain on sale of subsidiary .....	
Interest capitalized on loans (negative amortization) .....	
Federal Home Loan Bank stock dividends .....	
Loans originated for sale .....	(3,
Proceeds from sales of loans held for sale, including those sold via mortgage-backed securities .....	3,
Other, net .....	
-----	
Net cash provided by (used for) operating activities .....	
-----	
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sale of:	
Subsidiary, net .....	
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:	

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

U.S. Treasury securities, agency obligations and other investment securities available for sale .....	(
Loans receivable held for investment .....	
Federal Home Loan Bank stock .....	
Originations of loans receivable held for investment (net of refinances of \$557,183 at September 30, 2001 and \$89,667 at September 30, 2000) .....	(1,
Principal payments on loans receivable held for investment and mortgage-backed securities available for sale .....	2,
Net change in undisbursed loan funds .....	
Proceeds from (investments in) real estate held for investment .....	
Other, net .....	
-----	
Net cash provided by (used for) investing activities .....	
-----	

See accompanying notes to consolidated financial statements.

4

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Continued)

(In Thousands)	2001	Nine Mon Septemb
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits .....	\$ 786,093	\$
Proceeds from Federal Home Loan Bank advances .....	2,040,850	
Repayments of Federal Home Loan Bank advances .....	(3,091,800)	
Net decrease in other borrowings .....	(195)	
Proceeds from exercise of stock options .....	161	
Cash dividends .....	(7,617)	
-----		
Net cash provided by (used for) financing activities .....	(272,508)	
-----		
Net decrease in cash and cash equivalents .....	(22,402)	
Cash and cash equivalents at beginning of period .....	127,803	
-----		
CASH AND CASH EQUIVALENTS AT END OF PERIOD .....	\$ 105,401	\$
=====		
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest .....	\$ 404,885	\$
Income taxes .....	59,016	
Supplemental disclosure of non-cash investing:		
Loans transferred to held for investment from held for sale .....	4,287	
Loans transferred from held for investment to held for sale .....	--	
Loans transferred from held for investment to wholly owned real estate ....	15,688	
Loans exchanged for mortgage-backed securities .....	2,525,816	
Real estate acquired in settlement of loans .....	17,588	
Loans to facilitate the sale of real estate acquired in settlement of loans	8,156	
=====		

See accompanying notes to consolidated financial statements.

5

# Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

## 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, 2001, December 31, 2000 and September 30, 2000, the results of operations and comprehensive income for the three months and nine months ended September 30, 2001 and 2000, and changes in cash flows for the nine months ended September 30, 2001 and 2000. 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, 2000, 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, 2000 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) - NET INCOME PER SHARE

Net income per share is calculated on both a basic and diluted basis. Basic net income per share excludes dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted net income 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.

(Dollars in Thousands, Except Per Share Data)	Three Months Ended September 30,			
	2001		2000	
	Net Income	Per Share Amount	Net Income	Per S Amo
Basic earnings per share .....	\$21,766	\$0.77	\$26,338	\$
Effect of dilutive stock options ..	--	--	--	
Diluted earnings per share ....	\$21,766	\$0.77	\$26,338	\$
=====				
Weighted average shares outstanding				
Basic .....		28,212,575		28,195
Dilutive stock options .....		65,910		52
-----				

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Diluted .....	28,278,485	28,247	
=====			
6			
	Nine Months Ended September		
	2001	2000	
	Net Income	Per Share Amount	Net Income
(Dollars in Thousands, Except Per Share Data)			
-----			
BEFORE CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE			
Basic earnings per share .....	\$81,049	\$2.87	\$76,256
Effect of dilutive stock options .....	--	0.01	--
-----			
Diluted earnings per share .....	\$81,049	\$2.86	\$76,256
=====			
AFTER CUMULATIVE EFFECT OF CHANGE IN ACCOUNTING PRINCIPLE			
Basic earnings per share .....	\$81,085	\$2.87	\$76,256
Effect of dilutive stock options .....	--	0.01	--
-----			
Diluted earnings per share .....	\$81,085	\$2.86	\$76,256
=====			
WEIGHTED AVERAGE SHARES OUTSTANDING			
Basic .....		28,211,100	
Dilutive stock options .....		63,794	
-----			
Diluted .....		28,274,894	
=====			

NOTE (3) - BUSINESS SEGMENT REPORTING

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

(In Thousands)	Banking	Real Estate Investment	Elimination	Tot
-----				
THREE MONTHS ENDED SEPTEMBER 30, 2001				
Net interest income (loss) .....	\$ 73,473	\$ (26)	\$ --	\$ 73
Provision for loan losses .....	791	--	--	791
Other income .....	5,987	1,083	--	7,070
Operating expense .....	40,071	1,864	--	41,935
Net intercompany income (expense) .....	92	(92)	--	--
-----				
Income (loss) before income taxes (benefit)	38,690	(899)	--	37,791
Income taxes (benefit) .....	16,389	(364)	--	16,025
-----				
Net income (loss) .....	\$ 22,301	\$ (535)	\$ --	\$ 21,766
=====				
AT SEPTEMBER 30, 2001				
Assets:				
Loans and mortgage-backed securities .	\$ 9,912,489	\$ --	\$ --	\$ 9,912,489
Real estate held for investment .....	--	38,043	--	38,043



Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Other .....	797,775	1,629	(33,642)	765
Total assets .....	10,710,264	39,672	(33,642)	10,716
Equity .....	\$ 698,475	\$ 33,642	\$ (33,642)	\$ 698
THREE MONTHS ENDED SEPTEMBER 30, 2000				
Net interest income .....	\$ 67,137	\$ 73	\$ --	\$ 67
Provision for loan losses .....	1,007	--	--	1
Other income .....	7,953	4,112	--	12
Operating expense .....	32,216	260	--	32
Net intercompany income (expense) .....	83	(83)	--	
Income before income taxes .....	41,950	3,842	--	45
Income taxes .....	17,870	1,584	--	19
Net income .....	\$ 24,080	\$ 2,258	\$ --	\$ 26
AT SEPTEMBER 30, 2000				
Assets:				
Loans and mortgage-backed securities .	\$ 9,646,741	\$ --	\$ --	\$ 9,646
Real estate held for investment .....	--	15,851	--	15
Other .....	715,933	6,347	(17,659)	704
Total assets .....	10,362,674	22,198	(17,659)	10,367
Equity .....	\$ 602,624	\$ 17,659	\$ (17,659)	\$ 602

7

(In Thousands)	Banking	Real Estate Investment	Elimination	Totals
NINE MONTHS ENDED SEPTEMBER 30, 2001				
Net interest income .....	\$225,843	\$ 12	\$ --	\$225,855
Provision for loan losses .....	1,274	--	--	1,274
Other income .....	31,881	3,423	--	35,304
Operating expense .....	115,924	3,402	--	119,326
Net intercompany income (expense) .....	273	(273)	--	--
Income (loss) before income taxes (benefit) .	140,799	(240)	--	140,559
Income taxes (benefit) .....	59,606	(96)	--	59,510
Net income (loss) before cumulative effect of change in accounting principle .....	81,193	(144)	--	81,049
Cumulative effect of change in accounting principle, net of income taxes .....	36	--	--	36
Net income (loss) .....	\$ 81,229	\$ (144)	\$ --	\$ 81,085
NINE MONTHS ENDED SEPTEMBER 30, 2000				
Net interest income .....	\$193,353	\$ 185	\$ --	\$193,538
Provision for loan losses .....	2,740	--	--	2,740
Other income:				
Gain on sale of subsidiary .....	9,762	--	--	9,762
All other .....	25,178	8,069	--	33,247
Operating expense .....	100,258	867	--	101,125

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Net intercompany income (expense) .....	298	(298)	--	--
Income before income taxes .....	125,593	7,089	--	132,682
Income taxes .....	53,509	2,917	--	56,426
Net income .....	\$ 72,084	\$ 4,172	\$ --	\$ 76,256

NOTE (4) - MORTGAGE SERVICING RIGHTS

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

(Dollars in Thousands)	Three Months E		
	September 30, 2001	June 30, 2001	March 31, 2001
Gross balance at beginning of period .....	\$ 55,848	\$ 49,323	\$ 46,214
Additions .....	10,294	13,403	5,394
Amortization .....	(2,495)	(2,299)	(2,063)
Sale of servicing .....	(582)	(2,328)	--
Impairment write-down .....	(1,414)	(2,251)	(222)
Gross balance at end of period .....	61,651	55,848	49,323
Allowance balance at beginning of period .....	13,706	13,606	5,483
Provision for impairment .....	11,852	2,351	8,345
Impairment write-down .....	(1,414)	(2,251)	(222)
Allowance balance at end of period .....	24,144	13,706	13,606
Total mortgage servicing rights, net .....	\$ 37,507	\$ 42,142	\$ 35,717
Estimated fair value (1) .....	\$ 37,507	\$ 42,142	\$ 35,752
AT PERIOD END			
Mortgage loans serviced for others:			
Total .....	\$ 5,458,970	\$ 5,056,120	\$ 4,296,883
With capitalized mortgage servicing rights (2):			
Amount .....	5,078,088	4,456,822	3,999,380
Weighted average interest rate .....	7.19%	7.29%	7.50%
Custodial escrow balances .....	\$ 15,415	\$ 9,924	\$ 5,281

