

DOWNEY FINANCIAL CORP

Form 10-Q

May 03, 2006

[Navigation Links](#)

Click here to quickly move through the content of the Form 10-Q filing.

---

**UNITED STATES  
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 **March 31, 2006**

OR

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

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

Commission File Number **1-13578**

**DOWNEY FINANCIAL CORP.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**33-0633413**

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

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

(Address of principal executive office)

**92660**

(Zip Code)

Registrant's telephone number, including area code

**(949) 854-0300**

**N/A**

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated file  Accelerated filer  Non-accelerated filer

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

At March 31, 2006, 27,853,783 shares of the Registrant's Common Stock, \$0.01 par value were outstanding.

Page

[Navigation Links](#)

## DOWNEY FINANCIAL CORP.

### March 31, 2006 QUARTERLY REPORT ON FORM 10-Q

#### TABLE OF CONTENTS

##### *PART I FINANCIAL INFORMATION*

ITEM 1.	FINANCIAL STATEMENTS	1
	Consolidated Balance Sheets at March 31, 2006 and 2005 and December 31, 2005	1
	Consolidated Statements of Income for the three months ended March 31, 2006 and 2005	2
	Consolidated Statements of Comprehensive Income for the three months ended March 31, 2006 and 2005	3
	Consolidated Statements of Cash Flows for the three months ended March 31, 2006 and 2005	4
	Notes To Consolidated Financial Statements	6
ITEM 2.	MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS	15
ITEM 3.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	46
ITEM 4.	CONTROLS AND PROCEDURES	46

##### *PART II OTHER INFORMATION*

ITEM 1.	LEGAL PROCEEDINGS	47
ITEM 1A.	RISK FACTORS	47

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

ITEM 2.	UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS	47
ITEM 3.	DEFAULTS UPON SENIOR SECURITIES	47
ITEM 4.	SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS	47
ITEM 5.	OTHER INFORMATION	47
ITEM 6.	EXHIBITS	47
	AVAILABILITY OF REPORTS	48
	SIGNATURES	48

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

(Dollars in Thousands, Except Per Share Data)

March 31, December 31, March 31,  
2006 2005 2005

**Assets**

Cash	\$ 168,822	\$ 190,396	\$ 133,621
Federal funds	-	-	10,003

Cash and cash equivalents	168,822	190,396	143,624
---------------------------	---------	---------	---------

U.S. Treasury, government sponsored entities and other investment securities

available for sale, at fair value	730,402	626,313	511,703
-----------------------------------	---------	---------	---------

Loans held for sale, at lower of cost or fair value	561,511	464,488	1,279,734
---	---------	---------	-----------

Mortgage-backed securities available for sale, at fair value	271	277	296
--	-----	-----	-----

Loans held for investment	15,912,318	15,391,759	14,485,191
---------------------------	------------	------------	------------

Allowance for loan losses	(44,504 )	(34,601 )	(35,072 )
---------------------------	-----------	-----------	-----------

Loans held for investment, net	15,867,814	15,357,158	14,450,119
--------------------------------	------------	------------	------------

Investments in real estate and joint ventures	49,182	49,344	56,964
---	--------	--------	--------

Real estate acquired in settlement of loans	385	908	2,783
---	-----	-----	-------

Premises and equipment	110,595	109,574	105,596
------------------------	---------	---------	---------

Federal Home Loan Bank stock, at cost	182,557	179,844	243,613
---------------------------------------	---------	---------	---------

Mortgage servicing rights, net	20,165	20,302	19,610
--------------------------------	--------	--------	--------

Other assets	111,055	97,059	80,936
--------------	---------	--------	--------

	\$ 17,802,759	\$ 17,095,663	\$ 16,894,978
--	---------------	---------------	---------------

**Liabilities and Stockholders Equity**

Deposits	\$ 12,198,903	\$ 11,876,848	\$ 10,309,077
----------	---------------	---------------	---------------

Federal Home Loan Bank advances	3,825,811	3,557,515	5,093,874
---------------------------------	-----------	-----------	-----------

Senior notes	198,129	198,087	197,964
--------------	---------	---------	---------

Accounts payable and accrued liabilities	189,552	114,527	118,649
--	---------	---------	---------

Deferred income taxes	140,961	140,467	121,078
-----------------------	---------	---------	---------

Total liabilities	16,553,356	15,887,444	15,840,642
-------------------	------------	------------	------------

**Stockholders equity**

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Preferred stock, par value of \$0.01 per share; authorized  
5,000,000 shares;

outstanding none	-	-	-
------------------	---	---	---

Common stock, par value of \$0.01 per share; authorized  
50,000,000 shares;

issued 28,235,022 shares at March 31, 2006,  
December 31, 2005 and

March 31, 2005; outstanding 27,853,783 shares at  
March 31, 2006,

December 31, 2005 and March 31, 2005	282	282	282
--------------------------------------	-----	-----	-----

Additional paid-in capital	93,792	93,792	93,792
----------------------------	--------	--------	--------

Accumulated other comprehensive loss	(6,196 )	(5,408 )	(1,951 )
--------------------------------------	----------	----------	----------

Retained earnings	1,178,317	1,136,345	979,005
-------------------	-----------	-----------	---------

Treasury stock, at cost, 381,239 shares at March 31,  
2006,

December 31, 2005 and March 31, 2005	(16,792 )	(16,792 )	(16,792 )
--------------------------------------	-----------	-----------	-----------

Total stockholders equity	1,249,403	1,208,219	1,054,336
---------------------------	-----------	-----------	-----------

	\$ 17,802,759	\$ 17,095,663	\$ 16,894,978
--	---------------	---------------	---------------

*See accompanying notes to consolidated financial statements.*

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

*Three Months Ended  
March 31,*

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

	2006	2005
<b>Interest income</b>		
Loans	\$ 255,345	\$ 183,910
U.S. Treasury and government sponsored entities securities	7,336	4,838
Mortgage-backed securities	3	3
Other investment securities	2,279	2,538
<b>Total interest income</b>	<b>264,963</b>	<b>191,289</b>
<b>Interest expense</b>		
Deposits	91,835	49,023
Federal Home Loan Bank advances	43,914	33,980
Senior notes	3,298	3,295
<b>Total interest expense</b>	<b>139,047</b>	<b>86,298</b>
<b>Net interest income</b>	<b>125,916</b>	<b>104,991</b>
<b>Provision for credit losses</b>	<b>10,057</b>	<b>2,038</b>
<b>Net interest income after provision for credit losses</b>	<b>115,859</b>	<b>102,953</b>
<b>Other income, net</b>		
Loan and deposit related fees	8,558	8,604
Real estate and joint ventures held for investment, net	2,289	2,580
Secondary marketing activities:		
Loan servicing income, net	189	1,484
Net gains on sales of loans and mortgage-backed securities	11,654	30,615
Net gains on sales of mortgage servicing rights	-	981
Net gains on sales of investment securities	-	27
Other	520	520
<b>Total other income, net</b>	<b>23,210</b>	<b>44,811</b>
<b>Operating expense</b>		
Salaries and related costs	40,780	39,155
Premises and equipment costs	8,538	8,000
Advertising expense	1,242	1,350

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

SAIF insurance premiums and regulatory assessments	1,014	927
Professional fees	792	336
Other general and administrative expense	9,175	8,392
<hr/>		
Total general and administrative expense	61,541	58,160
Net operation of real estate acquired in settlement of loans	(9 )	64
<hr/>		
Total operating expense	61,532	58,224
<hr/>		
<b>Income before income taxes</b>	77,537	89,540
Income taxes	32,780	37,801
<hr/>		
<b>Net income</b>	\$ 44,757	\$ 51,739
<hr/>		
<b>Per share information</b>		
Basic	\$ 1.61	\$ 1.86
Diluted	\$ 1.61	\$ 1.86
Cash dividends declared and paid	\$ 0.10	\$ 0.10
<b>Weighted average shares outstanding</b>		
Basic	27,853,783	27,853,783
Diluted	27,883,221	27,881,839
<hr/>		

*See accompanying notes to consolidated financial statements.*

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

*Three Months Ended*  
*March 31,*

*(In Thousands)*

	2006	2005
<b>Net income</b>	\$ 44,757	\$ 51,739
<b>Other comprehensive income (loss), net of income taxes (benefits)</b>		
Unrealized gains (losses) on securities available for sale:		
U.S. Treasury, government sponsored entities and other investment		
securities available for sale, at fair value	(1,367 )	(2,443 )
Mortgage-backed securities available for sale, at fair value	-	-
Reclassification of realized amounts included in net income	-	(17 )
Unrealized gains (losses) on cash flow hedges:		
Net derivative instruments	503	(78 )
Reclassification of realized amounts included in net income	76	269
<b>Total other comprehensive loss, net of income tax benefits</b>	<b>(788 )</b>	<b>(2,269 )</b>
<b>Comprehensive income</b>	<b>\$ 43,969</b>	<b>\$ 49,470</b>

*See accompanying notes to consolidated financial statements.*



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

*Three Months Ended*  
*March 31,*

*(In Thousands)*

2006

2005

**Cash flows from operating activities**

Net income	\$ 44,757	\$ 51,739
Adjustments to reconcile net income to net cash used for operating activities:		
Depreciation	3,285	3,309
Amortization	26,076	16,630
Provision for losses on loans, loan-related commitments, investments, real estate and joint ventures, mortgage servicing rights, real estate acquired in settlement of loans, and other assets	10,018	835
Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, investment securities, real estate and other assets	(12,618 )	(33,092 )
Interest capitalized on loans (negative amortization)	(64,827 )	(18,707 )
Federal Home Loan Bank stock dividends	(2,274 )	-
Loans originated and purchased for sale	(980,164 )	(2,181,392 )
Proceeds from sales of loans held for sale, including those sold as mortgage-backed securities	887,037	2,059,786
Other, net	(18,877 )	(48,432 )
<b>Net cash used for operating activities</b>	<b>(107,587 )</b>	<b>(149,324 )</b>

**Cash flows from investing activities**

Proceeds from sales of:		
Wholly owned real estate and real estate acquired in settlement of loans	681	663
Proceeds from maturities or calls of U.S. Treasury, government sponsored entities and other investment securities available for sale		
	4,750	8,100
Purchase of:		
U.S. Treasury, government sponsored entities and other investment securities available for sale	(61,225 )	(27,044 )
Loans held for investment	(12,218 )	(25,360 )
Premises and equipment	(9,902 )	(4,673 )
Federal Home Loan Bank stock	(439 )	-
Originations of loans held for investment (net of refinances of \$199,203 for the three months ended March 31, 2006 and \$166,659 for the three months ended March 31, 2005)	(1,621,617 )	(1,876,331 )
Principal payments on loans held for investment and mortgage-backed securities available for sale	1,194,760	876,996
Net change in undisbursed loan funds	(2,881 )	36,450
Investments in real estate held for investment	1,051	(136 )

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Other, net	5,445	2,175
<hr/>		
Net cash used for investing activities	(501,595 )	(1,009,160 )
<hr/>		

*See accompanying notes to consolidated financial statements.*

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

*Three Months Ended*  
*March 31,*

*(In Thousands)*

2006

2005

**Cash flows from financing activities**

Net increase in deposits	\$ 322,055	\$ 651,099
Proceeds from Federal Home Loan Bank advances	7,148,170	10,558,350
Repayments of Federal Home Loan Bank advances	(6,877,100 )	(10,015,350 )
Cash dividends	(2,785 )	(2,785 )
Other, net	(2,732 )	(8,708 )

Net cash provided by financing activities	587,608	1,182,606
---	---------	-----------

Net increase (decrease) in cash and cash equivalents	(21,574 )	24,122
Cash and cash equivalents at beginning of period	190,396	119,502

<b>Cash and cash equivalents at end of period</b>	<b>\$ 168,822</b>	<b>\$ 143,624</b>
---	-------------------	-------------------

**Supplemental disclosure of cash flow information:**

Cash paid during the period for:

Interest	\$ 151,688	\$ 83,249
Income taxes	393	18,872

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

Loans transferred to held for investment from held for sale	4,006	9,972
Loans transferred from held for investment to held for sale	166	106
U.S. Treasury, government sponsored entities and other investment securities		
available for sale, purchased and not settled	49,996	-
Loans exchanged for mortgage-backed securities	213,980	269,411
Real estate acquired in settlement of loans	104	805
Loans to facilitate the sale of real estate acquired in settlement of loans	-	65

*See accompanying notes to consolidated financial statements.*

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

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

In the opinion of Downey Financial Corp. and subsidiaries ( Downey, we, us and our ), the accompanying consolidated financial statements contain all adjustments (consisting of normal recurring accruals unless otherwise disclosed in this Form 10-Q) necessary for a fair presentation of Downey s financial condition as of March 31, 2006, December 31, 2005 and March 31, 2005, the results of operations and comprehensive income for the three months ended March 31, 2006 and 2005, and changes in cash flows for the three months ended March 31, 2006 and 2005. Certain prior period amounts have been reclassified to conform to the current period presentation.

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements and are in compliance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial condition, results of operations, comprehensive income and cash flows. The information under the heading Management s Discussion and Analysis of Financial Condition and Results of Operations presumes that the interim consolidated financial statements will be read in conjunction with Downey s Annual Report on Form 10-K for the year ended December 31, 2005, 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, 2005 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) Reclassification of Prior Period Amounts**

During the first quarter of 2006, loan prepayment and late fees were reclassified from loan and deposit related fees to loan interest income to conform with the current quarter classification change from prior reporting requirements received from the Office of Thrift Supervision ( OTS ). Previously reported periods were restated to conform to the current period presentation. The reclassification had no effect on net income or stockholders equity. Loan prepayment and late fees of \$22.3 million were reclassified in the current quarter, compared to \$23.6 million in the fourth quarter of 2005 and \$10.9 million in the year-ago quarter.

Downey maintains an allowance for losses to provide for inherent losses for loan-related commitments associated with undisbursed loan funds and unused lines of credit. During the first quarter of 2006, the allowance for losses on loan-related commitments was reclassified from the allowance for loan losses to accounts payable and accrued liabilities. The allowance for losses on loan-related commitments is calculated using the same methodology as that used to determine the allowance for loan losses. Previously reported periods were restated to conform to the current period presentation. The reclassifications had no effect on the provision for credit losses, which continues to be comprised of the sum of the provision for loan losses and the provision for losses on loan-related commitments; thus, there was no effect on net income or stockholders equity. The allowance for losses on loan-related commitments was \$1 million at March 31, 2006 and December 31, 2005, compared to \$2 million at March 31, 2005.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

**NOTE (3) Mortgage Servicing Rights ( MSRs )**

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

	<i>Three Months Ended</i>				
<i>(Dollars in Thousands)</i>	<i>March 31,</i> 2006	<i>December 31,</i> 2005	<i>September 30,</i> 2005	<i>June 30,</i> 2005	<i>March 31,</i> 2005
Gross balance at beginning of period	\$ 21,157	\$ 20,917	\$ 20,626	\$ 20,834	\$ 20,502
Additions	1,022	1,740	1,858	1,217	1,609
Amortization	(1,198 )	(1,252 )	(1,346 )	(1,398 )	(1,160 )
Sales	-	-	(87 )	-	(14 )
Impairment write-down	(561 )	(248 )	(134 )	(27 )	(103 )
<b>Gross balance at end of period</b>	<b>20,420</b>	<b>21,157</b>	<b>20,917</b>	<b>20,626</b>	<b>20,834</b>
Allowance balance at beginning of period	855	1,800	3,793	1,224	2,538
Provision for (reduction of) impairment	(39 )	(697 )	(1,859 )	2,596	(1,211 )
Impairment write-down	(561 )	(248 )	(134 )	(27 )	(103 )
<b>Allowance balance at end of period</b>	<b>255</b>	<b>855</b>	<b>1,800</b>	<b>3,793</b>	<b>1,224</b>
<b>Total mortgage servicing rights, net</b>	<b>\$ 20,165</b>	<b>\$ 20,302</b>	<b>\$ 19,117</b>	<b>\$ 16,833</b>	<b>\$ 19,610</b>
As a percentage of associated mortgage loans	0.85 %	0.86 %	0.83 %	0.75 %	0.89 %
Estimated fair value <sup>(a)</sup>	\$ 21,894	\$ 20,351	\$ 19,139	\$ 16,863	\$ 19,665
Weighted average expected life (in months)	51	47	47	40	54
Custodial account earnings rate	4.90 %	4.46 %	3.99 %	3.45 %	3.21 %
Weighted average discount rate	9.45	9.32	9.20	9.12	9.13
<b>At period end</b>					
Mortgage loans serviced for others:					
Total	\$ 5,794,067	\$ 5,292,253	\$ 11,444,758	\$ 10,287,991	\$ 8,043,655
With capitalized mortgage servicing rights: <sup>(a)</sup>					
Amount	2,372,534	2,362,539	2,310,726	2,249,030	2,207,403
Weighted average interest rate	5.63 %	5.60 %	5.57 %	5.57 %	5.57 %
Total loans sub-serviced without mortgage servicing rights: <sup>(b)</sup>					
Term less than six months	\$ 153,655	\$ 123,552	\$ 292,480	\$ 269,165	\$ 475,327
Term indefinite	3,248,012	2,785,090	8,818,890	7,744,459	5,332,613

Custodial account balances	\$ 124,324	\$ 117,451	\$ 326,906	\$ 237,722	\$ 157,624
----------------------------	------------	------------	------------	------------	------------

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

*(b) Servicing is performed for a fixed fee per loan each month.*

Key assumptions, which vary due to changes in market interest rates and are used to determine the fair value of MSRs, include: expected prepayment speeds, which impact the average life of the portfolio; the earnings rate on custodial accounts, which impacts the value of custodial accounts; and the discount rate used in valuing future cash flows. The following table summarizes the estimated changes in the fair value of mortgage servicing rights for changes in those assumptions individually and in combination associated with an immediate 100 basis point increase or decrease in market rates. The table also summarizes the earnings impact associated with provisions for or reductions of the valuation allowance for mortgage servicing rights. Impairment is measured on a disaggregated basis based upon the predominant risk characteristics of the underlying mortgage loans, which include loans by loan term and coupon rate stratified in 50 basis point increments. Impairment losses are recognized through a valuation allowance for each impaired stratum, with any associated provision recorded as a component of loan servicing income (loss). During the quarter, the coupon rate strata was reduced, which did not have a significant impact on the valuation allowance. Certain stratum may have impairment, while other stratum may not. Therefore, changes in overall fair value may not equal provisions for or reductions of the valuation allowance.

