DOWNEY FINANCIAL CORP
Form 10-K
March 01, 2005

Navigation Links Click here to quickly move through the content of the Form 10-K filing.

Securities And Exchange Commission
Washington, D.C. 20549

Form 10-K

(Mark One)

þ Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2004.

¨ Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from ______________ to ______________.

Commission File Number 1-13578

DOWNEY FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

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

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

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

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

Title of each class	**Name of each exchange**
Common Stock, $0.01 par value	New York Stock Exchange
	Pacific Exchange

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).
Yes þ No ¨

The aggregate market value of the registrant s outstanding Common Stock held by non-affiliates on June 30, 2004, based upon the closing sale price on that date of $53.25, as quoted on the New York Stock Exchange, was $1,121,632,121.

At February 28, 2005, 27,853,783 shares of the Registrant's Common Stock, $0.01 par value, were outstanding.

Documents Incorporated by Reference: Portions of the Registrant's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the Annual Meeting of Stockholders to be held April 27, 2005 are incorporated by reference in Part III hereof.

TABLE OF CONTENTS

TABLE OF CONTENTS

PART I

Certain matters discussed in this Annual Report may constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and, as such, may involve risks and uncertainties. These forward-looking statements relate to, among other things, expectations of the business environment in which Downey Financial Corp. ("Downey," "we," "us" and "our") operates, projections of future performance, perceived opportunities in the market and statements regarding our mission and vision. Some forward-looking statements may be identified by use of terms such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," or words of similar meaning, or future or conditional verbs such as "will," "would," "should," "could" or "may." Our actual results, performance or achievements may differ significantly from the results, performance or achievements expressed or implied in such forward-looking statements. 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. For additional information concerning these factors, see Factors That May Affect Future Results Of Operations on page 18.

ITEM 1. BUSINESS

GENERAL

We were incorporated in Delaware on October 21, 1994. On January 23, 1995, after we obtained necessary stockholder and regulatory approvals, we acquired 100% of the issued and outstanding capital stock of Downey Savings and Loan Association ("Bank") and the Bank s stockholders became holders of our stock. Downey was thereafter funded by the Bank and presently operates as the Bank s holding company. Our stock is traded on the New York Stock Exchange and Pacific Exchange under the trading symbol "DSL." Corporate governance guidelines, charters for the audit, compensation, and nominating and corporate governance committees of the Board of Directors and code of business conduct and ethics are available free of charge from our internet site, 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 "Corporate Filings" on our "Investor Relations" page.

The Bank was formed in 1957 as a California-licensed savings and loan association and converted to a federal charter in 1995. As of December 31, 2004, it conducts its business primarily through 169 retail deposit branches, including 93 full-service, in-store branches.

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

- As a federally chartered savings association, the Bank s activities and investments are generally governed by the Home Owners Loan Act, as amended, and regulations and policies of the Office of Thrift Supervision ("OTS").
- The Bank and Downey are subject to the primary regulatory and supervisory jurisdiction of the OTS.
- As a federally insured depository institution, the Bank is regulated and supervised by the Federal Deposit Insurance Corporation ("FDIC") with respect to some of its activities and investments.
- The Bank is a member of the Federal Home Loan Bank ("FHLB") of San Francisco, which is one of the 12 regional banks for federally insured depository institutions comprising the FHLB System.
- The Bank s savings deposits are insured through the Savings Association Insurance Fund ("SAIF") of the FDIC, an instrumentality of the United States government.
- The Bank is regulated by the Federal Reserve with respect to reserves the Bank is required to maintain against deposits and other matters.

General economic conditions, the monetary and fiscal policies of the federal government and the regulatory policies of governmental authorities significantly influence our operations. Additionally, interest rates on competing investments and general market interest rates influence our deposit flows and the costs we incur on interest-bearing liabilities, which represents our cost of funds. Similarly, market interest rates and other factors

Navigation Links

that affect the supply of and demand for housing and the availability of funds affect our loan volume, our yields on loans and mortgage-backed securities as well as the valuation of our mortgage servicing rights ("MSRs") associated with the portfolio of loans we service for others.

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

BANKING ACTIVITIES

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

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

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

Our primary sources of revenue from our banking business are:

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

Our principal expenses in connection with our banking business are:

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

Our primary sources of funds from our banking business are:

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

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

Lending Activities

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

Our primary focus continues to be our origination of adjustable rate single family mortgage loans for portfolio, including subprime loans which carry higher interest rates. In addition, we will originate for portfolio other loans including:

- multi-family loans;
- commercial real estate loans;
- construction and land loans to developers;
- loans to individuals for the construction and permanent financing of single family homes; and
- consumer loans.

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

For more information, see Secondary Marketing and Loan Servicing Activities on page 5. For additional information on the composition of our loan and mortgage-backed securities portfolio, see Loans and Mortgage-Backed Securities on page 35.

Loan and Mortgage-Backed Securities Portfolio

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

We identify loans that may be sold before their maturity. In our balance sheets, we classify these as loans held for sale and record them at the lower of cost or fair value. The cost includes a basis adjustment to the loan at funding resulting from the change in the fair value of the associated interest rate lock derivative from the date of commitment to the date of funding. We recognize net unrealized losses on these loans, if any, in a valuation allowance by making charges to our income.