NOTE (5) - ACCOUNTING FOR DERIVATIVES AND HEDGING ACTIVITIES

On January 1, 2001, we adopted Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, ("SFAS 133"). SFAS 133 required the recognition of all derivative financial instruments at fair value and reported as either assets or liabilities on the balance sheet. The accounting for gains and losses associated with changes in the fair value of derivatives are reported in current earnings or

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

other comprehensive income, net of tax, depending on whether they qualify for hedge accounting and whether the hedge is highly effective in achieving offsetting changes in the fair value or cash flows of the asset or liability hedged. Under the provisions of SFAS 133, the method used for assessing the effectiveness of a hedging derivative, as well as the measurement approach for determining the ineffective aspects of the hedge, must have been established at the inception of the hedge. Those methods must also be consistent with the entity's approach to managing risk. 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 actual cash flows or the overall economics of the transactions.

With the implementation of SFAS 133, we recorded after-tax transition amounts associated with establishing the fair values of the derivative instruments and hedged items on the balance sheet as an increase of \$36,000 to net income and a reduction of \$388,000 in other comprehensive income. All of the other comprehensive income transition amount was reclassified into earnings during the first quarter of 2001.

### Derivatives

We offer short-term interest rate lock commitments to help us attract potential home loan borrowers. The rate locks guarantee a specified interest rate for a loan if our underwriting standards are met, but do not obligate the potential borrower. The rate lock commitments we ultimately expect to sell in the secondary market are treated as derivatives. Consequently, as derivatives, the expected rate lock commitments do not qualify for hedge accounting. Associated fair value adjustments are recorded in the balance sheet in either other assets or accounts payable and accrued liabilities, with an offset to current earnings under net gains on sales of loans and mortgage-backed securities. At September 30, 2001, we had rate lock commitments estimated to sell as part of our secondary marketing activities of \$423 million. At origination, the fair value of our rate lock derivatives are capitalized into the basis of our loans held for sale and, from that point until sale, qualify for hedge accounting under SFAS 133.

### Hedging Activities

As part of our secondary marketing activities, we typically utilize short-term forward sale and purchase contracts to offset the impact of changes in market interest rates on the value of rate lock derivatives and loans originated for sale. Contracts associated with originated loans are accounted for as cash flow hedges. These contracts have a high correlation to the price movement of both the rate lock derivatives and the loans being hedged. Changes in forward sale contract values not assigned to originated loans and the ineffectiveness of hedge transactions are recorded in net gains on sales of loans and mortgage-backed securities. The changes in values on forward sale contracts assigned as cash flow hedges to originated loans are recorded in other comprehensive income, net of tax, as long as cash flow hedge requirements are met. 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 losses in accumulated other comprehensive income will be reclassified into earnings within the next three months. At September 30, 2001, forward sale contracts amounted to \$827 million, of which \$369 million were designated as cash flow hedges, and forward purchase contracts totaled \$53 million.

### NOTE (6) - INCOME TAXES

Downey and its wholly owned subsidiaries file a consolidated federal income

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

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 1995 and are currently reviewing returns filed for the 1996 tax year. Adjustments proposed by the Internal Revenue Service have been protested by Downey and are currently moving through the government appeals process. Downey believes it has established appropriate liabilities for any resultant deficiencies. Tax years subsequent to 1996 remain open to review by federal and state tax authorities.

9

### NOTE (7) - SALE OF SUBSIDIARY

On February 29, 2000, Downey Savings and Loan Association, F.A. sold its indirect automobile finance subsidiary, Downey Auto Finance Corp., to Auto One Acceptance Corp., a subsidiary of California Federal Bank and recognized a pre-tax gain from the sale of \$9.8 million. As of December 31, 1999, Downey Auto Finance Corp. had loans totaling \$366 million and total assets of \$373 million.

### NOTE (8) - CURRENT ACCOUNTING ISSUES

In July 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, "Business Combinations" ("SFAS 141") and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142").

SFAS 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. The use of the pooling-of-interests method will be prohibited. It is not anticipated that the financial impact of this statement will have a material effect on Downey.

SFAS 142 applies to all acquired intangible assets whether acquired singularly, as part of a group, or in a business combination. The Statement supersedes APB Opinion No. 17, "Intangible Assets," and will carry forward provisions in Opinion 17 related to internally developed intangible assets. The Statement 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. For the first nine months of 2001, the amortization of excess of cost over fair value of net assets acquired was \$0.3 million and as of September 30, 2001, goodwill amounted to \$3.3 million. It is not anticipated that the financial impact of this statement will have a material effect on Downey.

10

### 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 2001 totaled \$21.8 million or \$0.77 per share on a diluted basis, down 17.4% from the \$26.3 million or \$0.93 per

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

share in the third quarter of 2000.

The decline in our net income between third quarters was primarily due to the addition we made to our valuation allowance for mortgage servicing rights. The addition was reflected within the category of loan servicing fees and was necessary due to the continued drop in market interest rates that have increased the expected rate of prepayments on loans we service for others, as well as a decline in the value of associated custodial accounts. The pre-tax addition during the third quarter was \$11.9 million, compared to \$0.6 million a year ago. If that valuation allowance had not been necessary, our net income in the current quarter would have been \$28.6 million, up \$1.9 million or 7.1% from the adjusted year-ago level. This reflected an increase of \$4.7 million in adjusted net income from our banking operations, that more than offset a \$2.8 million decline in net income from real estate investment activities. Adjusted net income from banking operations increased due to the following:

- o a \$9.3 million increase in other income due to higher loan and deposit related fees as well as higher net gains from the sales of loans and mortgage-backed securities;
- o a \$6.3 million or 9.4% increase in net interest income due to increases in both average earning assets and our effective interest rate spread; and
- o a \$0.2 million reduction in provision for loan losses.

These favorable items were partially offset by a \$7.9 million increase in our operating expense associated with an increased number of branch locations and higher loan origination activity.

For the first nine months of 2001, our net income totaled \$81.1 million or \$2.86 per share on a diluted basis. This is an increase of 14.8% over the \$70.6 million or \$2.50 per share for the first nine months of 2000, excluding the \$5.6 million or \$0.20 per share after-tax gain from the sale of our indirect automobile finance subsidiary from the year-ago results. Including the gain, our net income for the first nine months of 2000 totaled \$76.3 million or \$2.70 per share on a diluted basis. The increase between nine-month periods primarily reflected higher net income from our banking operations.

For the third quarter of 2001, our return on average assets was 0.82% and our return on average equity was 12.63%. For the first nine months of 2001, our return on average assets was 1.00% and our return on average equity was 16.31%.

At September 30, 2001, our assets totaled \$10.7 billion, up \$349 million or 3.4% from a year ago, but down \$106 million from June 30, 2001. Our single family loan originations totaled \$1.988 billion in the third quarter of 2001, up 128.7% from the \$869 million we originated in the third quarter of 2000 but 6.3% below the record \$2.122 billion we originated in the second quarter of 2001. Of the current quarter total, \$872 million represented originations of loans for portfolio, of which \$101 million represented subprime credits. In addition to single family loans, we originated \$57 million of other loans in the quarter.

Between third quarters, we funded our asset growth with a \$1.2 billion or 15.3% increase in deposits. At quarter-end, our deposits totaled \$8.9 billion. During the quarter, one new traditional branch and four new in-store branches were opened, bringing our total branches at quarter end to 134, with the total equally divided between traditional and in-store locations. A year ago, branches totaled 107, of which 43 were in-store.

Our non-performing assets increased \$15 million during the quarter to \$75 million or 0.70% of total assets. The increase was all in residential loans, of which \$7 million were subprime.

At September 30, 2001, our primary subsidiary, Downey Savings and Loan

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Association, F.A. (the "Bank"), had core and tangible capital ratios of 7.04% and a risk-based capital ratio of 14.11%. These capital levels were substantially above the "well capitalized" standards defined by regulation of 5% for core and tangible capital and 10% for risk-based capital.