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

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

<i>(Dollars in Thousands)</i>	<i>Expected Prepayment Speeds</i>	<i>Custodial Accounts Rate</i>	<i>Discount Rate</i>	<i>Combination</i>
<b>Increase rates 100 basis points: <sup>(a)</sup></b>				
Increase (decrease) in fair value	\$ 1,350	\$ 1,152	\$ (805 )	\$ 1,801
Reduction of (increase in) valuation allowance	159	118	(171 )	168
<b>Decrease rates 100 basis points: <sup>(b)</sup></b>				
Increase (decrease) in fair value	(3,944 )	(1,172 )	829	(4,885 )
Reduction of (increase in) valuation allowance	(3,368 )	(315 )	99	(3,881 )

<sup>(a)</sup> The weighted-average expected life of the MSR portfolio becomes 57 months.

<sup>(b)</sup> The weighted-average expected life of the MSR portfolio becomes 36 months.

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

<i>(In Thousands)</i>	<i>Three Months Ended</i>				
	<i>March 31, 2006</i>	<i>December 31, 2005</i>	<i>September 30, 2005</i>	<i>June 30, 2005</i>	<i>March 31, 2005</i>
Net cash servicing fees	\$ 1,566	\$ 1,743	\$ 1,968	\$ 1,753	\$ 1,627
Payoff and curtailment interest cost <sup>(a)</sup>	(218 )	(250 )	(315 )	(288 )	(194 )
Amortization of mortgage servicing rights	(1,198 )	(1,252 )	(1,346 )	(1,398 )	(1,160 )
(Provision for) reduction of impairment of mortgage servicing rights	39	697	1,859	(2,596 )	1,211
<b>Total loan servicing income (loss), net</b>	<b>\$ 189</b>	<b>\$ 938</b>	<b>\$ 2,166</b>	<b>\$ (2,529 )</b>	<b>\$ 1,484</b>

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

### **NOTE (4) Derivatives, Hedging Activities, Financial Instruments with Off-Balance Sheet Risk and Other Contractual Obligations (Risk Management)**

#### ***Derivatives***

Downey offers short-term interest rate lock commitments to help attract potential home loan borrowers. The commitments guarantee a specified interest rate for a loan if underwriting standards are met, but do not obligate the potential borrower. Accordingly, some commitments

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

never become loans and merely expire. The residential one-to-four unit interest rate lock commitments Downey ultimately expects to result in loans and sell in the secondary market are treated as derivatives. Consequently, as derivatives, the hedging of the interest rate lock commitments does not qualify for hedge accounting. Associated fair value adjustments to the interest rate lock commitments are recorded in current earnings under net gains (losses) on sales of loans and mortgage-backed securities with an offset to the balance sheet in either other assets, or accounts payable and accrued liabilities. Fair values for the interest rate lock commitments are based on dealer quoted market prices acquired from third parties. The carrying amount of loans held for sale includes a basis adjustment to the loan balance at funding resulting from the change in fair value of the interest rate lock derivative from the date of commitment to the date of funding. At March 31, 2006, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of \$308 million, with a change in fair value resulting in a recorded loss of \$0.8 million.

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



**Hedging Activities**

As part of its secondary marketing activities, Downey typically utilizes short-term loan forward sale and purchase contracts derivatives that mature in less than one year to offset the impact of changes in market interest rates on the value of residential one-to-four unit interest rate lock commitments and loans held for sale. In general, interest rate lock commitments associated with fixed rate loans require a higher percentage of loan forward sale contracts to mitigate interest rate risk than those associated with adjustable rate loans. Contracts designated as hedges for the forecasted sale of loans from the held for sale portfolio are accounted for as cash flow hedges because these contracts have a high correlation to the price movement of the loans being hedged (within a range of 80% - 125%). The measurement approach for determining the ineffective aspects of the hedge is established at the inception of the hedge. Changes in fair value of the loan forward sale contracts not designated as cash flow hedges and the ineffectiveness of hedge transactions that are not perfectly correlated are recorded in net gains (losses) on sales of loans and mortgage-backed securities. Changes in expected future cash flows related to the fair value of the loan forward sale contracts designated as cash flow hedges for the forecasted sale of loans held for sale are recorded in other comprehensive income (loss), net of tax, provided cash flow hedge requirements are met. The offset to these changes are recorded in the balance sheet as either other assets, or accounts payable and accrued liabilities. The amounts recorded in accumulated other comprehensive income (loss) are recognized in the income statement when the hedged forecasted transactions settle. Downey estimates that all of the related unrealized gains or losses in accumulated other comprehensive income will be reclassified into earnings within the next three months. Fair values for the loan forward sale contracts are based on dealer quoted market prices acquired from third parties. At March 31, 2006, the notional amount of loan forward sale contracts amounted to \$806 million, with a change in fair value resulting in a gain of \$3.8 million, of which \$544 million were designated as cash flow hedges. There were no loan forward purchase contracts at March 31, 2006.

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

In connection with its interest rate risk management, Downey from time-to-time enters into interest rate exchange agreements ( swap contracts ) with certain national investment banking firms or the Federal Home Loan Bank ( FHLB ) under terms that provide mutual payment of interest on the outstanding notional amount of swap contracts. These swap contracts help Downey manage the effects of adverse changes in interest rates on net interest income. Downey has interest rate swap contracts on which Downey pays variable interest based on the 3-month London Inter-Bank Offered Rate ( LIBOR ) while receiving fixed interest. The swaps were designated as a hedge of changes in the fair value of certain FHLB fixed rate advances due to changes in market interest rates. The payment and maturity dates of the swap contracts match those of the advances. This hedge effectively converts fixed interest rate advances into debt that adjusts quarterly to movements in 3-month LIBOR. Because the terms of the swap contracts match those of the advances, the hedge has no ineffectiveness and results are reported in interest expense. The fair value of interest rate swap contracts is based on dealer quoted market prices acquired from third parties and represents the estimated amount Downey would receive or pay upon terminating the contracts, taking into consideration current interest rates and the remaining contract terms. The fair value of the swap contracts is recorded on the balance sheet in either other assets or accounts payable and accrued liabilities. With no ineffectiveness, the recorded swap contract values will essentially act as fair value adjustments to the advances being hedged. At March 31, 2006, swap contracts with a notional amount totaling \$430 million were outstanding and had a fair value loss of \$21 million recorded on the balance sheet in accounts payable and accrued liabilities and as a decrease to the advances being hedged.

The following table summarizes Downey s interest rate swap contracts at March 31, 2006.

<i>(Dollars in Thousands)</i>	<i>Notional Amount</i>	<i>Weighted Average Interest Rate</i>	<i>Term</i>	
Pay Variable (3-month LIBOR)	\$ (100,000 )	4.81 %	March 2004	October 2008
Receive Fixed	100,000	3.20		
Pay Variable (3-month LIBOR)	(130,000 )	4.81	March 2004	October 2008
Receive Fixed	130,000	3.21		
Pay Variable (3-month LIBOR)	(100,000 )	4.81	March 2004	November 2008
Receive Fixed	100,000	3.26		
Pay Variable (3-month LIBOR)	(100,000 )	4.81	March 2004	November 2008
Receive Fixed	100,000	3.27		



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

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

### Three Months Ended

(In Thousands)	March 31, 2006	December 31, 2005	September 30, 2005	June 30, 2005	March 31, 2005
Net gains (losses) on non-qualifying hedge transactions	\$ 238	\$ 841	\$ (1,400 )	\$ 1,258	\$ 2,913
Net gains (losses) on qualifying cash flow hedge transactions:					
Unrealized hedge ineffectiveness	-	-	-	-	-
Less reclassification of realized hedge ineffectiveness	-	-	-	-	-
<b>Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)</b>	<b>238</b>	<b>841</b>	<b>(1,400 )</b>	<b>1,258</b>	<b>2,913</b>
Other comprehensive income (loss)	579	(406 )	395	(205 )	191
<b>Notional amount or balance at period end</b>					
Non-qualifying hedge transactions:					
Interest rate lock commitments <sup>(a)</sup>	\$ 307,635	\$ 285,002	\$ 513,459	\$ 624,604	\$ 727,899
Associated loan forward sale contracts	261,359	268,321	402,363	572,977	633,031
Qualifying cash flow hedge transactions:					
Loans held for sale, at lower of cost or fair value	561,511	464,488	501,611	932,248	1,279,734
Associated loan forward sale contracts	544,141	449,923	489,137	905,373	1,247,969
Qualifying fair value hedge transactions:					
Designated FHLB advances pay-fixed	430,000	430,000	430,000	430,000	430,000
Associated interest rate swap contracts pay-variable, receive-fixed	430,000	430,000	430,000	430,000	430,000

<sup>(a)</sup> Amounts are reduced by an anticipated fallout factor for those commitments not expected to fund.

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

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

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

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

those instruments reflect the extent of involvement Downey has in particular classes of financial instruments.

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

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

<i>(In Thousands)</i>	<i>March 31, 2006</i>	<i>December 31, 2005</i>	<i>September 30, 2005</i>	<i>June 30, 2005</i>	<i>March 31, 2005</i>
<hr/>					
Commitments to originate adjustable rate loans					
held for investment	\$ 508,426	\$ 390,238	\$ 639,249	\$ 228,310	\$ 241,414
Undisbursed loan funds and unused lines of credit	406,675	409,555	440,257	491,375	494,210
Commitments to invest in community development					
funds	-	-	-	1,832	5,445

---

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

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

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

Downey maintains an allowance for losses to provide for inherent losses for loan-related commitments associated with undisbursed loan funds and unused lines of credit. The allowance for losses on loan-related commitments was \$1 million at March 31, 2006 and December 31, 2005, compared to \$2 million at March 31, 2005.

### **Other Contractual Obligations**

Downey sells all loans without recourse. When a loan sold to an investor without recourse fails to perform according to the contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred and whether such defects give rise to a violation of a representation or warranty made to the investor in connection with the sale. If such a defect is identified, Downey may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, Downey has no commitment to repurchase the loan. During the first three months of 2006, Downey recorded a negligible repurchase loss related to defects in the origination process and repurchased \$0.2 million of loans. These loan and servicing sale contracts may also contain provisions to refund sales price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Downey reserved less than \$1 million at March 31, 2006, December 31, 2005 and \$1 million at March 31, 2005 to cover the estimated loss exposure related to early payoffs. However, if all the loans related to those sales prepaid within the refund period, as of March 31, 2006, Downey's maximum sales price premium refund would be \$8.6 million.

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

At March 31, 2006, scheduled maturities of certificates of deposit, FHLB advances, senior notes and future operating minimum lease commitments were as follows:

<i>(In Thousands)</i>	<i>Within 1 Year</i>	<i>1 - 3 Years</i>	<i>4 - 5 Years</i>	<i>Over 5 Years</i>	<i>Total Balance</i>
Certificates of deposit	\$ 8,264,947	\$ 636,939	\$ 194,353	\$ -	\$ 9,096,239
FHLB advances	3,416,370	409,441	-	-	3,825,811
Senior notes	-	-	-	198,129	198,129
Operating leases	5,381	7,780	4,096	1,734	18,991
<b>Total other contractual obligations</b>	<b>\$ 11,686,698</b>	<b>\$ 1,054,160</b>	<b>\$ 198,449</b>	<b>\$ 199,863</b>	<b>\$ 13,139,170</b>

### **Litigation**

On June 21, 2005, a former loan underwriting employee brought an action in Contra Costa Superior Court, Case No. C05-01293, entitled *Teresa Sims, et al. v. Downey Savings and Loan Association*. The complaint seeks unspecified damages for alleged unpaid overtime wages and bonuses, inadequate meal and rest breaks, and related claims. The plaintiff is seeking class action status to represent all other current and former Downey Savings employees that held the position of loan underwriter, including, but not limited to, the job title of Senior Loan Underwriter within the State of California (a) at any time during the four years prior to June 21, 2005 and/or (b) who was employed by Downey Savings on or about September 30, 2002, when Downey Savings terminated an annual bonus program. Based on a review of the current facts and circumstances with retained outside counsel, (i) Downey Savings plans to oppose the claim and assert all appropriate defenses and (ii) management has provided for what is believed to be a reasonable estimate of exposure for this matter in the



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

event of loss. While acknowledging the uncertainties of litigation, management believes that the ultimate outcome of this matter will not have a material adverse effect on its operations, cash flows or financial position.

Downey has been named as a defendant in other legal actions arising in the ordinary course of business, none of which, in the opinion of management, will have a material adverse effect on its operations, cash flows or financial position.

### NOTE (5) Income Taxes

Downey and its wholly owned subsidiaries file a consolidated federal income tax return and various state income and franchise tax returns on a calendar year basis. The Internal Revenue Service has examined Downey's tax returns for all tax years through 2003, while state taxing authorities have reviewed tax returns through 2000. Downey's management believes it has adequately provided for potential exposure to issues that may be raised by tax auditors in years which remain open to review.

### NOTE (6) Employee Stock Option Plans

During 1994, the Bank adopted and the stockholders approved the Downey Savings and Loan Association 1994 Long Term Incentive Plan ( LTIP ). The LTIP provided for the granting of stock appreciation rights, restricted stock, performance awards and other awards. Effective January 23, 1995, Downey Financial Corp. and the Bank executed an amendment to the LTIP by which Downey Financial Corp. adopted and ratified the LTIP such that shares of Downey Financial Corp. shall be issued upon exercise of options or payment of other awards, for which payment is to be made in stock, in lieu of the Bank's common stock. The LTIP terminated in 2004; however, options granted and outstanding at termination remain exercisable until the specific termination date of the option. At March 31, 2006, options for 52,914 shares were outstanding at a weighted average remaining contractual life of 3 years, all of which were exercisable at a weighted average option price per share of \$25.44, which represented at least the fair market value of such shares on the date the options were granted. At March 31, 2006, 381,239 shares of treasury stock existed that may be used to satisfy the exercise of the options. No other stock based plan exists.

Downey measured its employee stock-based compensation arrangements under the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). Accordingly, no compensation expense has been recognized for the stock option plan, as stock options were granted at fair value at the date of grant. Had compensation expense for Downey's stock option plan been determined based on the fair value estimated using the Black-Scholes model at the grant date for previous awards, stock-based compensation would have been fully expensed over the vesting period as of December 31, 2002. Therefore, for the three months ended March 31, 2006 and 2005, Downey's net income and income per share would not have been reduced.

### NOTE (7) Earnings Per Share

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

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

	<i>Three Months Ended March 31,</i>					
	<i>2006</i>			<i>2005</i>		
	<i>Net</i>	<i>Weighted Average Shares Outstanding</i>	<i>Per Share Amount</i>	<i>Net</i>	<i>Weighted Average Shares Outstanding</i>	<i>Per Share Amount</i>
<i>(Dollars in Thousands, Except Per Share Data)</i>	<i>Income</i>			<i>Income</i>		
Basic earnings per share	\$ 44,757	27,853,783	\$ 1.61	\$ 51,739	27,853,783	\$ 1.86
Effect of dilutive stock options	-	29,438	-	-	28,056	-

---

Diluted earnings per share	\$ 44,757	27,883,221	\$ 1.61	\$ 51,739	27,881,839	\$ 1.86
----------------------------	-----------	------------	---------	-----------	------------	---------

---

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



Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

**NOTE (8) Business Segment Reporting**

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

<i>(In Thousands)</i>	<i>Banking</i>	<i>Real Estate Investment</i>	<i>Elimination</i>	<i>Totals</i>
<b>Three months ended March 31, 2006</b>				
Net interest income	\$ 125,632	\$ 284	\$ -	\$ 125,916
Provision for credit losses	10,057	-	-	10,057
Other income	20,671	2,539	-	23,210
Operating expense	60,797	735	-	61,532
Net intercompany income (expense)	87	(87 )	-	-
<hr/>				
Income before income taxes	75,536	2,001	-	77,537
Income taxes	31,960	820	-	32,780
<hr/>				
Net income	\$ 43,576	\$ 1,181	\$ -	\$ 44,757
<hr/>				
<b>At March 31, 2006</b>				
Assets:				
Loans and mortgage-backed securities, net	\$ 16,429,596	\$ -	\$ -	\$ 16,429,596
Investments in real estate and joint ventures	-	49,182	-	49,182
Other	1,364,430	29,974	(70,423 )	1,323,981
<hr/>				
Total assets	17,794,026	79,156	(70,423 )	17,802,759
<hr/>				
Equity	\$ 1,249,403	\$ 70,423	\$ (70,423 )	\$ 1,249,403
<hr/>				
<b>Three months ended March 31, 2005</b>				
Net interest income	\$ 104,888	\$ 103	\$ -	\$ 104,991
Provision for credit losses	2,038	-	-	2,038
Other income	41,995	2,816	-	44,811
Operating expense	57,858	366	-	58,224
Net intercompany income (expense)	(38 )	38	-	-
<hr/>				
Income before income taxes	86,949	2,591	-	89,540
Income taxes	36,739	1,062	-	37,801
<hr/>				
Net income	\$ 50,210	\$ 1,529	\$ -	\$ 51,739
<hr/>				
<b>At March 31, 2005</b>				
Assets:				
	\$ 15,730,149	\$ -	\$ -	\$ 15,730,149

Loans and mortgage-backed securities, net				
Investments in real estate and joint ventures	-	56,964	-	56,964
Other	1,155,426	19,659	(67,220 )	1,107,865
<b>Total assets</b>	<b>16,885,575</b>	<b>76,623</b>	<b>(67,220 )</b>	<b>16,894,978</b>
<b>Equity</b>	<b>\$ 1,054,336</b>	<b>\$ 67,220</b>	<b>\$ (67,220 )</b>	<b>\$ 1,054,336</b>

**NOTE (9) Current Accounting Issues*****Statement of Financial Accounting Standards No. 155***

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, Accounting for Certain Hybrid Financial Instruments ( SFAS 155 ), which provides the following: 1) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, 2) clarifies which interest-only strips and principal-only strips are not subject to the requirements of Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, 3) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, 4) clarifies that concentrations of credit in the form of subordination are not embedded derivatives, and 5) amends Statement of Financial Accounting Standards No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement 125 to eliminate the prohibition of a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 for accounting for certain hybrid financial instruments is effective for us beginning January 1, 2007. Adoption of SFAS 155 is not expected to have a material impact on Downey.