11

### RESULTS OF OPERATIONS

#### NET INTEREST INCOME

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

Our net interest income totaled \$73.4 million in the third quarter of 2001, up \$6.2 million or 9.3% from the same period last year. The improvement between third quarters reflected increases in both average earning assets and the effective interest rate spread. Our average earning assets increased by \$215 million or 2.1% between third quarters to \$10.3 billion. Our effective interest rate spread of 2.85% in the current quarter was up from the year-ago quarter level of 2.66%. This improvement was due to our cost of funds declining more rapidly than our yield on earning assets. This is indicative of what typically happens when interest rates decline, as there is an administrative lag in the repricing of our loans which are primarily priced to the Federal Home Loan Bank ("FHLB") Eleventh District Cost of Funds Index ("COFI"). Our current quarter effective interest rate spread, however, was down 4 basis points from the second quarter 2001 level, as our earning asset yield fell slightly faster than with our cost of funds on a linked-quarter basis. For the first nine months of 2001, net interest income totaled \$225.9 million, up \$32.3 million or 16.7% from a year ago.

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 using the average of each month's daily average balance during the periods indicated.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

12

Three Months Ended September 30,					
-----					
2001					
-----					
(Dollars in Thousands)	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest
-----					
Interest-earning assets:					
Loans .....	\$ 9,893,414	\$187,867	7.60%	\$ 9,728,972	\$198,084
Mortgage-backed securities ....	4,951	62	5.01	13,715	224
Investment securities .....	420,635	5,767	5.44	361,046	6,062
-----					
Total interest-earning assets	10,319,000	193,696	7.51	10,103,733	204,370
Non-interest-earning assets .....	354,634			333,522	
-----					
Total assets .....	\$10,673,634			\$10,437,255	
=====					
Transaction accounts:					
Non-interest-bearing checking .	\$ 313,665	\$ --	-- %	\$ 216,800	\$ --
Interest-bearing checking (1) .	406,779	501	0.49	383,563	882
Money market .....	93,388	648	2.75	87,702	628
Regular passbook .....	1,184,206	9,426	3.16	793,046	6,845
-----					
Total transaction accounts ..	1,998,038	10,575	2.10	1,481,111	8,355
Certificates of deposit .....	6,929,044	96,458	5.52	5,937,680	90,602
-----					
Total deposits .....	8,927,082	107,033	4.76	7,418,791	98,957
Borrowings .....	805,879	10,176	5.01	2,189,570	35,163
Capital securities .....	120,000	3,040	10.14	120,000	3,040
-----					
Total deposits, borrowings and capital securities.....	9,852,961	120,249	4.84	9,728,361	137,160
Other liabilities .....	131,469			119,577	
Stockholders' equity .....	689,204			589,317	
-----					
Total liabilities and stockholders' equity .....	\$10,673,634			\$10,437,255	
=====					
Net interest income/interest rate spread .....		\$ 73,447	2.67%		\$ 67,210
Excess of interest-earning assets over deposits, borrowings and capital securities.....	\$ 466,039			\$ 375,372	
Effective interest rate spread ....			2.85		
=====					

Nine Months Ended September 30,					
-----					
2001					
-----					
(Dollars in Thousands)	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest
-----					

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Interest-earning assets:					
Loans .....	\$10,043,997	\$604,449	8.02%	\$ 9,418,857	\$557,202
Mortgage-backed securities ....	6,121	277	6.03	17,518	876
Investment securities .....	450,942	20,171	5.98	335,471	16,507
-----					
Total interest-earning assets	10,501,060	624,897	7.93	9,771,846	574,585
Non-interest-earning assets .....	357,013			339,743	
-----					
Total assets .....	\$10,858,073			\$10,111,589	
=====					
Transaction accounts:					
Non-interest-bearing checking .	\$ 285,427	\$ --	-- %	\$ 202,844	\$ --
Interest-bearing checking (1) .	404,065	1,633	0.54	379,592	2,741
Money market .....	90,869	1,903	2.80	89,675	1,908
Regular passbook .....	942,245	23,369	3.32	806,779	21,271
-----					
Total transaction accounts ..	1,722,606	26,905	2.09	1,478,890	25,920
Certificates of deposit .....	6,968,361	309,315	5.93	5,621,411	244,489
-----					
Total deposits .....	8,690,967	336,220	5.17	7,100,301	270,409
Borrowings .....	1,254,497	53,700	5.72	2,219,932	101,516
Capital securities .....	120,000	9,122	10.14	120,000	9,122
-----					
Total deposits, borrowings and capital securities .....	10,065,464	399,042	5.30	9,440,233	381,047
Other liabilities .....	129,714			105,137	
Stockholders' equity .....	662,895			566,219	
-----					
Total liabilities and stockholders' equity .....	\$10,858,073			\$10,111,589	
=====					
Net interest income/interest rate spread .....		\$225,855	2.63%		\$193,538
Excess of interest-earning assets over deposits, borrowings and capital securities .....	\$ 435,596			\$ 331,613	
Effective interest rate spread ....			2.87		
=====					

13

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.

Three Months Ended September 30,



Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

2001 Versus 2000  
Changes Due To

(In Thousands)	Volume	Rate	Rate/ Volume	Net	Volume
<b>Interest income:</b>					
Loans .....	\$ 3,348	\$ (13,340)	\$ (225)	\$ (10,217)	\$ 36,982
Mortgage-backed securities .....	(143)	(52)	33	(162)	(570)
Investment securities .....	906	(1,031)	(170)	(295)	5,652
<hr/>					
Change in interest income .....	4,111	(14,423)	(362)	(10,674)	42,064
<hr/>					
<b>Interest expense:</b>					
Transaction accounts:					
Interest-bearing checking (1) .	53	(409)	(25)	(381)	177
Money market .....	46	(25)	(1)	20	42
Regular passbook .....	3,417	(560)	(276)	2,581	3,536
<hr/>					
Total transaction accounts ..	3,516	(994)	(302)	2,220	3,755
Certificates of deposit .....	16,177	(8,845)	(1,476)	5,856	58,326
<hr/>					
Total interest-bearing deposits	19,693	(9,839)	(1,778)	8,076	62,081
Borrowings .....	(22,138)	(7,566)	4,717	(24,987)	(44,231)
Capital securities .....	--	--	--	--	--
<hr/>					
Change in interest expense ....	(2,445)	(17,405)	2,939	(16,911)	17,850
<hr/>					
Change in net interest income .....	\$ 6,556	\$ 2,982	\$ (3,301)	\$ 6,237	\$ 24,214

PROVISION FOR LOAN LOSSES

Provision for loan losses was \$0.8 million in the current quarter, down from \$1.0 million in the third quarter of 2000. For the first nine months of 2001, provision for loan losses was \$1.3 million, compared to \$2.7 million in the year-ago period. For 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 30.

OTHER INCOME

Our total other income was \$7.1 million in the third quarter of 2001, down \$5.0 million from a year ago primarily due to:

- o an \$11.9 million addition to the valuation allowance for mortgage servicing rights reflected within the category of loan servicing fees due to the continued drop in market interest rates that have increased the expected rate of prepayments on loans serviced for others, as well as a decline in the value of associated custodial accounts; and
- o a \$3.3 million decrease in income from real estate held for investment due to lower gains from sales and lower recapture of valuation allowances.

Those decreases were partially offset by a \$5.3 million increase in loans and deposit related fees due to increases of \$3.3 million in loan prepayment fees and \$1.0 million in deposit related fees, as well as an increase of \$4.6 million in net gains

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

from sales of loans and mortgage-backed securities. For the first nine months of 2001, total other income was \$35.3 million, down \$7.7 million from a year ago, of which \$9.8 million was attributable to the year-ago pre-tax gain from the sale of our indirect automobile finance subsidiary. Below is a further discussion of the major other income categories.

Loan and Deposit Related Fees

Loan and deposit related fees totaled \$13.3 million in the third quarter of 2001, up \$5.3 million from a year ago. Our loan related fees accounted for \$4.3 million of the increase between third quarters, of which \$3.3 million represented higher loan prepayment fees. Our deposit related fees increased by \$1.0 million or 29.2%, primarily due to higher fees from our checking accounts. For the nine months of 2001, loan and deposit related fees totaled \$37.6 million, up \$16.9 million from the same period of 2000.

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

(In Thousands)	Three Months Ended				
	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000	September 30, 2000
Loan related fees:					
Prepayment fees .....	\$ 6,384	\$ 7,455	\$ 4,525	\$ 3,899	\$ 3,000
Other fees .....	2,257	2,251	1,779	1,513	1,300
Deposit related fees:					
Automated teller machine fees .....	1,671	1,650	1,533	1,618	1,500
Other fees .....	2,962	2,780	2,393	2,270	2,000
<b>Total loan and deposit related fees</b>	<b>\$13,274</b>	<b>\$14,136</b>	<b>\$10,230</b>	<b>\$ 9,300</b>	<b>\$ 7,900</b>

Real Estate and Joint Ventures Held for Investment

Income from our real estate and joint ventures held for investment totaled \$0.7 million in the third quarter of 2001, down from \$4.0 million a year ago. Our net gains on sales declined by \$2.7 million between third quarters, while the recapture of valuation allowances were lower by \$0.2 million. For the first nine months of 2001, income from real estate and joint ventures held for investment totaled \$2.4 million, down \$5.4 million from the same period of 2000.