*Statement of Financial Accounting Standards No. 156*

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156, Accounting for Servicing of Financial Assets ( SFAS 156 ), which provides the following: 1) revised guidance on when a servicing asset and servicing liability should be recognized, 2) requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable, 3) permits an entity to elect to measure servicing assets and servicing liabilities at fair value each reporting date and report changes in fair value in earnings in the period in which the changes occur, 4) upon initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities for securities which are identified as offsetting the entity's exposure to changes in the fair value of servicing assets or liabilities that a servicer elects to subsequently measure at fair value, and 5) requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional footnote disclosures. SFAS 156 is effective for us beginning January 1, 2007 with the effects of initial adoption being reported as a cumulative-effect adjustment to retained earnings. The impact to retained earnings as a result of the initial adoption of SFAS 156 is expected to be immaterial.

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

*Certain statements under this caption may constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995, which involve risks and uncertainties. Forward-looking statements do not relate strictly to historical information or current facts. Some forward-looking statements may be identified by use of terms such as expects, anticipates, intends, plans, believes, seeks, estimates, or similar meaning, or future or conditional verbs such as will, would, should, could or may. Our actual results may differ significantly from results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation. For additional information concerning these factors, see Item 1A. Risk Factors on page 47. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made.*

**OVERVIEW**

Our net income for the first quarter of 2006 totaled \$44.8 million or \$1.61 per share on a diluted basis, down 13.5% from \$51.7 million or \$1.86 per share in the first quarter of 2005.

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

- A \$19.0 million decline in net gains on sales of loans and mortgage-backed securities due to a lower volume of loans sold and gain per dollar of loan sold;
- A \$8.0 million increase in provision for credit losses;
- A \$3.4 million or 5.8% increase in general and administrative expense;
- A \$1.3 million decline in income from loan servicing activities; and
- A \$1.0 million decline in gains from sales of loan servicing.

Those unfavorable factors were partially offset by a \$20.9 million or 19.9% increase in net interest income reflecting both a higher level of average interest-earning assets and effective interest rate spread.

During the first quarter of 2006, loan prepayment and late fees were reclassified from loan and deposit related fees to loan interest income to conform with the current quarter classification change from prior reporting requirements received from the Office of Thrift Supervision (OTS). Previously reported periods were restated to conform to the current period presentation. The reclassification had no effect on net income or stockholders' equity. Loan prepayment and late fees of \$22.3 million were reclassified in the current quarter, compared to \$10.9 million in the year-ago quarter.

For the first quarter, our return on average assets was 1.03%, down from 1.28% a year ago, while our return on average equity was 14.58%, down from 20.09% a year ago.

At March 31, 2006, assets totaled \$17.803 billion, up 5.4% from a year ago and up 4.1% from year-end 2005. During the current quarter, assets increased \$707 million due primarily to increases of \$511 million in loans held for investment, \$104 million in securities available for sale and \$97 million in loans held for sale.

Loan originations (including purchases) totaled \$2.813 billion in the current quarter, down 33.8% from \$4.250 billion a year ago. Loans originated for sale declined \$1.201 billion to \$980 million, while single family loans originated for portfolio declined \$197 million to \$1.719 billion. Of the current quarter total originated for portfolio, \$55 million represented subprime credits. At quarter end, the subprime portfolio totaled \$963 million, with an average loan-to-value ratio at origination of 70% and, of the total, 97% represented Alt. A and A- credits. In addition to single family loans, \$114 million of other loans were originated in the current quarter.

Deposits totaled \$12.199 billion at quarter end, up 18.3% from a year ago and up \$322 million or 2.7% from year-end 2005. At quarter end, the number of branches totaled 173, of which 93 were in-store and four were located in Arizona, unchanged from year-end 2005. A year ago, we had 169 branches, of which 92 were in-store and four were located in Arizona.

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

Our non-performing assets increased \$4 million during the quarter to \$39 million or 0.22% of total assets, compared to 0.21% at year-end 2005. The increase during the quarter was equally spread between our prime and subprime residential loan categories.

At March 31, 2006, Downey Savings and Loan Association, F.A. (the Bank), our primary subsidiary, exceeded all regulatory capital requirements, with capital-to-asset ratios of 7.56% for both tangible and core capital and 14.89% for risk-based capital. These capital levels are significantly above the well capitalized standards defined by the federal banking regulators of 5% for core capital and 10% for risk-based capital.

Page 16

---

[Navigation Links](#)

**CRITICAL ACCOUNTING POLICIES**

We have established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in Downey's Annual Report on Form 10-K for the year ended December 31, 2005. Certain accounting policies require us to make significant estimates and assumptions which could have a material impact on the carrying value of certain assets and liabilities, and we consider these to be critical accounting policies. The estimates and assumptions are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the future carrying value of assets and liabilities and our results of operations for the reporting periods. Management has discussed the development and selection of these critical accounting policies with the Audit Committee of our Board of Directors.

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

- The valuation of interest rate lock commitments. We enter into commitments to make loans that we intend to sell to investors whereby the interest rate on the loan is set prior to funding. These interest rate lock commitments are considered to be derivatives and are recorded at fair value. This value is calculated using market sources, reduced by an anticipated fallout factor for interest rate lock commitments that are not expected to fund. At March 31, 2006, Downey had a notional amount of interest rate lock commitments identified to sell as part of its secondary marketing activities of \$308 million, with a change in fair value resulting in a loss of \$0.8 million, compared to a notional amount of interest rate lock commitments of \$728 million with a change in fair value resulting in a gain of \$0.3 million at March 31, 2005. For further information, see Note 4 on page 8 of Notes to Consolidated Financial Statements.
- The allowance for credit and real estate losses. The allowance for credit losses, which includes an allowance for loan losses reported as a reduction of outstanding loans and an allowance for loan-related commitments included in accounts payable and accrued liabilities, and the allowance for real estate losses reported as a reduction to real estate held for investment are maintained at amounts management deems adequate to cover inherent losses in the portfolios. On March 31, 2006, we reclassified to accounts payable and accrued liabilities our allowance for loan-related commitments which was previously included with the allowance for loan losses. We use an internal asset review system and credit loss allowance methodology designed to provide for the detection of problem assets and an adequate allowance to cover credit losses. In determining the allowance for credit losses related to loan relationships of \$5 million or more, we evaluate the loans on an individual basis, including an analysis of the borrower's creditworthiness, cash flows and financial status, and the condition and the estimated value of the collateral. Unless an individual loan or borrower relationship warrants separate analysis, we generally review all loans under \$5 million by analyzing their performance and the composition of their collateral as a whole because of the relatively homogeneous nature of the loans. This allowance is determined by applying against asset and loan-related commitment balances the associated loss factors for each major credit type that consider past loss experience and asset duration, or loss statistics against current classified credit balances. Those amounts may be adjusted based upon an analysis of macro-economic and other trends that are likely to affect a borrower's ability to repay their loan according to their loan terms. The allowance totaled \$46 million at March 31, 2006, compared to \$38 million at March 31, 2005. For further information, see Allowance for Credit and Real Estate Losses on page 40.
- The valuation of mortgage servicing rights (MSRs). The fair value of MSRs is measured using a discounted cash flow analysis based on available market quotes, anticipated prepayment speeds, a custodial account rate and market-adjusted discount rates. Market sources are used to determine prepayment speeds, the net cost of servicing per loan, inflation rate, and default and interest rates for mortgages. MSRs are reviewed for impairment based on their fair value. Impairment is measured on a disaggregated basis based upon the predominant risk characteristics of the underlying mortgage loans, which include loans by loan term and coupon rate stratified at 50 basis point increments. Impairment losses are recognized through a valuation allowance for each impaired stratum, with any associated provision recorded as a component of loan servicing income (loss). During the quarter, the coupon rate strata was reduced, which did not have a significant impact on the valuation allowance. At March 31, 2006, the MSR valuation allowance totaled less than \$1 million, compared to \$1 million at March 31, 2005. For further information, see Note 3 on page 7 of Notes to Consolidated Financial Statements.

- The prepayment reserves related to sales of loans and MSR. The gains on sales of loans and of MSRs are recorded net of reserves for anticipated prepayments. These sales contracts typically contain provisions to refund sale price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. Loan and MSR sales reserves are estimated using the prepayment experience of similar products. The estimates are updated during the 120 day period for actual payoffs. The reserve was less than \$1 million at March 31, 2006 and \$1 million at March 31, 2005. For further information, see Note 3 on page 7 and Note 4 on page 8 of Notes to Consolidated Financial Statements and Secondary Marketing Activities on page 22.

## RESULTS OF OPERATIONS

### Net Interest Income

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

Our net interest income totaled \$125.9 million in the first quarter of 2006, up \$20.9 million or 19.9 % from a year ago. The increase reflected both a higher level of average interest-earning assets and effective interest rate spread. Interest-earning assets averaged \$16.986 billion in the current quarter, up 7.4% from the same period a year ago. The effective interest rate spread averaged 2.97% in the current quarter, up from 2.65% a year ago. The improvement in the effective interest rate spread between first quarters primarily reflected two items. First, our interest-earning assets in the current quarter were funded with a higher proportion of interest free funds (non-interest-bearing checking accounts and the excess of interest-earning assets over deposits and borrowings) and the value of those funds was worth more due to the higher interest rate levels prevalent in the current quarter. Second, prepayment fees collected as a result of loan payoffs in the current quarter covered a higher proportion of the deferred loan origination costs that were written-off as a result of those payoffs. For further information regarding a reclassification of certain prior period amounts, see Note 2 on page 6 of Notes to Consolidated Financial Statements.



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

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

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

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

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

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

(Dollars in Thousands)	<i>Three Months Ended</i>								
	<i>March 31, 2006</i>			<i>December 31, 2005</i>			<i>March 31, 2005</i>		
	<i>Average Balance</i>	<i>Average Interest</i>	<i>Average Yield/ Rate</i>	<i>Average Balance</i>	<i>Average Interest</i>	<i>Average Yield/ Rate</i>	<i>Average Balance</i>	<i>Average Interest</i>	<i>Average Yield/ Rate</i>
<b>Interest-earning assets:</b>									
Loans	\$ 16,137,510	\$ 255,345	6.33 %	\$ 15,633,782	\$ 229,518	5.87 %	\$ 15,081,234	\$ 183,910	4.88 %
Mortgage-backed securities	276	3	4.35	281	3	4.27	301	3	3.99
Investment securities <sup>(a)</sup>	848,460	9,615	4.60	766,808	6,067	3.14	740,503	7,376	4.04
<b>Total interest-earning assets</b>	<b>16,986,246</b>	<b>264,963</b>	<b>6.24</b>	<b>16,400,871</b>	<b>235,588</b>	<b>5.75</b>	<b>15,822,038</b>	<b>191,289</b>	<b>4.84</b>
Non-interest-earning assets	419,058			435,809			384,519		
<b>Total assets</b>	<b>\$ 17,405,304</b>			<b>\$ 16,836,680</b>			<b>\$ 16,206,557</b>		
<b>Transaction accounts:</b>									
<b>Non-interest-bearing</b>									
Checking	\$ 699,971	\$ -	- %	\$ 845,532	\$ -	- %	\$ 613,945	\$ -	- %
Interest-bearing checking <sup>(b)</sup>	515,516	435	0.34	523,134	456	0.35	532,416	476	0.36
Money market	164,212	423	1.04	164,673	433	1.04	158,491	410	1.05
Regular passbook	1,727,033	4,384	1.03	1,899,085	4,973	1.04	2,635,858	7,166	1.10
<b>Total transaction accounts</b>	<b>3,106,732</b>	<b>5,242</b>	<b>0.68</b>	<b>3,432,424</b>	<b>5,862</b>	<b>0.68</b>	<b>3,940,710</b>	<b>8,052</b>	<b>0.83</b>
Certificates of deposit	8,904,238	86,593	3.94	8,488,817	79,315	3.71	6,016,710	40,971	2.76
<b>Total deposits</b>	<b>12,010,970</b>	<b>91,835</b>	<b>3.10</b>	<b>11,921,241</b>	<b>85,177</b>	<b>2.83</b>	<b>9,957,420</b>	<b>49,023</b>	<b>2.00</b>
LB advances <sup>(c)</sup>	3,689,386	43,914	4.83	3,244,012	36,124	4.42	4,791,811	33,980	2.88

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

for notes	198,112	3,298	6.66	198,069	3,297	6.66	197,949	3,295	6.66
al deposits and borrowings	15,898,468	139,047	3.55	15,363,322	124,598	3.22	14,947,180	86,298	2.34
er liabilities	278,843			283,847			229,195		
ckholders equity	1,227,993			1,189,511			1,030,182		
al liabilities and ckholders equity	\$ 17,405,304			\$ 16,836,680			\$ 16,206,557		
interest income/interest spread		\$ 125,916	2.69 %		\$ 110,990	2.53 %		\$ 104,991	2.50 %
ess of interest-earning ts over									
osits and borrowings	\$ 1,087,778			\$ 1,037,549			\$ 874,858		
ective interest rate spread			2.97			2.71			2.65

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

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

*(c) The impact of swap contracts was included, with notional amounts totaling \$430 million of receive-fixed, pay-3-month London Inter-Bank Offered Rate ( LIBOR ) variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.*

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

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

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

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

*Three Months Ended March 31,  
2006 Versus 2005  
Changes Due To*

<i>(In Thousands)</i>	<i>Volume</i>	<i>Rate</i>	<i>Rate/ Volume</i>	<i>Net</i>
<b>Interest income:</b>				
Loans	\$ 12,881	\$ 54,721	\$ 3,833	\$ 71,435
Mortgage-backed securities	-	-	-	-
Investment securities	1,075	1,016	148	2,239
<hr/>				
Change in interest income	13,956	55,737	3,981	73,674
<hr/>				
<b>Interest expense:</b>				
Transaction accounts:				
Interest-bearing checking	(15 )	(27 )	1	(41 )
Money market	15	(2 )	-	13
Regular passbook	(2,471 )	(475 )	164	(2,782 )
<hr/>				
Total transaction accounts	(2,471 )	(504 )	165	(2,810 )
Certificates of deposit	19,663	17,541	8,418	45,622
<hr/>				
Total interest-bearing deposits	17,192	17,037	8,583	42,812
FHLB advances	(7,818 )	23,056	(5,304 )	9,934
Senior notes	3	-	-	3
<hr/>				
Change in interest expense	9,377	40,093	3,279	52,749
<hr/>				
Change in net interest income	\$ 4,579	\$ 15,644	\$ 702	\$ 20,925

### Provision for Credit Losses

Provision for credit losses totaled \$10.1 million in the first quarter of 2006, up \$8.0 million from a year ago. During the current quarter, certain segments of the California residential real estate market began to show signs of slower sales and flattening home values on a sequential month basis. In addition, we have noted increased usage of negative amortization associated with option ARM loans. Therefore, even though net charge-offs were virtually unchanged at \$0.1 million in the current quarter, an increase in the allowance for credit losses associated with

residential loans was deemed appropriate. The allowance for credit losses was \$46 million at March 31, 2006, comprised of \$45 million for loan losses and \$1 million for loan-related commitments. That compares to an allowance for credit losses of \$36 million at year-end 2005, comprised of \$35 million for loan losses and \$1 million for loan-related commitments.

**Other Income**

Our total other income was \$23.2 million in the current quarter, down \$21.6 million from a year ago. Contributing to the decline between first quarters was:

- a \$19.0 million decline in net gains from sales of loans and mortgage-backed securities;
- a \$1.3 million decline in income from loan servicing activities;
- a \$1.0 million decline on gains on sales of mortgage servicing rights; and
- a \$0.3 million decline in income from real estate held for investment.

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

Below is a further detailed discussion of the major other income categories.