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

(In Thousands)	Three Months Ended			
	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000
Operations, net:				
Rental operations, net of expenses .....	\$ 259	\$ 452	\$ 508	\$ 500
Equity in net income from joint ventures .....	12	121	391	300
Interest from joint venture advances .....	101	152	132	100

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total operations, net .....	372	725	1,031	
Net gains on sales of wholly owned real estate .....	--	--	2	
(Provision for) reduction of losses on real estate and joint ventures .....	374	(33)	(33)	
Income from real estate and joint ventures held for investment, net .....	\$ 746	\$ 692	\$ 1,000	\$

Secondary Marketing Activities

Sales of loans and mortgage-backed securities we originated increased to \$1.120 billion in the third quarter of 2001 from \$620 million a year ago. Net gains associated with these sales totaled \$4.2 million in the third quarter of 2001, up from a loss of \$0.3 million a year ago. The year-ago loss was due to a conversion to a new loan origination system that temporarily affected the hedge position against our loans held for sale. The net gains included capitalized mortgage servicing rights of \$10.3 million in the third quarter of 2001, compared to \$6.3 million a year ago. For the first nine months of 2001, net gains on sales of loans and mortgage-backed securities totaled \$15.3 million, up from \$2.2 million from the same period of 2000.

15

A loss of \$11.8 million was recorded in loan servicing fees from our portfolio of loans serviced for others during the third quarter of 2001, compared to a loss of \$0.1 million a year ago. The loss in the 2001 third quarter reflects an \$11.9 million provision to the valuation allowance for mortgage servicing rights due to the continued drop in interest rates that have increased the expected rate of prepayments on loans serviced for others, as well as a decline in the value of associated custodial accounts. At September 30, 2001, we serviced \$5.5 billion of loans for others, compared to \$4.0 billion at both December 31, 2000 and September 30, 2000. For the first nine months of 2001, a loss of \$22.9 million was recorded in loan servicing fees, compared to income of \$0.5 million from the same period of 2000.

The following table presents a breakdown of the components of our loan servicing fees for the periods indicated.

(In Thousands)	Three Months Ended				
	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000	September 30, 2000
Income from servicing operations	\$ 2,576	\$ 1,752	\$ 2,223	\$ 2,718	\$ 2,086
Amortization of MSRs .....	(2,495)	(2,299)	(2,063)	(1,803)	(1,559)
Provision for impairment .....	(11,852)	(2,351)	(8,345)	(5,028)	(606)
Total loan servicing fees ....	\$(11,771)	\$(2,898)	\$(8,185)	\$(4,113)	\$(79)

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

OPERATING EXPENSE

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Operating expense totaled \$41.9 million in the current quarter, up \$9.5 million from the third quarter of 2000. The increase was primarily due to a \$9.6 million or 29.8% increase in general and administrative expense. That increase was primarily due to higher costs associated with an increased number of branch locations and higher loan origination activity. For the first nine months of 2001, operating expenses totaled \$119.3 million, up \$18.2 million from the same period of 2000.

The following table presents a breakdown of our operating expense for the periods indicated.

(In Thousands)	Three Months Ended			
	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000
Salaries and related costs .....	\$ 24,943	\$ 24,646	\$ 23,271	\$ 21,743
Premises and equipment costs .....	6,628	6,042	6,043	5,945
Advertising expense .....	939	1,127	1,176	1,121
Professional fees .....	2,432	1,604	577	1,274
SAIF insurance premiums and regulatory assessments .....	786	741	732	696
Other general and administrative expense .....	5,981	5,973	5,339	5,188
Total general and administrative expense .	41,709	40,133	37,138	35,967
Net operation of real estate acquired in settlement of loans .....	110	(106)	(2)	263
Amortization of excess of cost over fair value of net assets acquired .....	116	114	114	114
Total operating expense .....	\$ 41,935	\$ 40,141	\$ 37,250	\$ 36,344

### PROVISION FOR INCOME TAXES

Income taxes for the current quarter totaled \$16.0 million, resulting in an effective tax rate of 42.4%, compared to \$19.5 million and 42.5% for the like quarter of a year ago. For the first nine months of 2001, our effective tax rate was 42.3%, compared to 42.5% for the same period of 2000. For further information regarding income taxes, see Notes to Consolidated Financial Statements--Note (6) - Income Taxes on page 9.

16

### BUSINESS SEGMENT REPORTING

The previous sections of the Results of Operations discussed our consolidated results. The purpose of this section is to present data and discussion on 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.

Three Months Ended

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

(In Thousands)	September 30, 2001	June 30, 2001	March 31, 2001	December 2000
Banking net income .....	\$22,301	\$33,619	\$25,309	\$22,738
Real estate investment net income (loss)	(535)	(164)	555	257
<b>Total net income .....</b>	<b>\$21,766</b>	<b>\$33,455</b>	<b>\$25,864</b>	<b>\$22,995</b>

	Nine Months ----- 2001			
Banking net income .....	\$81,229			
Real estate investment net income (loss)	(144)			
<b>Total net income .....</b>	<b>\$81,085</b>			

Banking

Net income from our banking operations for the third quarter of 2001 totaled \$22.3 million, down 7.4% from \$24.1 million in the third quarter of 2000.

The decrease between third quarters primarily reflected the \$11.9 million addition to the valuation allowance for mortgage servicing rights reflected within the category of loan servicing fees as a result of the continued drop in market interest rates that have increased the expected rate of prepayments on loans serviced for others, as well as a decline in the value of associated custodial accounts. If that valuation allowance had not been necessary, net income from our banking operations would have been \$29.1 million, up \$4.7 million or 19.2% from the adjusted year-ago level. The adjusted increase primarily resulted from:

- o a \$6.3 million increase in net interest income due to increases in both our average earning assets and effective interest rate spread;
- o a \$5.0 million increase in loan and deposit related fees;
- o a \$4.6 million increase in net gains on sales of loans and mortgage-backed securities; and
- o a \$0.2 million reduction in provision for loan losses.

Partially offsetting these favorable items was a \$7.9 million increase in operating expense due to higher costs associated with an increased number of branch locations and higher loan origination activity.

17

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

(In Thousands)	Three Months Ended			
	September 30, 2001	June 30, 2001	March 31, 2001	December 2000
Net interest income .....	\$ 73,473	\$ 76,236	\$ 76,134	\$ 68,8

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Provision for loan losses .....	791	431	52	5
Other income .....	5,987	21,211	4,683	6,4
Operating expense .....	40,071	38,863	36,990	35,7
Net intercompany income .....	92	84	97	
<hr/>				
Income before income taxes .....	38,690	58,237	43,872	39,1
Income taxes .....	16,389	24,618	18,599	16,4
<hr/>				
Net income before cumulative effect of change in accounting principle .....	22,301	33,619	25,273	22,7
Cumulative effect of change in accounting principle, net of income taxes .....	--	--	36	--
<hr/>				
Net income .....	\$ 22,301	\$ 33,619	\$ 25,309	\$ 22,7
<hr/>				
AT PERIOD END				
Assets:				
Loans and mortgage-backed securities .	\$ 9,912,489	\$ 9,981,213	\$10,272,222	\$10,084,3
Other .....	797,775	837,387	755,324	806,2
<hr/>				
Total assets .....	10,710,264	10,818,600	11,027,546	10,890,5
<hr/>				
Equity .....	\$ 698,475	\$ 680,719	\$ 648,592	\$ 624,6
<hr/>				

For the first nine months of 2001, our net income from banking totaled \$81.2 million, up \$9.1 million from the same period a year ago. The sale of our indirect automobile finance subsidiary benefited our year-ago nine-month period net income by \$5.6 million. Excluding that gain, net income from our banking operations would have increased by \$14.8 million or 22.2% from a year ago.

The following table sets forth our banking operational results for the periods indicated.

(In Thousands)	Nine Months Ended Sept	
	2001	20
Net interest income .....	\$225,843	\$193,
Provision for loan losses .....	1,274	2,
Other income:		
Gain on sale of subsidiary .....	--	9,
All other .....	31,881	25,
Operating expense .....	115,924	100,
Net intercompany income .....	273	
<hr/>		
Income before income taxes .....	140,799	125,
Income taxes .....	59,606	53,
<hr/>		
Net income before cumulative effect of change in accounting principle ..	81,193	72,
Cumulative effect of change in accounting principle, net of income taxes	36	-
<hr/>		
Net income (1) .....	\$ 81,229	\$ 72,
<hr/>		

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

### Real Estate Investment

Our real estate investment operations recorded a loss of \$0.5 million in the third quarter of 2001, compared to net income of \$2.3 million in the year-ago quarter. The decline was primarily attributed to lower gains from sales, lower recapture of valuation allowances and higher operating expenses due to litigation matters associated with certain joint venture partners.