### ***Loan and Deposit Related Fees***

Loan and deposit related fees totaled \$8.6 million in the current quarter, essentially unchanged from a year ago. Loan related fees were down \$0.2 million or 14.0% and deposit related fees were up \$0.1 million or 1.7%. Within deposit related fees, automated teller machine fees declined 16.7% primarily reflecting the removal of 200 standalone machines in the fourth quarter of 2005 while all other deposit related fees increased 11.7%. For further information regarding a reclassification of certain prior period amounts, see Note 2 on page 6 of Notes to Consolidated Financial Statements.

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

<i>(In Thousands)</i>	<i>Three Months Ended</i>				
	<i>March 31,</i>	<i>December 31,</i>	<i>September 30,</i>	<i>June 30,</i>	<i>March 31,</i>
	<i>2006</i>	<i>2005</i>	<i>2005</i>	<i>2005</i>	<i>2005</i>
Loan related fees	\$ 1,066	\$ 1,346	\$ 1,538	\$ 1,401	\$ 1,240
Deposit related fees:					
Automated teller machine fees	2,149	2,453	2,770	2,784	2,581
Other fees	5,343	5,278	5,265	5,057	4,783
Total loan and deposit related fees	\$ 8,558	\$ 9,077	\$ 9,573	\$ 9,242	\$ 8,604

### ***Real Estate and Joint Ventures Held for Investment***

Income from our real estate and joint ventures held for investment totaled \$2.3 million in the current quarter, down \$0.3 million from the year-ago quarter due primarily to lower gains from sales. The current quarter included gains of \$1.0 million, compared to gains of \$1.5 million a year ago.

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

<i>(In Thousands)</i>	<i>Three Months Ended</i>				
	<i>March 31,</i>	<i>December 31,</i>	<i>September 30,</i>	<i>June 30,</i>	<i>March 31,</i>
	<i>2006</i>	<i>2005</i>	<i>2005</i>	<i>2005</i>	<i>2005</i>
Rental operations, net of expenses	\$ 487	\$ 387	\$ 199	\$ 300	\$ 456
Net gains on sales of wholly owned real estate	-	-	407	39	31
Equity in net income (loss) from joint ventures	1,802	(1,268 )	1,368	1,389	2,093
Reduction of losses on real estate and joint ventures	-	-	1,333	-	-
Total income (loss) from real estate and joint ventures held for investment, net	\$ 2,289	\$ (881 )	\$ 3,307	\$ 1,728	\$ 2,580

*Secondary Marketing Activities*

We service loans for others and those activities generated income of \$0.2 million in the current quarter, down from \$1.5 million in the year-ago quarter. The primary reason for the unfavorable change was that the current quarter included a less than \$0.1 million recapture of the valuation allowance for MSRs, compared to a \$1.2 million recapture in the year-ago quarter.

At March 31, 2006, MSRs, net of a \$0.3 million valuation allowance, totaled \$20.2 million or 0.85% of the \$2.373 billion of associated loans serviced for others. That compares to MSRs in the year-ago quarter, net of a \$1.2 million valuation allowance, of \$19.6 million or 0.89% of the \$2.207 billion of associated loans serviced for others. In addition to the loans we serviced for others with capitalized MSRs, at March 31, 2006, we serviced \$3.422 billion of loans for which we have no risk associated with changing MSR values. On loans we sub-service, we receive a fixed fee per loan each month.

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

The following table presents a breakdown of the components of our loan servicing income (loss), net for the quarters indicated.

### Three Months Ended

<i>(In Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December</i> <i>31,</i> <i>2005</i>	<i>September</i> <i>30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
Net cash servicing fees	\$ 1,566	\$ 1,743	\$ 1,968	\$ 1,753	\$ 1,627
Payoff and curtailment interest cost <sup>(a)</sup>	(218 )	(250 )	(315 )	(288 )	(194 )
Amortization of mortgage servicing rights	(1,198 )	(1,252 )	(1,346 )	(1,398 )	(1,160 )
(Provision for) reduction of impairment of mortgage servicing rights	39	697	1,859	(2,596 )	1,211
<b>Total loan servicing income (loss), net</b>	<b>\$ 189</b>	<b>\$ 938</b>	<b>\$ 2,166</b>	<b>\$ (2,529 )</b>	<b>\$ 1,484</b>

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

For further information, see Note 3 on page 7 of Notes to Consolidated Financial Statements.

Sales of loans and mortgage-backed securities we originated for sale declined from \$2.030 billion a year ago to \$876 million in the current quarter. Net gains associated with these sales totaled \$11.7 million in the current quarter, down from \$30.6 million a year ago. The decline was not only due to a lower volume of loans sold, but also a lower gain per dollar of loans sold. The current quarter included a \$0.2 million gain due to the SFAS 133 impact of valuing derivatives associated with the sale of loans, down from a SFAS 133 gain of \$2.9 million in the year-ago quarter. Excluding the impact of SFAS 133, a gain equal to 1.30% on secondary market sales was realized, down from the year-ago gain of 1.36%.

The following table presents a breakdown of the components of our net gains on sales of loans and mortgage-backed securities for the quarters indicated.

### Three Months Ended

<i>(In Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December</i> <i>31,</i> <i>2005</i>	<i>September</i> <i>30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
Mortgage servicing rights	\$ 1,022	\$ 1,740	\$ 1,858	\$ 1,217	\$ 1,609
All other components excluding SFAS 133	10,394	8,418	29,041	46,373	26,093
SFAS 133	238	841	(1,400 )	1,258	2,913
<b>Total net gains on sales of loans and mortgage-backed securities</b>	<b>\$ 11,654</b>	<b>\$ 10,999</b>	<b>\$ 29,499</b>	<b>\$ 48,848</b>	<b>\$ 30,615</b>
<b>Secondary marketing gain excluding SFAS 133 as a percentage of associated sales</b>	<b>1.30 %</b>	<b>0.93 %</b>	<b>1.47 %</b>	<b>1.54 %</b>	<b>1.36 %</b>

**Operating Expense**

Operating expense totaled \$61.5 million in the current quarter, up \$3.3 million from a year ago due to a 5.8% increase in general and administrative expense. Except for a modest decline in advertising expense, all major categories of general and administrative expense were higher.



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

The following table presents a breakdown of key components comprising operating expense for the quarters indicated.

### Three Months Ended

<i>(In Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December 31,</i> <i>2005</i>	<i>September 30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
Salaries and related costs	\$ 40,780	\$ 37,397	\$ 38,155	\$ 39,042	\$ 39,155
Premises and equipment costs	8,538	8,301	8,079	7,891	8,000
Advertising expense	1,242	1,610	1,557	1,551	1,350
SAIF insurance premiums and regulatory assessments	1,014	984	957	927	927
Professional fees	792	596	(69 )	345	336
Other general and administrative expense	9,175	9,621	9,938	8,605	8,392
<b>Total general and administrative expense</b>	<b>61,541</b>	<b>58,509</b>	<b>58,617</b>	<b>58,361</b>	<b>58,160</b>
Net operation of real estate acquired in settlement of loans	(9 )	(172 )	91	(79 )	64
<b>Total operating expense</b>	<b>\$ 61,532</b>	<b>\$ 58,337</b>	<b>\$ 58,708</b>	<b>\$ 58,282</b>	<b>\$ 58,224</b>

### Provision for Income Taxes

Income taxes for the first quarter totaled \$32.8 million, resulting in an effective tax rate of 42.3%, compared to \$37.8 million and 42.2% for the year-ago quarter. For further information, see Note 5 of Notes to Consolidated Financial statements on page 12.

### Business Segment Reporting

The previous discussion and analysis of the Results of Operations pertained to our consolidated results. This section discusses and analyzes the results of operations of our two business segments banking and real estate investment. For further information, see Note 8 of Notes to Consolidated Financial Statements on page 13.

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

### Three Months Ended

<i>(In Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December 31,</i> <i>2005</i>	<i>September 30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
Banking net income	\$ 43,576	\$ 43,054	\$ 57,687	\$ 62,932	\$ 50,210
Real estate investment net income (loss)	1,181	(1,165 )	2,049	1,138	1,529
<b>Total net income</b>	<b>\$ 44,757</b>	<b>\$ 41,889</b>	<b>\$ 59,736</b>	<b>\$ 64,070</b>	<b>\$ 51,739</b>

**Banking**

Net income from our banking operations for the current quarter totaled \$43.6 million, down \$6.6 million or 13.2% from a year ago. The decline between first quarters primarily reflected:

- A \$19.0 million decline in net gains on sales of loans and mortgage-backed securities due to a lower volume of loans sold and gain per dollar of loan sold;
- A \$8.0 million increase in provision for credit losses, as we deemed it appropriate to increase the allowance for credit losses associated with residential loans;
- A \$2.9 million or 5.1% increase in operating expense, as all major categories were higher except for a modest decline in advertising expense;
- A \$1.3 million decline in income from loan servicing activities, due primarily to a lower recapture of the valuation allowance for MSR in the current quarter; and
- A \$1.0 million decline in gains from sales of loan servicing, as there were no sales in the current quarter.

Those unfavorable factors were partially offset by a \$20.7 million or 19.8% increase in net interest income reflecting both a higher level of average interest-earning assets and effective interest rate spread.

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

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

<i>Three Months Ended</i>					
<i>(In Thousands)</i>	<i>March 31,</i> 2006	<i>December 31,</i> 2005	<i>September 30,</i> 2005	<i>June 30,</i> 2005	<i>March 31,</i> 2005
Net interest income	\$ 125,632	\$ 110,749	\$ 109,878	\$ 110,256	\$ 104,888
Provision for (reduction of) credit losses	10,057	393	(751 )	583	2,038
Other income	20,671	20,743	41,881	57,365	41,995
Operating expense	60,797	56,632	58,426	58,030	57,858
Net intercompany income (expense)	87	(45 )	29	(39 )	(38 )
Income before income taxes	75,536	74,422	94,113	108,969	86,949
Income taxes	31,960	31,368	36,426	46,037	36,739
Net income	\$ 43,576	\$ 43,054	\$ 57,687	\$ 62,932	\$ 50,210
<b>At period end</b>					
Assets:					
Loans and mortgage-backed securities, net	\$ 16,429,596	\$ 15,821,923	\$ 15,344,636	\$ 15,408,774	\$ 15,730,149
Other	1,364,430	1,265,220	1,214,285	1,196,756	1,155,426
Total assets	17,794,026	17,087,143	16,558,921	16,605,530	16,885,575
Equity	\$ 1,249,403	\$ 1,208,219	\$ 1,171,528	\$ 1,116,145	\$ 1,054,336

### **Real Estate Investment**

Net income from our real estate investment operations totaled \$1.2 million in the current quarter, down from \$1.5 million a year ago. The decline primarily reflected lower gains from sales. The current quarter included gains of \$1.0 million, compared to gains of \$1.5 million a year ago.

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

<i>Three Months Ended</i>					
<i>(In Thousands)</i>	<i>March 31,</i> 2006	<i>December 31,</i> 2005	<i>September 30,</i> 2005	<i>June 30,</i> 2005	<i>March 31,</i> 2005
Net interest income	\$ 284	\$ 241	\$ 148	\$ 110	\$ 103
Other income (loss)	2,539	(553 )	3,654	2,031	2,816

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Operating expense	735	1,705	282	252	366
Net intercompany income (expense)	(87 )	45	(29 )	39	38

Income (loss) before income taxes (benefits)	2,001	(1,972 )	3,491	1,928	2,591
Income taxes (benefits)	820	(807 )	1,442	790	1,062

Net income (loss)	\$ 1,181	\$ (1,165 )	\$ 2,049	\$ 1,138	\$ 1,529
-------------------	----------	-------------	----------	----------	----------

**At period end**

Assets:

Investments in real estate and joint ventures	\$ 49,182	\$ 49,344	\$ 49,351	\$ 58,941	\$ 56,964
Other	29,974	28,418	29,429	17,833	19,659

Total assets	79,156	77,762	78,780	76,774	76,623
--------------	--------	--------	--------	--------	--------

Equity	\$ 70,423	\$ 69,242	\$ 70,407	\$ 68,358	\$ 67,220
--------	-----------	-----------	-----------	-----------	-----------

For information on valuation allowances associated with real estate and joint venture loans, see Allowance for Credit and Real Estate Losses on page 40.

**FINANCIAL CONDITION**

**Loans and Mortgage-Backed Securities**

Total loans and mortgage-backed securities, including those we hold for sale, increased \$608 million during the current quarter to a total of \$16.4 billion or 92.3% of total assets at March 31, 2006. The increase was due primarily to an increase of \$511 million in our loans held for investment.

Our loan originations, including loans purchased, totaled \$2.8 billion in the current quarter, down 33.8% from the \$4.2 billion we originated in the year-ago first quarter and 8.5% below the \$3.1 billion we originated in the fourth quarter of 2005. Loans originated for sale declined \$1.2 billion from the year-ago quarter to \$1.0 billion, while one-to-four unit residential loans we originated for portfolio declined \$197 million to \$1.7 billion. Of our current quarter originations for portfolio, \$55 million represented subprime credits. Our prepayment speed, which measures the annualized percentage of loans repaid, for one-to-four unit residential loans increased from 30% a year ago to 34% in the current quarter, but was down from 41% in the fourth quarter of 2005. During the current quarter, 87% of our residential one-to-four unit originations represented refinance transactions. This is up from 83% in the fourth quarter of 2005 and 81% in the year-ago first quarter. In addition to single family loans, we originated \$114 million of other loans in the current quarter.

Originations of adjustable rate one-to-four unit residential loans for portfolio, including loans purchased, totaled \$1.7 billion in the current quarter. Of those, 88% were monthly adjustable rate loans that provide for negative amortization, with the balance primarily adjustable rate loans with the initial interest rate fixed for the first three to five years. Of the adjustable rate loans, 86% were tied to the FHLB Eleventh District Cost of Funds Index ( COFI ), with the remainder tied to the 12-month moving average of yields on actively traded U.S. Treasury securities adjusted to a constant maturity of one year ( MTA ) or LIBOR index. This is in contrast to the year-ago first quarter when virtually all of the originations were monthly adjustable rate loans and COFI-related loans represented 99% of the total.

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

	<i>Three Months Ended</i>				
<i>(In Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December 31,</i> <i>2005</i>	<i>September 30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
<b>Loans originated and purchased</b>					
Investment portfolio:					
Residential one-to-four units:					
Adjustable by index:					
COFI	\$ 1,309,298	\$ 1,445,612	\$ 1,309,055	\$ 920,152	\$ 1,904,087
MTA	209,134	526,811	602,125	350,462	2,241
LIBOR	11,396	1,540	880	1,765	10,003
Adjustable fixed for 3-5 years	189,385	5,827	-	-	-
Fixed	155	464	61	-	-
<b>Total residential one-to-four units</b>	<b>1,719,368</b>	<b>1,980,254</b>	<b>1,912,121</b>	<b>1,272,379</b>	<b>1,916,331</b>
Other	113,670	27,835	31,620	94,100	152,084
<b>Total for investment portfolio</b>	<b>1,833,038</b>	<b>2,008,089</b>	<b>1,943,741</b>	<b>1,366,479</b>	<b>2,068,415</b>
Sale portfolio <sup>(a)</sup>	980,164	1,067,861	1,699,900	2,766,047	2,181,392
	<b>\$ 2,813,202</b>	<b>\$ 3,075,950</b>	<b>\$ 3,643,641</b>	<b>\$ 4,132,526</b>	<b>\$ 4,249,807</b>

Total for investment and  
sale portfolios

---

*(a) All residential one-to-four unit loans.*

Our adjustable rate mortgages generally:

- either begin with an incentive interest rate ( start 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, or have a fixed interest rate for a period of three to five years then adjust semi-annually or annually thereafter;
- provide that the maximum interest rate cannot exceed the incentive rate by more than six to ten percentage points, depending on the type of loan and the initial rate offered; and
- limit interest rate adjustments, for loans that adjust both the interest rate and payment amount simultaneously, to 1% per adjustment for those that adjust semi-annually and 2% per adjustment for those that adjust annually.

Most of our adjustable rate mortgages are option ARM products with an interest rate that adjusts monthly and a required minimum monthly loan payment that adjusts annually. The start rate is lower than the fully-indexed rate and is the effective interest rate for the loan only during the first month. After the first month, interest accrues at the fully-indexed rate. The initial start rate, however, is used to calculate the required minimum monthly loan payment for the first twelve months. The borrower is required to make the minimum monthly payment, but retains the option to make a larger payment to reduce loan principal and avoid negative amortization, or the addition to loan principal of accrued interest that exceeds the required monthly loan payment. If the borrower chooses to make the minimum required monthly loan payment and the interest accrual, based on the fully-indexed rate, results in monthly interest due exceeding the payment amount, the loan balance will increase by the difference. These payment options are clearly defined in the loan documents signed by the borrower at funding and explained again on the borrower's monthly statement.

More particularly, these loans currently:

- limit negative amortization to 110% of the original loan amount;
- have a lifetime interest rate cap, but no periodic cap on interest rate adjustments; and
- include a payment cap that limits the change in required minimum monthly loan payments to 7.5% per year, unless the loan is recast (*i.e.*, a new monthly loan payment is calculated using the fully-indexed interest rate and provides for amortization of the loan balance over the remaining term of the loan). A loan is recast at the earlier of every five years or when the loan balance reaches the maximum level of negative amortization permitted.

The maximum home loan we make, except for a limited amount related to Community Reinvestment Act activities, is equal to 95% of a property's appraised value; however, any loan in excess of 80% of appraised value generally requires private mortgage insurance. Typically, this insures the loan down to a 75% loan-to-value ratio, consistent with secondary marketing requirements. A loan-to-value ratio is the proportion of the principal amount of the loan to the lower of the sales price or appraised value of the property securing the loan at origination. If a loan incurs significant negative amortization, the loan-to-value ratio could rise, which increases credit risk, and the fair value of the underlying collateral could be insufficient to satisfy fully the outstanding loan obligation in the event of a loan default.

With the negative amortization and loan-to-value limitations currently in place, the loan-to-value ratio over the life of an option ARM could never exceed 88% of the original appraised value, assuming the loan reached 110% of the original loan balance and had an 80% loan-to-value ratio at origination (the maximum permitted without the borrower obtaining private mortgage insurance).

Our loan portfolio held for investment does contain loans previously originated with a limit on negative amortization of 125% of the original loan amount. At March 31, 2006, loans with the higher 125% limit on negative amortization represented 5% of our adjustable rate one-to-four unit residential loan portfolio, while those with the 110% limit represent 87%. We permit adjustable rate mortgages to be assumed by qualified borrowers.

During the current quarter, we ceased offering option ARM products to our subprime borrowers, but continue to offer them to our prime borrowers. While start rates of our loan products fluctuate with the market, we do not use them to qualify a loan applicant. Rather, we qualify applicants for adjustable rate mortgages using a fully-amortizing payment calculated from the higher of the fully-indexed rate or, currently,:

- for prime borrowers:
  - 6.00% for owner occupied; or
  - 6.25% for non-owner occupied.
- for subprime borrowers (Alt. A and A- only, for non-option ARM products):
  - 7.00% for owner occupied; or
  - 7.25% for non-owner occupied.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

As set forth in the following table, \$13.9 billion or 92% of our residential one-to-four unit adjustable rate loans held for investment were option ARMs subject to negative amortization at March 31, 2006, of which \$182 million or 1.3% represented the amount of negative amortization included in the loan balance. At origination, these loans had a weighted average loan-to-value ratio of 72%. The amount of negative amortization had a net increase of \$48 million during the current quarter, as borrowers took advantage of the flexibility of this product. During the current quarter, approximately 25% of our loan interest income represented negative amortization, up from 21% in the fourth quarter of 2005 and 10% in the year-ago first quarter. In addition, \$723 million or 5% of our residential one-to-four unit adjustable rate loans represented loans requiring interest only payments over the initial terms of the loans, generally the first three to five years.

<i>March 31, 2006</i>							
	<i>Loan Balance</i>	<i>% of Total</i>	<i>Negative Amortization Included in Loan Balance</i>	<i>Loan to Value at Origination</i>	<i>Weighted Current Average</i>		
					<i>Loan to Value (<sup>(a)</sup>)</i>	<i>Loan to Value (<sup>(a)</sup>)</i>	<i>Age (Months)</i>
<i>(Dollars in Thousands)</i>							
<b>Prime loans subject to negative amortization</b>							
With negative amortization:							
Balance less than or equal to original loan amount	\$ 931,210	7 %	\$ 2,549	70 %	70 %	20	
Balance greater than original loan amount	9,316,760	72	169,752	73	74	15	
<b>Total with negative amortization</b>	<b>10,247,970</b>	<b>79</b>	<b>172,301</b>	<b>73</b>	<b>74</b>	<b>15</b>	
Not utilizing negative amortization	2,738,253	21	-	71	69	23	
<b>Total prime loans subject to negative amortization</b>	<b>12,986,223</b>	<b>100</b>	<b>172,301</b>	<b>72</b>	<b>73</b>	<b>17</b>	
<b>Subprime loans subject to negative amortization</b>							
With negative amortization:							
Balance less than or equal to original loan amount	80,186	9	223	71	70	25	
Balance greater than original loan amount	637,204	73	9,035	71	72	18	
<b>Total with negative amortization</b>	<b>717,390</b>	<b>82</b>	<b>9,258</b>	<b>71</b>	<b>72</b>	<b>19</b>	
Not utilizing negative amortization	162,332	18	-	72	70	34	
<b>Total subprime loans subject to negative amortization</b>	<b>879,722</b>	<b>100</b>	<b>9,258</b>	<b>71</b>	<b>71</b>	<b>22</b>	
<b>Total loans subject to negative amortization</b>							
With negative amortization:							
Balance less than or equal to original loan amount	1,011,396	7	2,772	70	70	20	
Balance greater than original loan amount	9,953,964	72	178,787	73	74	15	
<b>Total with negative amortization</b>	<b>10,965,360</b>	<b>79</b>	<b>181,559</b>	<b>73</b>	<b>74</b>	<b>16</b>	
Not utilizing negative amortization	2,900,585	21	-	71	69	24	



Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total loans subject to negative amortization	\$ 13,865,945	100 %	\$ 181,559	72 %	73 %	17
As a percentage of total residential one-to-four unit						
adjustable rate loans	92 %					
<b>Total loans with interest only payments</b>						
Prime	\$ 686,860	95 %	\$ -	71 %	70 %	22
Subprime	36,248	5	-	67	67	21
<b>Total loans with interest only payments</b>						
Total loans with interest only payments	\$ 723,108	100 %	\$ -	70 %	70 %	22
As a percentage of total residential one-to-four unit						
adjustable rate loans	5 %					

<sup>(a)</sup> Based upon appraised value at time of origination.

We have other credit risk elements within our real estate loans held for investment besides loans subject to negative amortization or loans with interest only payments. At March 31, 2006, these other credit risks included:

- 89% of our real estate loans were concentrated and secured by properties located in California, principally in Los Angeles, San Diego, Orange, Santa Clara and Riverside counties;
- 77% of our residential one-to-four unit loans were underwritten based on borrower stated income and asset verification and an additional 10% were underwritten with no verification of either borrower income or assets; and
- the loans are relatively new and unseasoned, as 11% of our residential one-to-four unit loans were originated in 2006, with an additional 42% originated in 2005.

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

We mitigate those risks during loan underwriting through the establishment of various minimum borrower credit requirements and maximum loan-to-value limitations. In addition, the average loan-to-value ratio of our residential one-to-four unit loans was 72% when the loan was originated. Over the past several years, residential property values have increased thereby further reducing our exposure to credit risk.

While our historic credit experience has been good, option ARMs do present greater credit risk in sustained periods of rising interest rates, as borrowers may see their loan payments increase significantly when their payments recast to fully-amortizing payments. In addition, credit risk increases if home values decline. In light of continued increases in market interest rates and changes we are beginning to see in the residential market, such as an increased level of unsold homes and relatively flat home prices on a sequential month basis, we recently instituted pricing changes for the option ARMs we originate for portfolio by increasing the initial start rate and thereby lowering their potential for negative amortization. Since our new start rate is now higher than those of many of our competitors, our production of option ARMs for portfolio may not offset loan payoffs. We are offering other types of adjustable rate product for portfolio that do not permit negative amortization, but those products are currently not as popular with borrowers. We will continue to closely monitor the trends in the residential housing and lending markets, especially the pricing of our competitors, and make pricing adjustments, as deemed necessary.

The following table sets forth our investment portfolio of residential one-to-four unit adjustable rate loans by index, excluding our adjustable fixed for 3-5 year loans which are still in their initial fixed rate period, at the dates indicated.

	March 31, 2006		December 31, 2005		September 30, 2005		June 30, 2005		March 31, 2005	
	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
<b>Investment Portfolio</b>										
Residential one-to-four units:										
Adjustable by index:										
COFI	\$ 11,172,831	77 %	\$ 10,733,770	76 %	\$ 10,290,282	76 %	\$ 9,964,759	77 %	\$ 9,810,346	77 %
MTA	2,841,747	20	2,846,273	20	2,542,053	19	2,185,982	17	2,068,230	16
LIBOR	351,128	2	410,010	3	510,399	4	675,872	5	813,800	6
Other, primarily CMT	151,003	1	155,498	1	150,566	1	128,281	1	148,566	1
<b>Total adjustable loans</b>										
<sup>(a)</sup>	\$ 14,516,709	100 %	\$ 14,145,551	100 %	\$ 13,493,300	100 %	\$ 12,954,894	100 %	\$ 12,840,942	100 %

<sup>(a)</sup> Excludes residential one-to-four unit adjustable fixed for 3-5 year loans still in their initial fixed rate period.

We continue to originate residential fixed interest rate mortgage loans to meet consumer demand, but we intend to sell the majority of these loans. We expect to sell some of our production of adjustable rate loans into the secondary market as needed to manage our balance sheet to remain in compliance with regulatory capital requirements. We sold \$876 million of loans and mortgage-backed securities in the current quarter, compared to \$1.1 billion in the fourth quarter of 2005 and \$2.0 billion in the year-ago first quarter. All amounts were secured by residential one-to-four unit property, and at March 31, 2006, loans held for sale totaled \$562 million.

At March 31, 2006, our unfunded loan application pipeline totaled \$1.7 billion. Within that pipeline, we had commitments to borrowers for short-term interest rate locks, before the reduction of expected fallout, of \$909 million, of which \$401 million were related to residential one-to-four unit loans being originated for sale in the secondary market. Furthermore, at March 31, 2006, we had commitments on undrawn lines of credit of \$350 million and loans in process of \$57 million. We believe our current sources of funds will enable us to meet these obligations.

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

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

### Three Months Ended

(In Thousands)	March 31, 2006	December 31, 2005	September 30, 2005	June 30, 2005	March 31, 2005
<b>Investment Portfolio</b>					
Loans originated:					
Loans secured by real estate:					
Residential one-to-four units:					
Adjustable	\$ 1,462,892	\$ 1,878,179	\$ 1,800,460	\$ 1,135,573	\$ 1,719,398
Adjustable subprime	54,718	72,453	102,079	132,491	171,573
Adjustable fixed for 3-5 years	189,385	5,827	-	-	-
Fixed	155	464	61	-	-
<b>Total residential one-to-four units</b>	<b>1,707,150</b>	<b>1,956,923</b>	<b>1,902,600</b>	<b>1,268,064</b>	<b>1,890,971</b>
Home equity loans and lines of credit	8,793	9,408	6,108	48,109	95,072
Residential five or more units adjustable	68,583	-	-	-	-
Commercial real estate	630	-	-	-	-
Construction	19,863	17,361	23,421	35,483	21,172
Land	15,102	300	1,193	9,514	35,211
Non-mortgage:					
Commercial	-	200	-	-	-
Other consumer	699	566	898	994	629
<b>Total loans originated</b>	<b>1,820,820</b>	<b>1,984,758</b>	<b>1,934,220</b>	<b>1,362,164</b>	<b>2,043,055</b>
Real estate loans purchased:					
One-to-four units	11,601	22,965	9,296	4,170	23,609
One-to-four units subprime	617	366	225	145	1,751
<b>Total real estate loans purchased</b>	<b>12,218</b>	<b>23,331</b>	<b>9,521</b>	<b>4,315</b>	<b>25,360</b>
<b>Total loans originated and purchased</b>	<b>1,833,038</b>	<b>2,008,089</b>	<b>1,943,741</b>	<b>1,366,479</b>	<b>2,068,415</b>
Loan repayments	(1,393,957 )	(1,596,505 )	(1,691,123 )	(1,385,603 )	(1,043,649 )
Other net changes <sup>(a)</sup>	71,575	102,833	113,889	45,239	17,793
<b>Increase in loans held for investment, net</b>	<b>510,656</b>	<b>514,417</b>	<b>366,507</b>	<b>26,115</b>	<b>1,042,559</b>
<b>Sale Portfolio</b>					
Residential one-to-four unit loans originated	979,000	1,062,495	1,682,834	2,741,341	2,171,625
Loans purchased	1,164	5,366	17,066	24,706	9,767

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Loans transferred to the investment portfolio <sup>(a)</sup>	(3,840 )	(4,887 )	(6,987 )	(9,842 )	(9,866 )
Originated whole loans sold	(662,306 )	(827,815 )	(1,828,698 )	(2,881,687 )	(1,760,376 )
Loans exchanged for mortgage-backed securities	(213,980 )	(269,423 )	(279,303 )	(211,086 )	(269,411 )
Capitalized basis adjustment <sup>(b)</sup>	(1,066 )	(313 )	(234 )	1,516	2,656
Other net changes <sup>(c)</sup>	(1,949 )	(2,546 )	(15,315 )	(12,434 )	(946 )

Increase (decrease) in loans held for sale, net	97,023	(37,123 )	(430,637 )	(347,486 )	143,449
---	--------	-----------	------------	------------	---------

Mortgage-backed securities, net:

Received in exchange for loans	213,980	269,423	279,303	211,086	269,411
Sold	(213,980 )	(269,423 )	(279,303 )	(211,086 )	(269,411 )
Repayments	(6 )	(6 )	(6 )	(6 )	(6 )
Other net changes	-	(1 )	(2 )	2	(2 )

Decrease in mortgage-backed securities

available for sale	(6 )	(7 )	(8 )	(4 )	(8 )
--------------------	------	------	------	------	------

Increase (decrease) in loans held for sale and

mortgage-backed securities available for sale	97,017	(37,130 )	(430,645 )	(347,490 )	143,441
---	--------	-----------	------------	------------	---------

Total increase (decrease) in loans and

mortgage-backed securities, net	\$ 607,673	\$ 477,287	\$ (64,138 )	\$ (321,375 )	\$ 1,186,000
---------------------------------	------------	------------	--------------	---------------	--------------

<sup>(a)</sup> Primarily included changes in undisbursed funds for lines of credit and construction loans, in loss allowances, in net deferred costs and premiums, in interest capitalized on loans (negative amortization), and from loans transferred to real estate acquired in settlement of loans or from (to) the held for sale portfolio.

<sup>(b)</sup> Reflected the change in fair value of the interest rate lock derivative from the date of commitment to the date of funding.

<sup>(c)</sup> Primarily included repayments and the change in net deferred costs and premiums.

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

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

(In Thousands)

	March 31, 2006	December 31, 2005	September 30, 2005	June 30, 2005	March 31, 2005
--	-------------------	----------------------	-----------------------	------------------	-------------------

### Investment Portfolio

#### Loans secured by real estate:

##### Residential one-to-four units:

Adjustable	\$ 13,424,089	\$ 12,968,647	\$ 12,205,405	\$ 11,600,453	\$ 11,498,211
Adjustable subprime	951,583	1,046,261	1,159,701	1,244,386	1,269,695
Adjustable fixed for 3-5 years	715,453	598,102	707,331	823,518	885,029
Adjustable fixed for 3-5 years subprime	8,989	10,253	12,837	14,583	16,495
Fixed	48,304	49,030	52,124	56,630	60,361
Fixed subprime	2,311	2,397	2,505	2,705	3,014

Total residential one-to-four units	15,150,729	14,674,690	14,139,903	13,742,275	13,732,805
-------------------------------------	------------	------------	------------	------------	------------

Home equity loans and lines of credit	250,804	274,014	300,300	318,592	306,831
---------------------------------------	---------	---------	---------	---------	---------

##### Residential five or more units:

Adjustable	134,340	68,390	69,052	89,408	92,554
Fixed	1,092	1,141	1,178	1,208	1,371

##### Commercial real estate:

Adjustable	25,967	25,547	25,743	25,935	25,409
Fixed	2,879	3,244	3,280	3,314	4,255
Construction	78,095	82,379	89,337	93,016	77,428
Land	27,379	23,630	41,361	65,377	59,470

##### Non-mortgage:

Commercial	3,481	3,981	4,223	4,496	4,766
Automobile	67	116	204	320	542
Other consumer	6,591	6,577	6,456	6,504	6,346

Total loans held for investment	15,681,424	15,163,709	14,681,037	14,350,445	14,311,777
---------------------------------	------------	------------	------------	------------	------------

##### Increase (decrease) for:

Undisbursed loan funds	(59,222 )	(51,838 )	(65,214 )	(85,377 )	(67,869 )
Net deferred costs and premiums	290,116	279,888	261,483	245,727	241,283
Allowance for losses	(44,504 )	(34,601 )	(34,565 )	(34,561 )	(35,072 )

Total loans held for investment, net	15,867,814	15,357,158	14,842,741	14,476,234	14,450,119
--------------------------------------	------------	------------	------------	------------	------------

### Sale Portfolio

#### Loans held for sale:

Residential one-to-four units	556,365	459,081	495,156	914,164	1,256,507
Net deferred costs and premiums	6,646	5,841	6,576	17,971	24,630
Capitalized basis adjustment <sup>(a)</sup>	(1,500 )	(434 )	(121 )	113	(1,403 )

Total loans held for sale, net	561,511	464,488	501,611	932,248	1,279,734
--------------------------------	---------	---------	---------	---------	-----------

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Mortgage-backed securities available for sale:

Adjustable	271	277	284	292	296
Fixed	-	-	-	-	-
<hr/>					
Total mortgage-backed securities available for sale	271	277	284	292	296
<hr/>					
Total loans held for sale and mortgage-backed securities available for sale	561,782	464,765	501,895	932,540	1,280,030
<hr/>					
Total loans and mortgage-backed securities, net	\$ 16,429,596	\$ 15,821,923	\$ 15,344,636	\$ 15,408,774	\$ 15,730,149

<sup>(a)</sup> Reflected the change in fair value of the interest rate lock derivative from the date of commitment to the date of funding.

We carry loans for sale at the lower of cost or fair value. At March 31, 2006, no valuation allowance was required as the fair value exceeded book value on an aggregate basis.