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

(In Thousands)	Three Months Ended			
	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000
Net interest income (loss) .....	\$ (26)	\$ 10	\$ 28	\$ 58
Other income .....	1,083	1,072	1,268	1,079
Operating expense .....	1,864	1,278	260	606
Net intercompany expense .....	92	84	97	99
Income (loss) before income taxes (benefit) ...	(899)	(280)	939	432
Income taxes (benefit) .....	(364)	(116)	384	175
Net income (loss) .....	\$ (535)	\$ (164)	\$ 555	\$ 257
<b>AT PERIOD END:</b>				
<b>Assets:</b>				
Investment in real estate and joint ventures	\$ 38,043	\$ 19,950	\$ 18,690	\$ 17,641
Other .....	1,629	1,673	3,337	3,584
Total assets .....	39,672	21,623	22,027	21,225
Equity .....	\$ 33,642	\$ 18,307	\$ 18,471	\$ 17,916

Our investment in real estate and joint ventures amounted to \$38 million at September 30, 2001, compared to \$18 million at December 31, 2000 and \$16 million at September 30, 2000. During the quarter, our investment increased by \$16 million due primarily to a settlement of litigation with former joint venture partners wherein we became the sole owner of two shopping centers.

For the first nine months of 2001, our net loss from real estate investment operations totaled \$0.1 million, down from net income of \$4.2 million during the same period a year ago.

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

(In Thousands)	Nine Months Ended September 30,	
	2001	2000
Net interest income .....	\$ 12	\$ 185
Other income .....	3,423	8,069
Operating expense .....	3,402	867
Net intercompany expense .....	273	298

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Income (loss) before income taxes (benefit)	(240)	7,089
Income taxes (benefit) .....	(96)	2,917
Net income (loss) .....	\$ (144)	\$ 4,172

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 30.

19

FINANCIAL CONDITION

LOANS AND MORTGAGE-BACKED SECURITIES

Total loans and mortgage-backed securities, including those we hold for sale, decreased \$69 million during the third quarter to a total of \$9.9 billion or 92.5% of assets at September 30, 2001. The decrease represents a lower level of single family loans held for investment, which declined \$34 million during the quarter as prepayments slightly exceeded originations. Given the low interest rate environment and borrower preference for fixed rate loans, our annualized prepayment speed in the current quarter was 39%, compared to 17% a year ago, but down from the record 44% of second quarter 2001.

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, 2001	June 30, 2001	March 31, 2001	December 31, 2000
Loans originated for investment:				
Residential one-to-four units:				
Adjustable .....	\$ 867,271	\$ 814,696	\$ 636,988	\$ 887,064
Fixed .....	4,445	10,849	4,117	2,713
Other .....	56,554	43,492	28,964	57,901
Total loans originated for investment	928,270	869,037	670,069	947,678
Loans originated for sale (1) .....	1,116,589	1,296,877	796,801	335,726
Total loans originated .....	\$2,044,859	\$2,165,914	\$1,466,870	\$1,283,404

Originations of residential one-to-four unit loans totaled \$1.988 billion in the third quarter of 2001, of which \$872 million were for portfolio and \$1.117 billion were for sale. This was 6.3% below the record \$2.122 billion we originated in the second quarter of 2001 but 128.7% above the \$869 million we originated in the year-ago third quarter. Of the current quarter originations for portfolio, \$101 million represented originations of subprime credits as part of our continuing strategy to enhance the portfolio's net yield. During the current quarter, 72% of our residential one-to-four unit originations represented refinancing transactions. This is similar to the previous quarter level but up from 35% in the year-ago third quarter. In addition to single family loans, we originated \$57 million of other loans in the current quarter.



## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

During the current quarter, loan originations for investment consisted primarily of adjustable rate mortgages tied to COFI, an index which lags the movement in market interest rates. This experience is similar to that of recent quarters.

Our adjustable rate mortgages generally:

- o begin with an incentive interest rate, which is an interest rate below the current market rate, that adjusts to the applicable index plus a defined spread, subject to periodic and lifetime caps, after one, three, six or twelve months;
- o 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 to 1% per adjustment period for those that adjust semi-annually and 2% per adjustment period for those that adjust annually.

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

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

Regarding negative amortization, if a loan incurs significant negative amortization, then there is an increased risk that the market value of the underlying collateral on the loan would be insufficient to satisfy fully the outstanding principal and interest. We currently impose a limit on the amount of negative amortization, so that the principal plus the added amount

20

cannot exceed 110% of the original loan amount. During the third quarter, we raised the limit on new loans with loan-to-value ratios of 80% or less to 125% of the original loan amount. This increased limit does not apply to subprime loans.

At September 30, 2001, \$6.9 billion of the adjustable rate mortgages in our loan portfolio were subject to negative amortization of which \$185 million represented the amount of negative amortization included in the loan balance.

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 \$1.120 billion of loans in the third quarter of 2001, compared to \$1.364 billion in the previous quarter and \$620 million in the third quarter of 2000. All were secured by residential one-to-four unit property, and at September 30, 2001, loans held for sale totaled \$373 million.

At September 30, 2001, our unfunded loan application pipeline totaled \$1.8 billion. Within that pipeline, we had commitments to borrowers for short-term interest rate locks of \$787 million, of which \$533 million were related to residential one-to-four unit loans being originated for sale in the secondary market. Furthermore, we had commitments on undrawn lines of credit of \$85 million and loans in process of \$54 million. We believe our current sources of funds will enable us to meet these obligations while exceeding all regulatory liquidity requirements.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

21

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

(In Thousands)	Three Month		
	September 30, 2001	June 30, 2001	March 2001
<b>INVESTMENT PORTFOLIO</b>			
Loans originated:			
Loans secured by real estate:			
Residential one-to-four units:			
Adjustable .....	\$ 767,246	\$ 620,539	\$ 501,9
Adjustable - subprime .....	100,025	106,148	135,0
<hr/>			
Total adjustable .....	867,271	726,687	636,9
Fixed .....	3,294	7,455	4,1
Fixed - subprime .....	1,103	3,394	--
Residential five or more units:			
Adjustable .....	--	--	--
Fixed .....	--	125	--
<hr/>			
Total residential .....	871,668	737,661	641,1
Commercial real estate .....	--	--	--
Construction .....	27,649	23,154	18,8
Land .....	4,870	6,219	--
Non-mortgage:			
Commercial .....	8,440	4,970	1
Automobile .....	957	1,502	2,0
Other consumer .....	7,965	7,522	7,5
<hr/>			
Total loans originated .....	921,549	781,028	669,8
Real estate loans purchased:			
One-to-four units .....	48	88,009	--
One-to-four units - subprime .....	--	--	--
Other (1) .....	6,673	--	2
<hr/>			
Total real estate loans purchased .....	6,721	88,009	2
<hr/>			
Total loans originated and purchased .....	928,270	869,037	670,0
Loan repayments .....	(968,918)	(1,095,547)	(705,1
Other net changes (2) .....	(24,333)	5,813	32,5
<hr/>			
Net increase (decrease) in loans held for investment	(64,981)	(220,697)	(2,4
<hr/>			
<b>SALE PORTFOLIO</b>			
Residential, one-to-four units:			
Originated whole loans .....	1,115,345	1,296,270	796,2
Originated whole loans - subprime .....	--	--	--
Loans purchased .....	1,244	607	5
Loans transferred from (to) the investment portfolio	(1,108)	(787)	(2,3
Originated whole loans sold .....	(129,237)	(292,552)	(134,3
Loans exchanged for mortgage-backed securities .....	(991,232)	(1,071,840)	(462,7
Other net changes .....	(530)	(649)	(3,1
SFAS 133 capitalized basis adjustment (3) .....	2,447	(753)	5

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Net increase (decrease) in loans held for sale ...	(3,071)	(69,704)	194,6
-----			
Mortgage-backed securities, net:			
Received in exchange for loans .....	991,232	1,071,840	462,7
Sold .....	(991,232)	(1,071,840)	(462,7
Repayments .....	(686)	(647)	(4,4
Other net changes .....	14	39	
-----			
Net decrease in mortgage-backed securities available for sale .....	(672)	(608)	(4,3
-----			
Net increase (decrease) in loans held for sale and mortgage-backed securities available for sale ...	(3,743)	(70,312)	190,3
-----			
Total net increase (decrease) in loans and mortgage-backed securities .....	\$ (68,724)	\$ (291,009)	\$ 187,8
=====			

22

The following table sets forth the composition of our loan and mortgage-backed securities portfolios at the dates indicated.

(In Thousands)	September 30, 2001	June 30, 2001	March 31, 2001
-----			
INVESTMENT PORTFOLIO			
Loans secured by real estate:			
Residential one-to-four units:			
Adjustable .....	\$ 7,191,929	\$ 7,097,270	\$ 7,215,12
Adjustable - subprime .....	1,588,573	1,683,302	1,748,71
Fixed .....	375,533	408,757	437,19
Fixed - subprime .....	17,421	18,256	16,94
-----			
Total residential one-to-four units .....	9,173,456	9,207,585	9,417,98
Residential five or more units:			
Adjustable .....	6,199	13,359	13,46
Fixed .....	5,290	5,464	5,45
Commercial real estate:			
Adjustable .....	41,987	47,236	47,58
Fixed .....	100,493	110,513	114,58
Construction .....	99,161	99,261	96,56
Land .....	21,121	21,283	21,23
Non-mortgage:			
Commercial .....	22,762	21,648	21,31
Automobile .....	29,109	32,594	36,59
Other consumer .....	53,243	56,096	58,61
-----			
Total loans held for investment .....	9,552,821	9,615,039	9,833,37
Increase (decrease) for:			
Undisbursed loan funds .....	(62,880)	(59,940)	(59,20
Net deferred costs and premiums .....	79,540	78,621	80,01
Allowance for losses .....	(35,043)	(34,301)	(34,05
-----			
Total loans held for investment, net .....	9,534,438	9,599,419	9,820,11
-----			
SALE PORTFOLIO, NET			
Loans held for sale:			

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Residential one-to-four units .....	371,237	376,755	445,700
Residential one-to-four units - subprime .....	--	--	--
SFAS 133 capitalized basis adjustment (1) .....	2,252	(195)	55
-----			
Total loans held for sale .....	373,489	376,560	446,260
Mortgage-backed securities available for sale:			
Adjustable .....	4,562	5,234	5,830
Fixed .....	--	--	--
-----			
Total mortgage-backed securities available for sale .....	4,562	5,234	5,840
-----			
Total loans held for sale and mortgage-backed securities available for sale .....	378,051	381,794	452,100
-----			
Total loans and mortgage-backed securities ..	\$ 9,912,489	\$ 9,981,213	\$ 10,272,220
=====			

We carry loans for sale at the lower of cost or market. At September 30, 2001, no valuation allowance was required as the market value exceeded book value on an aggregate basis.

At September 30, 2001, our residential one-to-four units subprime portfolio consisted of approximately 77% "A-" credit, 19% "B" credit and 4% "C" credit loans. At September 30, 2001, 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, 2001, reflected an unrealized loss of \$44,000. The current quarter-end unrealized loss, less the associated tax effect, is reflected within a separate component of other comprehensive income (loss) until realized.

23

DEPOSITS

At September 30, 2001, our deposits totaled \$8.9 billion, up \$1.2 billion or 15.3% from the year-ago quarter end but down \$171 million or 1.9% from the previous quarter. While our preference is to grow deposits, the rates being offered on new certificates of deposit have remained above borrowing rates. As a result, we elected not to retain all of our certificates of deposit that matured during the quarter. Compared to the year-ago period, our transaction accounts--i.e., checking, regular passbook and money market--increased \$665 million or 45.2% and our certificates of deposit increased \$512 million or 8.2%. Within transaction accounts, our regular passbook accounts increased \$532 million or 68.6% and our total checking accounts (non-interest and interest bearing) increased \$123 million or 20.3%.

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

	September 30, 2001		June 30, 2001		March 31, 2001		December 31, 2000
	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
(Dollars in Thousands)							
-----							

Transaction accounts:

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Non-interest-bearing								
checking .....	-- %	\$ 327,335	-- %	\$ 328,338	-- %	\$ 335,404	-- %	\$
Interest-bearing								
checking (1) .....	0.42	403,134	0.42	401,126	0.42	416,636	0.78	
Money market .....	2.29	97,548	2.79	89,949	2.87	91,733	2.88	
Regular passbook .....	2.96	1,308,959	3.44	986,488	3.38	807,503	3.41	
-----								
Total transaction								
accounts .....	2.00	2,136,976	2.11	1,805,901	1.92	1,651,276	2.12	
Certificates of deposit:								
Less than 3.00% .....	2.41	39,217	2.48	27,473	2.14	7,620	2.41	
3.00-3.49 .....	3.26	379,901	3.36	8,342	3.45	26	3.45	
3.50-3.99 .....	3.83	508,383	3.83	82,191	3.81	20,748	3.97	
4.00-4.49 .....	4.22	888,123	4.29	387,442	4.38	7,279	4.19	
4.50-4.99 .....	4.73	815,711	4.74	691,800	4.72	293,442	4.82	
5.00-5.99 .....	5.36	1,883,498	5.50	2,791,697	5.62	2,288,745	5.71	
6.00-6.99 .....	6.46	2,213,180	6.59	3,233,032	6.64	4,424,756	6.63	
7.00 and greater .....	7.04	3,793	7.03	12,186	7.03	14,383	7.02	
-----								
Total certificates of								
deposit .....	5.24	6,731,806	5.82	7,234,163	6.21	7,056,999	6.33	
-----								
Total deposits ....	4.46%	\$8,868,782	5.08%	\$9,040,064	5.40%	\$8,708,275	5.56%	\$
=====								

BORROWINGS

During the 2001 third quarter, our borrowings increased \$35 million to \$927 million. The current quarter increase occurred as we took advantage of obtaining long-term advances from the FHLB at attractive borrowing rates. This increase followed a decrease of \$564 million during the second quarter of 2001.

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

(Dollars in Thousands)	September 30, 2001	June 30, 2001	March 31, 2001	Decem 2
Federal Home Loan Bank advances .....	\$ 927,398	\$ 892,670	\$1,457,046	\$1,9
Other borrowings .....	29	94	145	
-----				
Total borrowings .....	\$ 927,427	\$ 892,764	\$1,457,191	\$1,9
=====				
Weighted average rate on borrowings during				
the period .....	5.01%	5.67%	6.14%	
Total borrowings as a percentage of total assets	8.65	8.25	13.21	
=====				

CAPITAL SECURITIES

On July 23, 1999, we issued \$120 million in capital securities, of which \$108 million was invested as additional common stock in the Bank. 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 including the amortization of deferred issuance costs on our capital securities was \$3.0

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

million for the third quarter of 2001.

### 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 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. There has been no significant change in our market risk since December 31, 2000.

25

The following table sets forth the repricing frequency of our major asset and liability categories as of September 30, 2001, as well as other information regarding the repricing and 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 shown.

	September 30, 2001			
(Dollars in Thousands)	Within 6 Months	7 - 12 Months	1 - 5 Years	6 - 10 Years
<b>Interest-earning assets:</b>				
Investment securities and FHLB stock (1)	\$ 327,089	\$ 58,654	\$ 30,992	\$ 68
Loans and mortgage-backed securities:(2)				
Loans secured by real estate:				
Residential:				
Adjustable .....	8,010,875	304,260	523,345	--
Fixed .....	468,635	70,684	203,411	25,952
Commercial real estate .....	47,866	13,617	72,093	3,208
Construction .....	50,687	--	--	--
Land .....	12,256	9	67	798
Non-mortgage loans:				
Commercial .....	13,602	--	--	--
Consumer .....	59,373	5,832	16,287	--
Mortgage-backed securities .....	4,562	--	--	--
<hr style="border-top: 1px dashed black;"/>				
Total loans and mortgage-backed				

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

securities .....	8,667,856	394,402	815,203	29,958
-----				
Total interest-earning assets .....	\$8,994,945	\$ 453,056	\$846,195	\$ 30,026
=====				
Transaction accounts:				
Non-interest-bearing checking .....	\$ 327,335	\$ --	\$ --	\$ --
Interest-bearing checking .....	(3) 403,134	--	--	--
Money market .....	(4) 97,548	--	--	--
Regular passbook .....	(4) 1,308,959	--	--	--
-----				
Total transaction accounts .....	2,136,976	--	--	--
Certificates of deposit .....	(1) 4,854,594	1,497,210	380,002	--
-----				
Total deposits .....	6,991,570	1,497,210	380,002	--
Borrowings .....	123,041	78,255	267,131	459,000
Capital securities .....	--	--	--	--
-----				
Total deposits, borrowings and capital securities .....	\$7,114,611	\$ 1,575,465	\$647,133	\$ 459,000
=====				
Excess (shortfall) of interest-earning assets over deposits, borrowings and capital securities .....	\$1,880,334	\$(1,122,409)	\$199,062	\$(428,974)
Cumulative gap .....	1,880,334	757,925	956,987	528,013
Cumulative gap - as a % of total assets:				
September 30, 2001 .....	17.55%	7.07%	8.93%	4.93%
December 31, 2000 .....	28.66	7.13	5.94	3.13
September 30, 2000 .....	31.93	7.31	5.77	2.88
=====				

26

Our six-month gap at September 30, 2001 was a positive 17.55%. This means that more interest-earning assets reprice within six months than total deposits, borrowings and capital securities. This compares to a positive six-month gap of 28.66% at December 31, 2000 and 31.93% at September 30, 2000. We continue to pursue our strategy of emphasizing the origination of adjustable rate mortgages. For the twelve months ended September 30, 2001, we originated and purchased for investment \$3.4 billion of adjustable rate loans which represented approximately 99% of all loans we originated and purchased for investment during the period.