At March 31, 2006, our residential one-to-four units subprime portfolio totaled \$963 million and consisted of 97% Alt. A and A- credit, 2% B credit and 1% C credit loans. The average loan-to-value ratio at origination for these loans was 70%.

We carry mortgage-backed securities available for sale at fair value which, at March 31, 2006, was essentially equal to our cost basis.

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

**Investment Securities**

The following table sets forth the composition of our investment securities portfolios at the dates indicated.

<i>(In Thousands)</i>	<i>March 31, 2006</i>	<i>December 31, 2005</i>	<i>September 30, 2005</i>	<i>June 30, 2005</i>	<i>March 31, 2005</i>
Federal funds	\$ -	\$ -	\$ 2	\$ 30,001	\$ 10,003
Investment securities available for sale:					
U.S. Treasury	-	-	-	-	-
Government sponsored entities	730,338	626,249	550,557	504,900	511,638
Other	64	64	64	65	65
<b>Total investment securities</b>	<b>\$ 730,402</b>	<b>\$ 626,313</b>	<b>\$ 550,623</b>	<b>\$ 534,966</b>	<b>\$ 521,706</b>

The fair value of temporarily impaired investment securities, the amount of unrealized losses and the length of time these unrealized losses existed as of March 31, 2006 are presented in the following table. The \$11.6 million unrealized loss on securities that have been in a loss position for less than and more than 12 months is due to changes in market interest rates. We have the intent and ability to hold the securities until that temporary impairment is eliminated.

<i>(In Thousands)</i>	<i>Less than 12 months</i>		<i>12 months or longer</i>		<i>Total</i>	
	<i>Unrealized Fair Value</i>	<i>Losses</i>	<i>Unrealized Fair Value</i>	<i>Losses</i>	<i>Unrealized Fair Value</i>	<i>Losses</i>
Investment securities available for sale:						
U.S. Treasury	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Government sponsored entities	556,516	8,015	173,822	3,563	730,338	11,578
Other	-	-	-	-	-	-
<b>Total temporarily impaired securities</b>	<b>\$ 556,516</b>	<b>\$ 8,015</b>	<b>\$ 173,822</b>	<b>\$ 3,563</b>	<b>\$ 730,338</b>	<b>\$ 11,578</b>

The following table sets forth the maturities of our investment securities and their weighted average yields at March 31, 2006.

<i>(Dollars in Thousands)</i>	<i>Amount Due as of March 31, 2006</i>				
	<i>In 1 Year or Less</i>	<i>After 1 Year Through 5 Years</i>	<i>After 5 Years Through 10 Years</i>	<i>After 10 Years</i>	<i>Total</i>
Federal funds	\$ -	\$ -	\$ -	\$ -	\$ -
Weighted average yield	-	%	-	%	-
Investment securities available for sale:					
U.S. Treasury	-	-	-	-	-

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Weighted average yield	- %	- %	- %	- %	- %
Government sponsored entities <sup>(a)</sup>	14,945	228,298	487,095	-	730,338
Weighted average yield	4.05 %	4.84 %	4.60 %	- %	4.66 %
Other	-	-	-	64	64
Weighted average yield	- %	- %	- %	6.25 %	6.25 %
<hr/>					
Total investment securities	\$ 14,945	\$ 228,298	\$ 487,095	\$ 64	\$ 730,402
Weighted average yield	4.05 %	4.84 %	4.60 %	6.25 %	4.66 %

<sup>(a)</sup> At March 31, 2006, 68% of our investment securities had step-up provisions that stipulate increases in the coupon rate ranging from 0.25% to 4.00% at various specified times over a range from March 2006 to December 2012. Yields for investment securities available for sale are calculated using historical cost balances and do not give effect to changes in fair value that are reflected as a component of stockholders equity.

### Deposits

At March 31, 2006, our deposits totaled \$12.2 billion, up \$1.9 billion or 18.3% from the year-ago level and up \$322 million or 2.7% since the previous quarter end. Compared to the year-ago period, our certificates of deposit increased \$2.6 billion or 40.5%, which was partially offset by a decline in our transaction accounts *i.e.*, checking, money market and regular passbook of \$734 million or 19.1%. As short-term market interest rates have continued to rise over the past year, our customers have moved monies from regular passbook accounts into certificates of deposit.



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

During the quarter, no new branches were opened. This leaves our total number of branches at 173, of which 93 were in-store and four were located in Arizona. A year ago, we had 169 branches, of which 92 were in-store and four were located in Arizona. At March 31, 2006, the average deposit size of our 80 traditional branches was \$120 million, while the average deposit size of our 93 in-store branches was \$28 million.

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

	March 31, 2006		December 31, 2005		September 30, 2005		June 30, 2005		March 31, 2005	
	Weighted Average		Weighted Average		Weighted Average		Weighted Average		Weighted Average	
	Rate	Amount	Rate	Amount	Rate	Amount	Rate	Amount	Rate	Amount
<i>(Dollars in Thousands)</i>										
<b>Transaction accounts:</b>										
<b>Non-interest-bearing</b>										
checking	- %	\$ 758,055	- %	\$ 705,077	- %	\$ 857,875	- %	\$ 715,152	- %	\$ 672,531
<b>Interest-bearing</b>										
checking <sup>(a)</sup>	0.29	525,564	0.30	529,133	0.30	530,467	0.31	513,559	0.31	538,842
Money market	1.05	166,496	1.05	164,192	1.05	161,910	1.05	159,402	1.05	159,241
Regular passbook	1.02	1,652,549	1.04	1,816,635	1.05	1,975,209	1.06	2,145,323	1.09	2,465,789
<b>Total transaction accounts</b>										
	0.65	3,102,664	0.69	3,215,037	0.68	3,525,461	0.74	3,533,436	0.79	3,836,403
<b>Certificates of deposit:</b>										
Less than 2.00%	1.49	47,149	1.68	86,992	1.70	131,006	1.68	218,223	1.62	446,819
2.00-2.49	2.37	81,014	2.41	147,632	2.44	294,160	2.45	1,222,193	2.40	2,232,900
2.50-2.99	2.81	159,742	2.78	215,297	2.79	321,523	2.79	429,479	2.81	474,212
3.00-3.49	3.34	368,255	3.27	1,001,901	3.27	2,068,056	3.22	3,341,993	3.17	2,494,034
3.50-3.99	3.86	2,681,838	3.78	4,114,751	3.76	4,164,594	3.72	1,568,814	3.80	171,466
4.00-4.49	4.23	4,422,839	4.17	2,622,618	4.16	787,167	4.21	266,015	4.23	196,138
4.50-4.99	4.68	1,320,831	4.81	455,192	4.83	429,715	4.83	429,941	4.83	425,732
5.00 and greater	5.07	14,571	5.17	17,428	5.59	30,554	5.60	31,978	5.59	31,373
<b>Total certificates of deposit</b>										
	4.10	9,096,239	3.83	8,661,811	3.62	8,226,775	3.27	7,508,636	2.94	6,472,674
<b>Total deposits</b>										
	3.22 %	\$ 12,198,903	2.98 %	\$ 11,876,848	2.74 %	\$ 11,752,236	2.46 %	\$ 11,042,072	2.14 %	\$ 10,309,077

<sup>(a)</sup> Included amounts swept into money market deposit accounts.

### Borrowings

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

During the current quarter, our borrowings increased \$268 million to \$4.0 billion, due to an increase in FHLB advances. This followed a \$395 million increase in borrowings during the fourth quarter of 2005.

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

<i>(Dollars in Thousands)</i>	<i>March 31,</i> 2006	<i>December 31,</i> 2005	<i>September 30,</i> 2005	<i>June 30,</i> 2005	<i>March 31,</i> 2005
Federal Home Loan Bank advances <sup>(a)</sup>	\$ 3,825,811	\$ 3,557,515	\$ 3,162,808	\$ 4,002,757	\$ 5,093,874
Senior notes	198,129	198,087	198,045	198,004	197,964
<b>Total borrowings</b>	<b>\$ 4,023,940</b>	<b>\$ 3,755,602</b>	<b>\$ 3,360,853</b>	<b>\$ 4,200,761</b>	<b>\$ 5,291,838</b>
Weighted average rate on borrowings during the quarter <sup>(a)</sup>	4.92 %	4.54 %	3.97 %	3.42 %	3.03 %
Total borrowings as a percentage of total assets	22.60	21.97	20.29	25.28	31.32

<sup>(a)</sup> Included the impact of swap contracts, with notional amounts totaling \$430 million of receive-fixed, pay-3-month LIBOR variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.

### **Off-Balance Sheet Arrangements**

We consolidate majority-owned subsidiaries that we control. We account for other affiliates, including joint ventures, in which we do not exhibit significant control or have majority ownership, by the equity method of accounting. For those relationships in which we own less than 20%, we generally carry our investment at cost. In the course of our business, we participate in real estate joint ventures through our wholly-owned subsidiary, DSL Service Company. Our real estate joint ventures do not require consolidation as a result of applying the provisions of Financial Accounting Standards Board Interpretation 46 (revised December 2003).

We also utilize financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our customers and to reduce our own exposure to fluctuations in interest rates. These financial instruments include commitments to originate fixed and variable rate mortgage loans held for investment, undisbursed loan funds, lines and letters of credit, commitments to purchase loans and mortgage-backed securities for our portfolio and commitments to invest in community development funds. The contract or notional amounts of these instruments reflect the extent of involvement we have in particular classes of financial instruments. For further information, see Asset/Liability Management and Market Risk on page 34 and Note 4 of Notes to the Consolidated Financial Statements on page 8.

We use the same credit policies in making commitments to originate or purchase loans, lines of credit and letters of credit as we do for on-balance sheet instruments. For commitments to originate loans held for investment, the contract amounts represent exposure to loss from market fluctuations as well as credit loss. In regard to these commitments, adverse changes from market fluctuations are generally not hedged. We control the credit risk of our commitments to originate loans held for investment through credit approvals, limits and monitoring procedures.

We do not dispose of troubled loans or problem assets by means of unconsolidated special purpose entities.

### **Transactions with Related Parties**

There are no related party transactions required to be disclosed in accordance with FASB Statement No. 57, Related Party Disclosures. Loans to our executive officers and directors were made in the ordinary course of business and were made on substantially the same terms as comparable transactions.

### **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. Interest rate risk primarily occurs to the degree that our interest-bearing liabilities reprice or mature on a different basis 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, our principal objectives are to actively monitor and manage the effects of adverse changes in interest rates on net interest income. Our primary strategy to manage interest rate risk is to emphasize the origination for investment of adjustable rate mortgages or loans with relatively short maturities. Interest rates on adjustable rate mortgages are primarily tied to the COFI, MTA, LIBOR and one-year constant maturity treasury ( CMT ) indexes. We also may execute swap contracts to change interest rate characteristics of our interest-earning assets or interest-bearing liabilities to better manage interest rate risk.

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

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

Changes in mortgage interest rates also impact the value of our MSR. Rising interest rates typically result in slower prepayment speeds on the loans being serviced for others which increase the value of MSR. Declining interest rates typically result in faster prepayment speeds which decrease the value of MSR. We may use securities or derivatives, or a combination of both, to provide an economic hedge against value changes in our MSR. In addition, the dollar amount used as an economic hedge may vary due to changes in the volume of MSR or their sensitivity to changes in market interest rates.

There has been no significant change in our market risk since December 31, 2005.

Page 35

---

[Navigation Links](#)

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

One measure of our exposure to differential changes in interest rates between assets and liabilities is shown in the following table which sets forth the repricing frequency of our major asset and liability categories as of March 31, 2006, as well as other information regarding the repricing and maturity differences between our interest-earning assets and total deposits and borrowings in future periods. We refer to these differences as *gap*. We have determined the repricing frequencies by reference to projected maturities, based upon contractual maturities as adjusted for scheduled repayments and repricing mechanisms provisions for changes in the interest and dividend rates of assets and liabilities. We assume prepayment rates on substantially all of our loan portfolio based upon our historical loan prepayment experience and anticipated future prepayments. Repricing mechanisms on a number of our assets are subject to limitations, such as caps on the amount that interest rates and payments on our loans may adjust, and accordingly, these assets do not normally respond to changes in market interest rates as completely or rapidly as our liabilities. The interest rate sensitivity of our assets and liabilities illustrated in the following table would vary substantially if we used different assumptions or if actual experience differed from the assumptions set forth.

<i>March 31, 2006</i>						
<i>(Dollars in Thousands)</i>	<i>Within 6 Months</i>	<i>7 12 Months</i>	<i>1 5 Years</i>	<i>6 10 Years</i>	<i>Over 10 Years</i>	<i>Total Balance</i>
<b>Interest-earning assets:</b>						
Investment securities and stock <sup>(a)</sup>	\$ 429,494	\$ 165,409	\$ 318,056	\$ -	\$ -	\$ 912,959
<b>Loans and mortgage-backed securities, net:</b>						
<sup>(b)</sup>						
<b>Loans secured by real estate:</b>						
<b>Residential one-to-four units:</b>						
Adjustable	15,307,904	252,507	216,352	-	-	15,776,763
Fixed	139,833	3,561	20,508	12,855	9,479	186,236
<b>Home equity loans and lines of credit</b>						
	248,368	153	808	142	-	249,471
<b>Residential five or more units:</b>						
Adjustable	92,234	16,487	11,366	-	-	120,087
Fixed	122	115	564	231	52	1,084
<b>Commercial real estate</b>						
Construction	19,290	1,503	7,042	58	-	27,893
Land	39,646	-	-	-	-	39,646
	20,230	-	-	-	-	20,230
<b>Non-mortgage loans:</b>						
Commercial	1,554	-	-	-	-	1,554
Consumer	6,321	8	32	-	-	6,361
<b>Mortgage-backed securities</b>						
	271	-	-	-	-	271
<b>Total loans and mortgage-backed</b>	<b>15,875,773</b>	<b>274,334</b>	<b>256,672</b>	<b>13,286</b>	<b>9,531</b>	<b>16,429,596</b>

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

securities, net						
<hr/>						
Total interest-earning assets	\$ 16,305,267	\$ 439,743	\$ 574,728	\$ 13,286	\$ 9,531	\$ 17,342,555
<hr/>						
Transaction accounts:						
Non-interest-bearing checking	\$ 758,055	\$ -	\$ -	\$ -	\$ -	\$ 758,055
Interest-bearing checking <sup>(c)</sup>	525,564	-	-	-	-	525,564
Money market <sup>(d)</sup>	166,496	-	-	-	-	166,496
Regular passbook <sup>(d)</sup>	1,652,549	-	-	-	-	1,652,549
<hr/>						
Total transaction accounts	3,102,664	-	-	-	-	3,102,664
Certificates of deposit <sup>(e)</sup>	5,986,596	2,278,351	831,292	-	-	9,096,239
<hr/>						
Total deposits	9,089,260	2,278,351	831,292	-	-	12,198,903
FHLB advances	3,295,370	121,000	409,441	-	-	3,825,811
Senior notes	-	-	-	198,129	-	198,129
Impact of swap contracts hedging borrowings	430,000	-	(430,000 )	-	-	-
<hr/>						
Total deposits and borrowings	\$ 12,814,630	\$ 2,399,351	\$ 810,733	\$ 198,129	\$ -	\$ 16,222,843
<hr/>						
Excess (shortfall) of interest-earning assets						
over deposits and borrowings	\$ 3,490,637	\$ (1,959,608 )	\$ (236,005 )	\$ (184,843 )	\$ 9,531	\$ 1,119,712
Cumulative gap	3,490,637	1,531,029	1,295,024	1,110,181	1,119,712	
Cumulative gap as a percentage of total assets:						
March 31, 2006	19.61 %	8.60 %	7.27 %	6.24 %	6.29 %	
December 31, 2005	23.22	11.19	7.08	5.80	5.82	
March 31, 2005	15.50	9.06	6.57	5.28	5.29	
<hr/>						

<sup>(a)</sup> Includes FHLB stock and is based upon contractual maturity and repricing date.

<sup>(b)</sup> Based upon contractual maturity, repricing date and projected repayment and prepayments of principal.

*(c) Included amounts swept into money market deposit accounts and is subject to immediate repricing.*

*(d) Subject to immediate repricing.*

*(e) Based upon contractual maturity and repricing date.*

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

Our six-month gap at March 31, 2006 was a positive 19.61%. This means that more interest-earning assets mature or reprice within six months than total deposits and borrowings. This compares to our positive six-month gap of 23.22% at December 31, 2005 and 15.50% a year ago.

We continue to emphasize the origination of adjustable rate mortgages for our investment portfolio and plan to sell the originations in excess of our balance sheet needs into the secondary market to the extent we can do so profitably. For the twelve months ended March 31, 2006, we originated and purchased for investment \$7.1 billion of adjustable rate loans which represented essentially all of the loans we originated and purchased for investment during the period.

At March 31, 2006, December 31, 2005 and March 31, 2005 essentially all of our interest-earning assets mature, reprice or are estimated to prepay within five years. Essentially all of our loans held for investment and mortgage-backed securities portfolios consisted of adjustable rate loans and loans with a due date of five years or less, and totaled \$15.6 billion at March 31, 2006, compared to \$15.1 billion at December 31, 2005 and \$14.2 billion a year ago. During the current quarter, 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 occasionally originate a small number of 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.