At September 30, 2001, essentially all of our interest-earning assets mature, reprice or are estimated to prepay within five years, up from 98% at December 31, 2000 and 97% at September 30, 2000. At September 30, 2001, loans held for investment and mortgage-backed securities with adjustable interest rates represented 91% of those portfolios. During the third quarter of 2001, 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, 2001, \$9.1 billion or 92% of our total loan portfolio, including mortgage-backed securities, consisted of adjustable rate loans, construction loans, and loans with a due date of five years or less, compared to \$9.4 billion or 93% at December 31, 2000 and \$9.0 billion or 93% at September 30, 2000.

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

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

	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000
-----				
Weighted average yield:				
Loans and mortgage-backed securities	7.68%	8.24%	8.56%	8.45%
Federal Home Loan Bank stock .....	6.00	6.00	5.51	5.52
Investment securities .....	5.18	5.54	6.00	6.45
-----				
Interest-earning assets yield ....	7.59	8.12	8.46	8.36
-----				
Weighted average cost:				
Deposits .....	4.46	5.08	5.40	5.56
Borrowings:				
Federal Home Loan Bank advances ..	4.70	5.36	5.94	6.26
Other borrowings .....	7.88	7.88	7.88	8.12
-----				
Total borrowings .....	4.70	5.36	5.94	6.26
Capital securities .....	10.00	10.00	10.00	10.00
-----				
Combined funds cost .....	4.55	5.16	5.53	5.75
-----				
Interest rate spread .....	3.04%	2.96%	2.93%	2.61%
=====				

The period-end weighted average yield on our loan portfolio decreased to 7.68% at September 30, 2001, down from 8.45% at December 31, 2000 and 8.40% at September 30, 2000. At September 30, 2001, our adjustable rate mortgage portfolio of single family residential loans, including mortgage-backed securities, totaled \$8.8 billion with a weighted average rate of 7.68%, compared to \$9.0 billion with a weighted average rate of 8.47% at December 31, 2000 and \$8.6 billion with a weighted average rate of 8.38% at September 30, 2000.

### PROBLEM LOANS AND REAL ESTATE

#### Non-Performing Assets

Non-performing assets consist of loans on which we have ceased the accrual of 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. Non-performing assets increased \$15 million during the quarter to \$75 million or 0.70% of total assets. This increase was due to a rise in residential non-performers, of which \$7 million were subprime. Non-performing assets at quarter end include non-accrual loans aggregating \$2 million which were not contractually past due, but were deemed non-accrual due to management's assessment of the borrower's ability to pay.

27

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

(Dollars in Thousands)	September 30, 2001	June 30, 2001	March 31, 2001	Dece
-----				



Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Non-accrual loans:				
Residential one-to-four units .....	\$29,266	\$22,494	\$16,965	\$2
Residential one-to-four units - subprime .....	31,076	25,737	26,353	2
Other .....	2,927	3,054	3,367	
-----				
Total non-accrual loans .....	63,269	51,285	46,685	4
Troubled debt restructure - below market rate (1) ...	204	204	205	
Real estate acquired in settlement of loans .....	11,870	8,366	11,634	
Repossessed automobiles .....	28	37	15	
-----				
Total non-performing assets .....	\$75,371	\$59,892	\$58,539	\$5
=====				
Allowance for loan losses:				
Amount .....	\$35,043	\$34,301	\$34,059	\$3
As a percentage of non-performing loans .....	55.21%	66.62%	72.64%	
Non-performing assets as a percentage of total assets	0.70	0.55	0.53	
=====				

Delinquent Loans

During the 2001 third quarter, our delinquencies as a percentage of total loans outstanding increased from 0.81% to 0.96% and were above the 0.63% of a year ago. The increase occurred in both of our residential one-to-four unit categories.

28

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

(Dollars in Thousands)	September 30, 2001				
	30-59 Days	60-89 Days	90+ Days (1)	Total	30-59 Days
-----					
Loans secured by real estate:					
Residential:					
One-to-four units .....	\$18,515	\$ 8,165	\$25,131	\$51,811	\$15,190
One-to-four units - subprime ...	11,212	8,569	21,649	41,430	11,402
Five or more units .....	--	--	--	--	--
Commercial real estate .....	--	--	--	--	--
Construction .....	--	--	--	--	--
Land .....	--	--	--	--	--
-----					
Total real estate loans .....	29,727	16,734	46,780	93,241	26,592
Non-mortgage:					
Commercial .....	--	--	1,290	1,290	--
Automobile .....	269	54	80	403	112
Other consumer .....	253	38	264	555	287
-----					
Total loans .....	\$30,249	\$16,826	\$48,414	\$95,489	\$26,991
=====					
Delinquencies as a percentage of total loans .....	0.30%	0.17%	0.49%	0.96%	0.27%
=====					

March 31, 2001

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Loans secured by real estate:

-----						
Residential:						
One-to-four units .....	\$14,166	\$ 6,961	\$15,490	\$36,617	\$12,400	\$
One-to-four units - subprime ...	11,223	6,651	17,860	35,734	7,300	
Five or more units .....	--	--	508	508	--	
Commercial real estate .....	--	--	--	--	--	
Construction .....	--	--	--	--	--	
Land .....	--	--	--	--	--	
-----						
Total real estate loans .....	25,389	13,612	33,858	72,859	19,700	
Non-mortgage:						
Commercial .....	--	1,290	--	1,290	--	
Automobile .....	230	55	74	359	393	
Other consumer .....	189	31	190	410	98	
-----						
Total loans .....	\$25,808	\$14,988	\$34,122	\$74,918	\$20,191	\$
=====						
Delinquencies as a percentage of total loans .....	0.25%	0.15%	0.33%	0.73%	0.20%	
=====						

September 30, 2000

Loans secured by real estate:

-----				
Residential:				
One-to-four units .....	\$14,970	\$ 3,037	\$16,176	\$34,183
One-to-four units - subprime ...	7,701	5,422	11,911	25,034
Five or more units .....	--	--	--	--
Commercial real estate .....	--	--	--	--
Construction .....	--	--	--	--
Land .....	--	--	--	--
-----				
Total real estate loans .....	22,671	8,459	28,087	59,217
Non-mortgage:				
Commercial .....	--	--	--	--
Automobile .....	356	50	116	522
Other consumer .....	200	86	433	719
-----				
Total loans .....	\$23,227	\$ 8,595	\$28,636	\$60,458
=====				
Delinquencies as a percentage of total loans .....	0.24%	0.09%	0.30%	0.63%
=====				

Allowance for Losses on Loans and Real Estate

We maintain valuation allowances 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 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

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

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 these allowances are those amounts associated with assets where it is probable that the value of the asset has been impaired and the loss can be reasonably estimated. If we determine the net fair value of the asset exceeds our carrying value, 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 \$38 million at both September 30, 2001 and December 31, 2000, and \$37 million at September 30, 2000.

Our provision for loan losses was \$0.8 million in the current quarter and exceeded our net loan charge-offs by \$0.7 million resulting in an increase in the allowance for loan losses to \$35.0 million at September 30, 2001. The current quarter allowance increase reflected an increase of \$0.7 million in general valuation allowances to \$27.1 million due to an increase in delinquencies. Allocated allowances increased by \$0.4 million in our single family portfolio and \$0.2 million in our commercial non-mortgage portfolio, which was essentially offset by a \$0.6 million decrease in the commercial real estate mortgage portfolio. There was no change in the unallocated allowance of \$2.8 million. Since year-end 2000, our allowance for loan losses increased by \$0.6 million, as allocated allowances increased by \$0.4 million and general valuation allowances increased by \$0.2 million.

The following table is a summary of the activity of our allowance for loan losses during the periods indicated.