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

	<i>March 31,</i> <i>2006</i>	<i>December 31,</i> <i>2005</i>	<i>September 30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
<b>Weighted average yield: <sup>(a)</sup></b>					
Loans and mortgage-backed securities	6.52 %	6.10 %	5.69 %	5.42 %	5.00 %
Investment securities <sup>(b)</sup>	4.66	4.37	4.09	3.96	3.86
<b>Interest-earning assets yield</b>					
	6.44	6.04	5.63	5.37	4.96
<b>Weighted average cost:</b>					
Deposits	3.22	2.98	2.74	2.46	2.14
<b>Borrowings:</b>					
Federal Home Loan Bank advances <sup>(c)</sup>	4.94	4.71	4.15	3.57	3.08
Senior notes	6.50	6.50	6.50	6.50	6.50
<b>Total borrowings</b>					
	5.02	4.80	4.29	3.71	3.21
<b>Combined funds cost</b>					
	3.67	3.42	3.08	2.80	2.50
<b>Interest rate spread</b>					
	2.77 %	2.62 %	2.55 %	2.57 %	2.46 %

<sup>(a)</sup> Excludes adjustments for non-accrual loans, amortization of net deferred costs to originate loans, premiums and discounts, prepayment and late fees and FHLB stock dividends.

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

<sup>(c)</sup> Included the impact of swap contracts, with notional amounts totaling \$430 million of receive-fixed, pay-3-month LIBOR variable interest, which contracts serve as a permitted hedge against a portion of our FHLB advances.



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

The period-end weighted average yield on our loan portfolio increased to 6.52% at March 31, 2006, up from 6.10% at December 31, 2005 and 5.00% at March 31, 2005. At March 31, 2006, our adjustable rate mortgage portfolio of single family residential loans, including mortgage-backed securities, totaled \$15.6 billion with a weighted average rate of 6.48%, compared to \$15.2 billion with a weighted average rate of 6.05% at December 31, 2005, and \$15.1 billion with a weighted average rate of 4.95% at March 31, 2005.

**Problem Loans and Real Estate*****Non-Performing Assets***

Non-performing assets consist of loans on which we have ceased accruing interest (which we refer to as non-accrual loans), loans restructured at a below market rate and real estate acquired in settlement of loans. Our non-performing assets increased \$4 million during the current quarter to \$39 million or 0.22% of total assets. The increase was equally spread between our prime and subprime residential loan categories.

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

<i>(Dollars in Thousands)</i>	<i>March 31,</i> 2006	<i>December 31,</i> 2005	<i>September</i> 30, 2005	<i>June 30,</i> 2005	<i>March 31,</i> 2005
<b>Non-accrual loans:</b>					
Residential one-to-four units	\$ 26,102	\$ 23,497	\$ 18,373	\$ 12,004	\$ 16,835
Residential one-to-four units subprime	12,401	10,774	9,018	10,599	8,798
Other	1	42	634	456	466
<b>Total non-accrual loans</b>	<b>38,504</b>	<b>34,313</b>	<b>28,025</b>	<b>23,059</b>	<b>26,099</b>
Real estate acquired in settlement of loans	385	908	2,323	2,201	2,783
<b>Total non-performing assets</b>	<b>\$ 38,889</b>	<b>\$ 35,221</b>	<b>\$ 30,348</b>	<b>\$ 25,260</b>	<b>\$ 28,882</b>
<b>Allowance for loan losses:</b>					
Amount	\$ 44,504	\$ 34,601	\$ 34,565	\$ 34,561	\$ 35,072
As a percentage of non-performing loans	115.58 %	100.84 %	123.34 %	149.88 %	134.38 %
Non-performing assets as a percentage of total assets	0.22	0.21	0.18	0.15	0.17

***Delinquent Loans***

Loans delinquent 30 days or more as a percentage of total loans was 0.37% at March 31, 2006, up slightly from 0.36% at December 31, 2005, and from 0.27% a year ago. The increase primarily occurred in our residential one-to-four units category.

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

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

(Dollars in Thousands)	March 31, 2006				December 31, 2005			
	30-59 Days	60-89 Days	90+ Days <sup>(a)</sup>	Total	30-59 Days	60-89 Days	90+ Days <sup>(a)</sup>	Total
Loans secured by real estate:								
Residential:								
One-to-four units	\$ 20,663	\$ 8,127	\$ 17,714	\$ 46,504	\$ 19,183	\$ 5,552	\$ 19,587	\$ 44,322
One-to-four units subprime	6,006	2,364	4,396	12,766	5,919	1,645	4,221	11,785
Home equity loans and lines of credit	61	-	-	61	-	59	24	83
Five or more units	-	-	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-	-	-
Construction	-	-	-	-	-	-	-	-
Land	-	-	-	-	-	-	-	-
<b>Total real estate loans</b>	<b>26,730</b>	<b>10,491</b>	<b>22,110</b>	<b>59,331</b>	<b>25,102</b>	<b>7,256</b>	<b>23,832</b>	<b>56,190</b>
Non-mortgage:								
Commercial	-	-	-	-	-	-	-	-
Automobile	49	-	1	50	-	3	-	3
Other consumer	12	6	-	18	20	13	18	51
<b>Total delinquent loans</b>	<b>\$ 26,791</b>	<b>\$ 10,497</b>	<b>\$ 22,111</b>	<b>\$ 59,399</b>	<b>\$ 25,122</b>	<b>\$ 7,272</b>	<b>\$ 23,850</b>	<b>\$ 56,244</b>
Delinquencies as a percentage of total loans								
	0.17 %	0.06 %	0.14 %	0.37 %	0.16 %	0.05 %	0.15 %	0.36 %

	September 30, 2005				June 30, 2005			
	Loans secured by real estate:							
Residential:								
One-to-four units	\$ 16,631	\$ 8,980	\$ 10,295	\$ 35,906	\$ 14,311	\$ 3,620	\$ 11,144	\$ 29,075
One-to-four units subprime	3,602	1,213	4,414	9,229	3,136	3,043	5,566	11,745
Home equity loans and lines of credit	-	380	185	565	347	-	7	354
Five or more units	-	-	-	-	-	-	-	-
Commercial real estate	-	-	-	-	-	-	-	-
Construction	-	-	-	-	-	-	-	-
Land	-	-	-	-	-	-	-	-
<b>Total real estate loans</b>	<b>20,233</b>	<b>10,573</b>	<b>14,894</b>	<b>45,700</b>	<b>17,794</b>	<b>6,663</b>	<b>16,717</b>	<b>41,174</b>
Non-mortgage:								
Commercial	-	-	428	428	-	-	428	428
Automobile	7	1	-	8	-	-	-	-
Other consumer	28	22	21	71	26	11	21	58

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Total delinquent loans	\$ 20,268	\$ 10,596	\$ 15,343	\$ 46,207	\$ 17,820	\$ 6,674	\$ 17,166	\$ 41,660
------------------------	-----------	-----------	-----------	-----------	-----------	----------	-----------	-----------

Delinquencies as a percentage of total loans	0.13 %	0.07 %	0.10 %	0.30 %	0.12 %	0.04 %	0.11 %	0.27 %
--	--------	--------	--------	--------	--------	--------	--------	--------

March 31, 2005

Loans secured by real estate:

Residential:

One-to-four units	\$ 14,341	\$ 4,837	\$ 12,562	\$ 31,740
One-to-four units subprime	2,474	1,961	5,487	9,922
Home equity loans and lines of credit	141	-	11	152
Five or more units	-	-	-	-
Commercial real estate	-	-	-	-
Construction	-	-	-	-
Land	-	-	-	-

Total real estate loans	16,956	6,798	18,060	41,814
-------------------------	--------	-------	--------	--------

Non-mortgage:

Commercial	-	-	428	428
Automobile	11	-	-	11
Other consumer	28	11	27	66

Total delinquent loans	\$ 16,995	\$ 6,809	\$ 18,515	\$ 42,319
------------------------	-----------	----------	-----------	-----------

Delinquencies as a percentage of total loans	0.11 %	0.04 %	0.12 %	0.27 %
--	--------	--------	--------	--------

<sup>(a)</sup> All 90 day or greater delinquencies are on non-accrual status and reported as part of non-performing assets.

*Allowance for Credit and Real Estate Losses*

We maintain a valuation allowance for credit and real estate losses to provide for losses inherent in those portfolios. The allowance for credit losses includes an allowance for loan losses reported as a reduction of loans held for investment and the allowance for loan-related commitments reported in accounts payable and accrued liabilities. On March 31, 2006, we reclassified to liabilities our allowance for loan-related commitments which was previously included with the allowance for loan losses. Management evaluates the adequacy of the allowance quarterly to maintain the allowance at levels sufficient to provide for inherent losses at the balance sheet date.

We use an internal asset review system and loss allowance methodology to provide for timely recognition of problem assets and an adequate allowance to cover asset and loan-related commitment losses. The amount of the allowance is based upon the total of general valuation allowances, allocated allowances and an unallocated allowance. General valuation allowances relate to assets and loan-related commitments with no well-defined deficiency or weakness and take into consideration losses that are imbedded within the portfolio but have not yet been realized. Allocated allowances relate to assets with well-defined deficiencies or weaknesses. If we determine the carrying value of our asset exceeds the net fair value and no alternative payment source exists, then a specific allowance is recorded for the amount of that difference. The unallocated allowance is more subjective and is reviewed quarterly to take into consideration estimation errors and economic trends that are not captured in determining the general valuation and allocated allowances.

Provision for credit losses totaled \$10.1 million in the first quarter of 2006, up \$8.0 million from a year ago. During the current quarter, certain segments of the California residential real estate market began to show signs of slower sales and flattening home values on a sequential month basis. In addition, we have noted increased usage of negative amortization associated with option ARM loans. Therefore, even though net charge-offs were virtually unchanged at \$0.1 million in the current quarter, an increase in the allowance for credit losses associated with residential loans was deemed appropriate. The current quarter allowance reflected an increase of \$10.1 million in the general valuation allowance, partially offset by a \$0.1 million decline in the allocated allowance, increasing the total allowance to \$46 million at March 31, 2006, comprised of \$45 million for loan losses and \$1 million for loan-related commitments. That compares to an allowance for credit losses of \$36 million at year-end 2005, comprised of \$35 million for loan losses and \$1 million for loan-related commitments. There was no change in our unallocated allowance of \$2.8 million.

The following table summarizes the activity in our allowance for losses on loans and loan-related commitments for the quarters indicated.

*Three Months Ended*

<i>(In Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December</i> <i>31,</i> <i>2005</i>	<i>September</i> <i>30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
<b>Allowance for loan losses</b>					
Balance at beginning of period	\$ 34,601	\$ 34,565	\$ 34,561	\$ 35,072	\$ 33,343
Provision (reduction)	9,974	512	(365 )	405	1,768
Charge-offs	(76 )	(479 )	(50 )	(925 )	(46 )
Recoveries	5	3	419	9	7
Balance at end of period	\$ 44,504	\$ 34,601	\$ 34,565	\$ 34,561	\$ 35,072
<b>Allowance for loan-related commitments</b>					
Balance at beginning of period	\$ 1,314	\$ 1,433	\$ 1,819	\$ 1,641	\$ 1,371
Provision (reduction)	83	(119 )	(386 )	178	270
Charge-offs	-	-	-	-	-
Recoveries	-	-	-	-	-
Balance at end of period	\$ 1,397	\$ 1,314	\$ 1,433	\$ 1,819	\$ 1,641

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

**Total allowance for credit losses**

Balance at beginning of period	\$ 35,915	\$ 35,998	\$ 36,380	\$ 36,713	\$ 34,714
Provision (reduction)	10,057	393	(751 )	583	2,038
Charge-offs	(76 )	(479 )	(50 )	(925 )	(46 )
Recoveries	5	3	419	9	7
<hr/>					
Balance at end of period	\$ 45,901	\$ 35,915	\$ 35,998	\$ 36,380	\$ 36,713

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

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

Three Months Ended

	March 31, 2006	December 31, 2005	September 30, 2005	June 30, 2005	March 31, 2005
<i>(Dollars in Thousands)</i>					
<b>Gross loan charge-offs</b>					
Loans secured by real estate:					
Residential:					
One-to-four units	\$ -	\$ 20	\$ 4	\$ 879	\$ -
One-to-four units subprime	25	-	-	-	-
Home equity loans and lines of credit	-	-	-	-	-
Five or more units	-	-	-	-	-
Commercial real estate	-	-	-	-	-
Construction	-	-	-	-	-
Land	-	-	-	-	-
Non-mortgage:					
Commercial	-	428	-	-	-
Automobile	-	-	-	1	8
Other consumer	51	31	46	45	38
<b>Total gross loan charge-offs</b>	<b>76</b>	<b>479</b>	<b>50</b>	<b>925</b>	<b>46</b>
<b>Gross loan recoveries</b>					
Loans secured by real estate:					
Residential:					
One-to-four units	-	-	410	-	-
One-to-four units subprime	-	-	-	-	-
Home equity loans and lines of credit	-	-	-	-	-
Five or more units	-	-	-	-	-
Commercial real estate	-	-	-	-	-
Construction	-	-	-	-	-
Land	-	-	-	-	-
Non-mortgage:					
Commercial	-	-	-	-	-
Automobile	-	-	-	-	-
Other consumer	5	3	9	9	7
<b>Total gross loan recoveries</b>	<b>5</b>	<b>3</b>	<b>419</b>	<b>9</b>	<b>7</b>
<b>Net loan charge-offs (recoveries)</b>					
Loans secured by real estate:					
Residential:					
One-to-four units	-	20	(406 )	879	-
One-to-four units subprime	25	-	-	-	-

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Home equity loans and lines of credit	-	-	-	-	-
Five or more units	-	-	-	-	-
Commercial real estate	-	-	-	-	-
Construction	-	-	-	-	-
Land	-	-	-	-	-
Non-mortgage:					
Commercial	-	428	-	-	-
Automobile	-	-	-	1	8
Other consumer	46	28	37	36	31
<hr/>					
Total net loan charge-offs (recoveries)	\$ 71	\$ 476	\$ (369 )	\$ 916	\$ 39
<hr/>					
Net loan charge-offs (recoveries) as a percentage					
of average loans	- %	0.01 %	(0.01 )%	0.02 %	- %
<hr/>					



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

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

<i>(Dollars in Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December</i> <i>31,</i> <i>2005</i>	<i>September</i> <i>30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
<b>Loans secured by real estate:</b>					
<b>Residential:</b>					
One-to-four units	\$ 31,608	\$ 23,467	\$ 21,538	\$ 20,577	\$ 21,700
One-to-four units subprime	6,266	5,127	6,190	6,877	6,355
Home equity loans and lines of credit	1,288	1,386	1,555	1,595	1,547
Five or more units	1,194	521	527	680	704
Commercial real estate	298	295	290	350	297
Construction	487	501	572	496	494
Land	251	175	358	444	424
<b>Non-mortgage:</b>					
Commercial	16	15	438	438	438
Automobile	2	3	3	5	8
Other consumer	294	311	294	299	305
Not specifically allocated	2,800	2,800	2,800	2,800	2,800
<b>Total for loans held for investment</b>	<b>\$ 44,504</b>	<b>\$ 34,601</b>	<b>\$ 34,565</b>	<b>\$ 34,561</b>	<b>\$ 35,072</b>

The following table indicates our allowance for loan losses as a percentage of loan category balance for the various categories of loans at the dates indicated.

<i>(Dollars in Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December</i> <i>31,</i> <i>2005</i>	<i>September</i> <i>30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
<b>Loans secured by real estate:</b>					
<b>Residential:</b>					
One-to-four units	0.22 %	0.17 %	0.17 %	0.16 %	0.17 %
One-to-four units subprime	0.65	0.48	0.53	0.55	0.49
Home equity loans and lines of credit	0.51	0.51	0.52	0.50	0.50
Five or more units	0.88	0.75	0.75	0.75	0.75
Commercial real estate	1.03	1.02	1.00	1.20	1.00
Construction	0.62	0.61	0.64	0.53	0.64
Land	0.92	0.74	0.87	0.68	0.71
<b>Non-mortgage:</b>					
Commercial	0.46	0.38	10.37	9.74	9.19
Automobile	2.99	2.59	1.47	1.56	1.48
Other consumer	4.46	4.73	4.55	4.60	4.81
<b>Total for loans held for investment</b>	<b>0.28 %</b>	<b>0.23 %</b>	<b>0.24 %</b>	<b>0.24 %</b>	<b>0.25 %</b>

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

The following table indicates by loan category the percentage mix of our total loans held for investment at the dates indicated.

<i>(Dollars in Thousands)</i>	<i>March 31,</i> <i>2006</i>	<i>December</i> <i>31,</i> <i>2005</i>	<i>September</i> <i>30,</i> <i>2005</i>	<i>June 30,</i> <i>2005</i>	<i>March 31,</i> <i>2005</i>
<b>Loans secured by real estate:</b>					
<b>Residential:</b>					
One-to-four units	90.48 %	89.79 %	88.31 %	86.97 %	86.95 %
One-to-four units subprime	6.14	6.98	8.00	8.79	9.01
Home equity loans and lines of credit	1.60	1.81	2.05	2.22	2.14
Five or more units	0.86	0.46	0.48	0.63	0.66
Commercial real estate	0.18	0.19	0.20	0.20	0.21
Construction	0.50	0.54	0.61	0.65	0.54
Land	0.18	0.16	0.28	0.46	0.42
<b>Non-mortgage:</b>					
Commercial	0.02	0.03	0.03	0.03	0.03
Automobile	-	-	-	-	-
Other consumer	0.04	0.04	0.04	0.05	0.04
<b>Total for loans held for investment</b>	<b>100.00 %</b>	<b>100.00 %</b>	<b>100.00 %</b>	<b>100.00 %</b>	<b>100.00 %</b>

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

At March 31, 2006, December 31, 2005, and March 31, 2005 there were no loans for which we recognized impairment; therefore, no allowance was recorded for losses related to impaired loans. There was no interest recognized on impaired loans in the current quarter, compared to \$0.1 million in the year-ago quarter.

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

(In Thousands)	<i>Three Months Ended</i>				
	<i>December</i>		<i>September</i>		<i>March 31,</i>
	<i>March 31,</i>	<i>31,</i>	<i>30,</i>	<i>June 30,</i>	
	<i>2006</i>	<i>2005</i>	<i>2005</i>	<i>2005</i>	<i>2005</i>
Balance at beginning of period	\$ -	\$ -	\$ -	\$ -	\$ 193
Reduction	-	-	-	-	(193 )
Charge-offs	-	-	-	-	-
Recoveries	-	-	-	-	-
<b>Balance at end of period</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ -</b>

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

(In Thousands)	<i>Three Months Ended</i>				
	<i>December</i>		<i>September</i>		<i>March 31,</i>
	<i>March 31,</i>	<i>31,</i>	<i>30,</i>	<i>June 30,</i>	
	<i>2006</i>	<i>2005</i>	<i>2005</i>	<i>2005</i>	<i>2005</i>
Balance at beginning of period	\$ 103	\$ 103	\$ 1,436	\$ 1,436	\$ 1,436
Reduction	-	-	(1,333 )	-	-
Charge-offs	-	-	-	-	-
Recoveries	-	-	-	-	-
<b>Balance at end of period</b>	<b>\$ 103</b>	<b>\$ 103</b>	<b>\$ 103</b>	<b>\$ 1,436</b>	<b>\$ 1,436</b>

### Capital Resources and Liquidity

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

Our primary sources of funds generated in the first quarter of 2006 were from:

- principal repayments of \$1.2 billion including prepayments, but excluding refinances of our existing loans on loans and mortgage-backed securities;
- an increase of \$322 million in deposits; and
- an increase of \$271 million in FHLB advances.

We used these funds to:

- originate and purchase \$1.6 billion of loans held for investment, excluding refinances of our existing loans; and
- a net increase of \$97 million in our loans held for sale.

Our principal source of liquidity is our ability to utilize borrowings, as needed. Our primary source of borrowings is the FHLB. At March 31, 2006, our FHLB borrowings totaled \$3.8 billion, representing 21.5% of total assets. We currently are approved by the FHLB to borrow up to 50% of total assets to the extent we provide qualifying collateral and hold sufficient FHLB stock. That approved limit would have permitted us, as of quarter end, to borrow an additional \$5.1 billion. To the extent deposit growth over the remainder of 2006 falls short of satisfying ongoing commitments to fund maturing and withdrawable deposits, repay maturing borrowings, fund existing and future loans and make investments, we may utilize the additional capacity from our FHLB borrowing arrangement or other sources. As of March 31, 2006, we had commitments to borrowers for short-term interest rate locks, before the reduction of expected fallout, of \$909 million, undisbursed loan funds and unused lines of credit of \$407 million and operating leases of \$19 million. We believe our current sources of funds, including repayments of existing loans, enable us to meet our obligations while maintaining liquidity at appropriate levels.

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

The holding company currently has adequate liquid assets to meet its obligations and can obtain further funds by means of dividends from subsidiaries, subject to certain limitations, or issuance of further debt or equity. As of March 31, 2006, the Bank had the capacity to declare a dividend totaling \$335 million subject to filing an application with the OTS at least 30 days prior to the distribution and the OTS does not communicate an objection. At March 31, 2006, the holding company's liquid assets, including due from Bank interest bearing balances, totaled \$41 million.

Stockholders' equity totaled \$1.2 billion at March 31, 2006 and December 31, 2005, up from \$1.1 billion a year ago.

### *Contractual Obligations and Other Commitments*

Through the normal course of operations, we have entered into contractual obligations and other commitments. Our obligations generally relate to funding of our operations through deposits and borrowings as well as leases for premises and equipment, and our commitments generally relate to our lending operations. We have obligations under long-term operating leases, principally for building space and land. Lease terms generally cover a five-year period, with options to extend, and are non-cancelable. Currently, we have no material contractual vendor obligations.

We executed interest rate swap contracts to change interest rate characteristics of a portion of our FHLB advances to better manage interest rate risk. The contracts have notional amounts totaling \$430 million of receive-fixed, pay 3-month LIBOR variable interest and serve as a permitted fair value hedge.

Our commitments to originate fixed and variable rate mortgage loans are agreements to lend to a customer as long as there is no violation of any condition established in the commitment. Undisbursed loan funds on construction projects and unused lines of credit on home equity and commercial loans include committed funds not disbursed. Letters of credit are conditional commitments issued by us to guarantee the performance of a customer to a third party.

Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some commitments expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The credit risk involved in issuing lines and letters of credit requires the same creditworthiness evaluation as that involved in extending loan facilities to customers. We evaluate each customer's creditworthiness.

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

Downey maintains an allowance for losses on loan-related commitments for undisbursed loan funds and unused lines of credit to provide for inherent losses. During the first quarter of 2006, the allowance for losses on loan-related commitments was reclassified from the allowance for loan losses to accounts payable and accrued liabilities. The allowance for losses on loan-related commitments is calculated using the same methodology as that used to determine the allowance for loan losses. Previously reported periods were restated to conform to the current period presentation. The reclassifications had no effect on the provision for credit losses, which continues to be comprised of the sum of the provision for loan losses and the provision for losses on loan-related commitments; thus, no effect was had on net income or stockholders' equity. The allowance for losses on loan-related commitments was \$1 million at March 31, 2006 and December 31, 2005, compared to \$2 million at March 31, 2005.

We enter into derivative financial instruments as part of our interest rate risk management process, including loan forward sale and purchase contracts related to our sale of loans in the secondary market. The associated fair value changes to the notional amount of the derivative instruments are recorded on-balance sheet. The total notional amount of our derivative financial instruments do not represent future cash requirements. For further information, see Asset/Liability Management and Market Risk on page 34 and Note 4 of Notes to the Consolidated Financial Statements on page 8.

We sell all loans without recourse. When a loan sold to an investor without recourse fails to perform according to the contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred and whether such defects give rise to a violation of a representation or warranty made to the investor in connection with the sale. If such a defect is identified, we may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, we have no commitment to repurchase the loan. During the first three months of 2006, we recorded a negligible repurchase loss related to defects in the origination process and repurchased \$0.2 million of loans. These loan and servicing sale contracts typically contain provisions to refund sales price premiums to the purchaser if the related loans prepay during a period not to exceed 120 days from the sale settlement date. We reserved less than \$1 million at March 31, 2006, and December 31, 2005 and \$1 million at March 31, 2005 to cover the estimated loss exposure related to early payoffs. However, if all the loans related to those sales prepaid within the refund period, as of March 31, 2006, our maximum purchase price premium refund would be \$8.6 million. See Note 4 of Notes to the Consolidated Financial Statements on page 8.



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

At March 31, 2006, scheduled maturities of obligations and commitments were as follows:

<i>(In Thousands)</i>	<i>Within 1 Year</i>	<i>1 - 3 Years</i>	<i>4 - 5 Years</i>	<i>Over 5 Years</i>	<i>Total Balance</i>
Certificates of deposit	\$ 8,264,947	\$ 636,939	\$ 194,353	\$ -	\$ 9,096,239
FHLB advances	3,416,370	409,441	-	-	3,825,811
Senior notes	-	-	-	198,129	198,129
Secondary marketing activities:					
Non-qualifying hedge transactions:					
Interest rate lock commitments <sup>(a)</sup>	307,635	-	-	-	307,635
Associated loan forward sale contracts	261,359	-	-	-	261,359
Qualifying cash flow hedge transactions:					
Loans held for sale, at lower of cost or fair value	561,511	-	-	-	561,511
Associated loan forward sale contracts	544,141	-	-	-	544,141
Qualifying fair value hedge transactions:					
Designated FHLB advances pay-fixed	-	430,000	-	-	430,000
Associated interest rate swap contracts pay-variable, receive-fixed	-	430,000	-	-	430,000
Commitments to originate adjustable loans held					
for investment	508,426	-	-	-	508,426
Undisbursed loan funds and unused lines of credit	31,871	21,845	-	352,959	406,675
Operating leases	5,381	7,780	4,096	1,734	18,991
<b>Total obligations and commitments</b>	<b>\$ 13,901,641</b>	<b>\$ 1,936,005</b>	<b>\$ 198,449</b>	<b>\$ 552,822</b>	<b>\$ 16,588,917</b>

<sup>(a)</sup> The notional amount before the reduction of expected fallout was \$401 million.

### Regulatory Capital Compliance

The Bank's core and tangible capital ratios were both 7.56% and its risk-based capital ratio was 14.89% at March 31, 2006. The Bank's capital ratios compare favorably with the well capitalized standards of 5.00% for core capital and 10.00% for risk-based capital, as defined by regulation.

The following table is a reconciliation of the Bank's stockholder's equity to federal regulatory capital as of March 31, 2006.

<i>(Dollars in Thousands)</i>	<i>Tangible Capital</i>		<i>Core Capital</i>		<i>Risk-Based Capital</i>	
	<i>Amount</i>	<i>Ratio</i>	<i>Amount</i>	<i>Ratio</i>	<i>Amount</i>	<i>Ratio</i>
Stockholder's equity	\$ 1,408,559		\$ 1,408,559		\$ 1,408,559	
Adjustments:						
Deductions:						
Investment in subsidiary, primarily real estate	(69,620)		(69,620)		(69,620)	
Excess cost over fair value of branch acquisitions	(3,150)		(3,150)		(3,150)	

Edgar Filing: DOWNEY FINANCIAL CORP - Form 10-Q

Non-permitted mortgage servicing rights	(2,016 )		(2,016 )		(2,016 )	
Additions:						
Unrealized losses on investment securities						
available for sale	6,196		6,196		6,196	
Allowance for credit losses, net of specific allowances <sup>(a)</sup>	-		-		44,449	
<hr/>						
Regulatory capital	1,339,969	7.56 %	1,339,969	7.56 %	1,384,418	14.89 %
Well capitalized requirement	265,926	1.50 <sup>(b)</sup>	886,418	5.00	930,034	10.00 <sup>(c)</sup>
<hr/>						
Excess	\$ 1,074,043	6.06 %	\$ 453,551	2.56 %	\$ 454,384	4.89 %
<hr/>						

<sup>(a)</sup> Limited to 1.25% of risk-weighted assets.

<sup>(b)</sup> Represents the minimum requirement for tangible capital, as no well capitalized requirement has been established for this category.

<sup>(c)</sup> A third requirement is Tier 1 capital to risk-weighted assets of 6.00%, which the Bank met and exceeded with a ratio of 14.41%.



**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

For information regarding quantitative and qualitative disclosures about market risk, see Asset/Liability Management and Market Risk on page 34.

**ITEM 4. CONTROLS AND PROCEDURES**

As of March 31, 2006, Downey carried out an evaluation, under the supervision and with the participation of Downey's management, including Downey's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Downey's disclosure controls and procedures pursuant to Securities and Exchange Commission (SEC) rules. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that Downey's disclosure controls and procedures were effective as of the end of the period covered by this report. There have been no significant changes during the most recent quarter in Downey's internal controls over financial reporting or in other factors that could significantly affect these controls subsequent to the evaluation date.

Disclosure controls and procedures are defined in SEC rules as controls and other procedures designed to ensure that information required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Downey's disclosure controls and procedures were designed to ensure that material information related to Downey, including subsidiaries, is made known to management, including the Chief Executive Officer and Chief Financial Officer, in a timely manner.

## PART II OTHER INFORMATION

### ITEM 1. Legal Proceedings

On June 21, 2005, a former loan underwriting employee brought an action in Contra Costa Superior Court, Case No. C05-01293, entitled Teresa Sims, et al. v. Downey Savings and Loan Association. The complaint seeks unspecified damages for alleged unpaid overtime wages and bonuses, inadequate meal and rest breaks, and related claims. The plaintiff is seeking class action status to represent all other current and former Downey Savings employees that held the position of loan underwriter, including, but not limited to, the job title of Senior Loan Underwriter within the State of California (a) at any time during the four years prior to June 21, 2005 and/or (b) who was employed by Downey Savings on or about September 30, 2002, when Downey Savings terminated an annual bonus program. Based on a review of the current facts and circumstances with retained outside counsel, (i) Downey Savings plans to oppose the claim and assert all appropriate defenses and (ii) management has provided for what is believed to be a reasonable estimate of exposure for this matter in the event of loss. While acknowledging the uncertainties of litigation, management believes that the ultimate outcome of this matter will not have a material adverse effect on its financial condition, results of operations or cash flows.

Downey has been named as a defendant in other legal actions arising in the ordinary course of business, none of which, in the opinion of management, will have a material adverse effect on its financial condition, results of operations or cash flows.

### ITEM 1A. Risk Factors

There has been no material changes in our risk factors since December 31, 2005.

### ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

### ITEM 3. Defaults Upon Senior Securities

None.

### ITEM 4. Submission of Matters to a Vote of Security Holders

None.

### ITEM 5. Other Information

None.

### ITEM 6. Exhibits

<i>Exhibit Number</i>	<i>Description</i>
<a href="#"><u>31.1</u></a>	Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
<a href="#"><u>31.2</u></a>	Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002.
<a href="#"><u>32.1</u></a>	Certification of Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002.
<a href="#"><u>32.2</u></a>	Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002.



## AVAILABILITY OF REPORTS

Corporate governance guidelines, charters for the audit, compensation, and nominating and corporate governance committees of the Board of Directors and codes of business conduct and ethics are available free of charge from our internet site, [www.downeysavings.com](http://www.downeysavings.com) by clicking on [Investor Relations](#) on our home page and proceeding to [Corporate Governance](#). Annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are posted on our internet site as soon as reasonably practical after we file them with the SEC and available free of charge under [Reports](#) on our [Investor Relations](#) page.

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

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

## SIGNATURES

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

## DOWNEY FINANCIAL CORP.

*/s/ Daniel D. Rosenthal*

Date: May 3, 2006

\_\_\_\_\_  
Daniel D. Rosenthal  
President and Chief Executive Officer

*/s/ Brian E. Côté*

Date: May 3, 2006

\_\_\_\_\_  
Brian E. Côté  
Chief Financial Officer

## **NAVIGATION LINKS**

### **FORM 10-O COVER**

### **PART I - FINANCIAL INFORMATION**

#### ITEM 1. FINANCIAL STATEMENTS

- [CONSOLIDATED BALANCE SHEETS](#)
- [CONSOLIDATED STATEMENTS OF INCOME](#)
- [CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME](#)
- [CONSOLIDATED STATEMENTS OF CASH FLOWS](#)
- [NOTES TO CONSOLIDATED FINANCIAL STATEMENTS](#)
  - [NOTE \(1\) Basis of Financial Statement Presentation](#)
  - [NOTE \(2\) Reclassification of Prior Period Amounts](#)
  - [NOTE \(3\) Mortgage Servicing Rights \("MSRs"\)](#)
  - [NOTE \(4\) Derivatives, Hedging Activities, Financial Instruments with Off-Balance Sheet Risk and Other Contractual Obligations \(Risk Management\)](#)
  - [NOTE \(5\) Income Taxes](#)
  - [NOTE \(6\) Employee Stock Option Plans](#)
  - [NOTE \(7\) Earnings Per Share](#)
  - [NOTE \(8\) Business Segment Reporting](#)
  - [NOTE \(9\) Current Accounting Issues](#)

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

- [OVERVIEW](#)
- [CRITICAL ACCOUNTING POLICIES](#)
- [RESULTS OF OPERATIONS](#)
  - [Net Interest Income](#)
  - [Provision for Credit Losses](#)
  - [Other Income](#)
    - [Loan and Deposit Related Fees](#)
    - [Real Estate and Joint Ventures Held for Investment](#)
    - [Secondary Marketing Activities](#)
  - [Operating Expense](#)
  - [Provision for Income Taxes](#)
  - [Business Segment Reporting](#)
    - [Banking](#)
    - [Real Estate Investment](#)
- [FINANCIAL CONDITION](#)
  - [Loans and Mortgage-Backed Securities](#)
  - [Investment Securities](#)
  - [Deposits](#)
  - [Borrowings](#)
  - [Off-Balance Sheet Arrangements](#)
  - [Transactions with Related Parties](#)
  - [Asset/Liability Management and Market Risk](#)
  - [Problem Loans and Real Estate](#)
    - [Non-Performing Assets](#)
    - [Delinquent Loans](#)
    - [Allowance for Credit and Real Estate Losses](#)
  - [Capital Resources and Liquidity](#)
    - [Contractual Obligations and Other Commitments](#)
  - [Regulatory Capital Compliance](#)

#### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

ITEM 4. CONTROLS AND PROCEDURES

**PART II OTHER INFORMATION**

ITEM 1. Legal Proceedings

ITEM 1A. Risk Factors

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

ITEM 3. Defaults Upon Senior Securities

ITEM 4. Submission of Matters to a Vote of Security Holders

ITEM 5. Other Information

ITEM 6. Exhibits

- **31.1 Certification of Chief Executive Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002**
- **31.2 Certification of Chief Financial Officer pursuant to Section 302 of Sarbanes-Oxley Act of 2002**
- **32.1 Certification of Chief Executive Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002**
- **32.2 Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act of 2002**

AVAILABILITY OF REPORTS

SIGNATURES