(In Thousands)	Three Months Ended				
	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000	September 2000
Balance at beginning of period	\$ 34,301	\$ 34,059	\$ 34,452	\$ 34,014	\$ 33,237
Provision .....	791	431	52	511	1,007
Charge-offs .....	(198)	(326)	(508)	(346)	(234)
Recoveries .....	149	137	63	273	4
Balance at end of period .....	\$ 35,043	\$ 34,301	\$ 34,059	\$ 34,452	\$ 34,014

30

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

(Dollars in Thousands)	Three Months Ended			
	September 30, 2001	June 30, 2001	March 31, 2001	Dec 2000
GROSS LOAN CHARGE-OFFS				
Loans secured by real estate:				
Residential:				

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

One-to-four units .....	\$ 25	\$ 115	\$ 268
One-to-four units - subprime .....	60	92	136
Five or more units .....	--	--	--
Commercial real estate .....	--	--	--
Construction .....	--	--	--
Land .....	--	--	--
Non-mortgage:			
Commercial .....	--	--	--
Automobile .....	26	72	48
Other consumer .....	87	47	56
<hr/>			
Total gross loan charge-offs .....	198	326	508
<hr/>			
GROSS LOAN RECOVERIES			
Loans secured by real estate:			
Residential:			
One-to-four units .....	86	121	59
One-to-four units - subprime .....	61	5	--
Five or more units .....	--	--	--
Commercial real estate .....	--	1	--
Construction .....	--	--	--
Land .....	--	--	--
Non-mortgage:			
Commercial .....	--	--	--
Automobile .....	--	4	--
Other consumer .....	2	6	4
<hr/>			
Total gross loan recoveries .....	149	137	63
<hr/>			
NET LOAN CHARGE-OFFS			
Loans secured by real estate:			
Residential:			
One-to-four units .....	(61)	(6)	209
One-to-four units - subprime .....	(1)	87	136
Five or more units .....	--	--	--
Commercial real estate .....	--	(1)	--
Construction .....	--	--	--
Land .....	--	--	--
Non-mortgage:			
Commercial .....	--	--	--
Automobile .....	26	68	48
Other consumer .....	85	41	52
<hr/>			
Total net loan charge-offs .....	\$ 49	\$ 189	\$ 445
<hr/>			
Net loan charge-offs as a percentage of average loans	- %	0.01%	0.02%
<hr/>			

31

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

	September 30, 2001			June 30, 2001		
	Allowance	Gross Loan Portfolio Balance	Allowance Percentage to Loan Balance	Allowance	Gross Loan Portfolio Balance	Allowance Percentage to Loan Balance
(Dollars in Thousands)						

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Loans secured by real estate:						
Residential:						
One-to-four units .....	\$16,598	\$7,567,462	0.22%	\$15,139	\$7,506,027	0.20%
One-to-four units - subprime .....	10,385	1,605,994	0.65	10,826	1,701,558	0.64
Five or more units .....	86	11,489	0.75	141	18,823	0.75
Commercial real estate ...	2,262	142,480	1.59	2,703	157,749	1.71
Construction .....	1,164	99,161	1.17	1,171	99,261	1.18
Land .....	262	21,121	1.24	263	21,283	1.24
Non-mortgage:						
Commercial .....	650	22,762	2.86	422	21,648	1.95
Automobile .....	196	29,109	0.67	175	32,594	0.54
Other consumer .....	640	53,243	1.20	661	56,096	1.18
Not specifically allocated ..	2,800	--	--	2,800	--	--
-----						
Total loans held for investment .....	\$35,043	\$9,552,821	0.37%	\$34,301	\$9,615,039	0.36%
=====						

	December 31, 2000			September 30, 2000		
	-----					
Loans secured by real estate:						
Residential:						
One-to-four units .....	\$15,254	\$7,655,238	0.20%	\$15,143	\$7,393,275	0.20%
One-to-four units - subprime .....	10,157	1,743,914	0.58	9,946	1,652,462	0.60
Five or more units .....	146	19,460	0.75	148	19,728	0.75
Commercial real estate ...	2,935	164,604	1.78	2,930	164,305	1.78
Construction .....	1,390	118,165	1.18	1,412	120,179	1.17
Land .....	332	26,880	1.24	325	26,294	1.24
Non-mortgage:						
Commercial .....	442	21,721	2.03	287	23,454	1.22
Automobile .....	269	39,614	0.68	234	40,303	0.58
Other consumer .....	727	60,653	1.20	789	60,362	1.31
Not specifically allocated ..	2,800	--	--	2,800	--	--
-----						
Total loans held for investment .....	\$34,452	\$9,850,249	0.35%	\$34,014	\$9,500,362	0.36%
=====						

At September 30, 2001, the recorded investment in loans for which we recognized impairment totaled \$15 million. The total allowance for losses related to these loans was \$1 million. During the third quarter of 2001, total interest recognized on the impaired loan portfolio was \$0.4 million, increasing the year-to-date total to \$1.3 million.

The following table is a summary of the activity in our allowance for loan losses associated with impaired loans during the periods indicated. We have recorded provisions and reductions to the allowance associated with changes in the net book value of loans classified as impaired.

	Three Months Ended				
	-----				
(In Thousands)	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000	Septem 2000
	-----				
Balance at beginning of period	\$ 782	\$ 798	\$ 800	\$ 791	\$ 79

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Provision (reduction) .....	428	(16)	(2)	9	(
Charge-offs .....	--	--	--	--	--
Recoveries .....	--	--	--	--	--
Balance at end of period .....	\$1,210	\$ 782	\$ 798	\$ 800	\$ 79

32

The following table is a summary of the activity in our allowance for real estate and joint ventures held for investment during the periods indicated.

(In Thousands)	Three Months Ended				
	September 30, 2001	June 30, 2001	March 31, 2001	December 31, 2000	September 30, 2000
Balance at beginning of period	\$ 3,063	\$ 3,030	\$ 2,997	\$ 2,961	\$ 3,561
Provision (reduction) .....	(374)	33	33	36	(600)
Charge-offs .....	--	--	--	--	--
Recoveries .....	--	--	--	--	--
Balance at end of period .....	\$ 2,689	\$ 3,063	\$ 3,030	\$ 2,997	\$ 2,961

CAPITAL RESOURCES AND LIQUIDITY

Our sources of funds include deposits, advances from the FHLB and other borrowings; proceeds from the sale of real estate, loans and mortgage-backed securities; 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 2001 were from:

- o principal repayments--including prepayments, but excluding refinances of our existing loans--on loans and mortgage-backed securities of \$790 million; and
- o maturities and sales of U.S. Treasury securities, agency obligations and other investment securities available for sale of \$62 million.

We used these funds for the following purposes:

- o to originate and purchase loans held for investment of \$745 million;
- o for a net decrease in deposits of \$171 million; and
- o to purchase U.S. Treasury securities, agency obligations and other investment securities available for sale of \$94 million.

At September 30, 2001, the Bank's ratio of regulatory liquidity was 4.1%, compared to 4.3% at December 31, 2000 and 4.9% at September 30, 2000.

Downey currently has liquid assets, including due from Bank--interest bearing balances, of \$21 million and can obtain further funds by means of dividends from subsidiaries, subject to certain limitations, or issuance of further debt or equity.

## Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Stockholders' equity totaled \$698 million at September 30, 2001, up from \$625 million at December 31, 2000 and \$603 million at September 30, 2000.

33

### REGULATORY CAPITAL COMPLIANCE

Our core and tangible capital ratios were 7.04% and our risk-based capital ratio was 14.11%. 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. During the quarter, the net investment in our real estate subsidiary increased by \$16 million due to a settlement of litigation with former joint venture partners wherein we became the sole owner of two shopping centers. This increase reduced regulatory capital until we are able to sell the shopping centers and return the capital to the bank.

The following table is a reconciliation of the Bank's stockholder's equity to federal regulatory capital as of September 30, 2001.

(Dollars in Thousands)	Tangible Capital		Core Capital	
	Amount	Ratio	Amount	Ratio
Stockholder's equity .....	\$793,071		\$793,071	
Adjustments:				
Deductions:				
Investment in subsidiary, primarily real estate .....	(34,440)		(34,440)	
Goodwill .....	(3,263)		(3,263)	
Non-permitted mortgage servicing rights ..	(3,751)		(3,751)	
Additions:				
Unrealized gains on securities available for sale .....	(897)		(897)	
General loss allowance - investment in DSL Service Company .....	196		196	
Allowance for loan losses, net of specific allowances (1) .....	--		--	
Regulatory capital .....	750,916	7.04%	750,916	7.04%
Well capitalized requirement .....	159,968	1.50 (2)	533,226	5.00
Excess .....	\$590,948	5.54%	\$217,690	2.04%

34

### PART II - OTHER INFORMATION

Item 6 - Exhibits and Reports on Form 8-K

(A) Exhibits

(B) Form 8-K filed July 16, 2001.

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

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

be signed on its behalf by the undersigned, thereunto duly authorized.

DOWNEY FINANCIAL CORP.

Date: November 1, 2001

/s/ Daniel D. Rosenthal

-----  
Daniel D. Rosenthal  
President and Chief Executive Officer

Date: November 1, 2001

/s/ Thomas E. Prince

-----  
Thomas E. Prince  
Executive Vice President and Chief Financial Officer