We carry mortgage-backed securities available for sale at fair value. In stockholders equity, we report net unrealized gains or losses on these securities, net of income taxes, as accumulated other comprehensive income until realized, unless the security is deemed other than temporarily impaired. If the security is determined to be other than temporarily impaired, we charge the amount of the impairment to operations.

Residential Real Estate Lending

Our primary lending activity is our origination of mortgage loans secured by single family residential properties consisting of one-to-four units located primarily in California. Residential loans are originated or purchased:

- by branch managers and loan officers in our branches;
- by loan officers who solicit loans from realtors and other business sources, including the internet;
- by wholesale loan representatives who obtain loans submitted by mortgage brokers; and
- by purchases of loans from correspondent banking institutions and mortgage bankers.

We provide these loans for borrowers to purchase residences or to refinance their existing mortgages and typically have contractual maturities at origination of 15 to 40 years. To limit the interest rate risk associated with these 15- to 40-year maturities, we, among other things, principally originate adjustable rate mortgages for our own loan portfolio. For more information, see Asset/Liability Management on page 8. We also originate residential fixed rate mortgage loans to meet consumer demand, but we sell the majority of these loans in the secondary market, rather than hold them in our portfolio. We may, however, place residential fixed rate loans in our portfolio of loans held for investment if these fixed rate loans are funded with long-term funds to mitigate interest rate risk. In addition, we originate a small volume of fixed rate loans for our own investment, which may not be funded with

long-term funds, if they meet specific yield and other approved guidelines, or to facilitate our sale of real estate acquired in settlement of loans. The average term of these fixed rate mortgage loans we originate for our own portfolio historically has been significantly shorter than their contractual maturity as a result of home sales, refinancings and prepayments. For more information, see Secondary Marketing and Loan Servicing Activities on page 5.

Our adjustable rate mortgages:

- generally either begin with an incentive interest rate, which is an interest rate below the current market rate, that adjusts to the applicable index plus a defined spread, subject to periodic and lifetime caps, after one, three, six or twelve months, or are fixed for a period of three to five years then adjust semi-annually or annually thereafter;
- generally 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 adjust the interest rate monthly and the payment amount annually. These monthly adjustable rate mortgages:

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

If a loan incurs significant negative amortization, the loan-to-value ratio could increase which also increases credit risk, as the fair value of the underlying collateral could be insufficient to satisfy fully the outstanding loan obligation. A loan-to-value ratio is the ratio of the principal amount of the loan to the lower of the sales price or appraised value of the property securing the loan at origination. Our loan contracts limit the amount of negative amortization that can occur. Our current practice imposes a limit on the amount of negative amortization on all our loans we originate to 110% of the original loan amount. However, our loan portfolio held for investment does contain loans previously originated with a contract limit of principal plus negative amortization of 125% of the original loan amount. At year-end 2004, loans with the higher 125% limit on negative amortization represented 11% of our adjustable rate one-to-four unit residential portfolio, while those with the 110% limit represented 71%. We permit adjustable rate mortgages to be assumed by qualified borrowers.

During 2004, approximately 88% of our one-to-four unit residential real estate loans were originated or purchased through outside mortgage brokers with the remaining amount originated by our branch managers and residential loan officers. Mortgage brokers do not operate from our offices and are not our employees.

We require that our residential real estate loans be approved at various levels of management, depending upon the amount of the loan. On a single family residential loan we originate for our portfolio, the maximum amount we generally will lend is $2 million. Our average loan size, however, is much lower. In 2004, our average loan size was $316,000. We generally make loans with loan-to-value ratios not exceeding 80%. We will make loans with loan-to-value ratios of over 80%, if the borrower obtains private mortgage insurance to reduce the effective loan-to-value ratio to between 67% and 80%, consistent with secondary marketing requirements. In addition, we require that borrowers obtain hazard insurance for all residential real estate loans covering the lower of the loan amount or the replacement value of the residence.

In our approval process for the loans we originate or purchase, we assess both the value of the property securing the loan and the applicant s ability to repay the loan. Qualified appraisers on our staff or approved outside appraisers establish the value of the collateral through appraisals or alternative valuation formats that meet regulatory requirements. Appraisal reports prepared by outside appraisers are selectively reviewed by our staff appraisers or by approved fee appraisers. We generally obtain information about the applicant s income, financial condition, employment and credit history.

We offer one-to-four unit residential loans to borrowers who have or, in the case of purchases, will have equity in their homes but whose credit rating contains exceptions which preclude them from qualifying for

lower or better market interest rates and terms. We refer to these lower rated credits, which we characterize as "Alt. A," "A-," "B" and "C" loans, as subprime loans in our loan portfolio. Our subprime loans are characterized by lower loan-to-value ratios and higher average interest rates than higher credit grade prime loans or "A" loans. We believe these lower credit rated borrowers represent an opportunity for us to earn a higher net return for the risks we assume. For further information, see Regulatory Capital Requirements on page 11.

We currently qualify applicants of our adjustable rate mortgages at the higher of the fully-indexed rate or:

- for prime borrowers:
  - 5.50% for owner occupied; or
  - 5.75% for non-owner occupied.
- for subprime borrowers:
  - 6.50% for owner occupied; or
  - 6.75% for non-owner occupied.

Secondary Marketing and Loan Servicing Activities

As part of our secondary marketing activities, we originate residential real estate adjustable rate mortgages and fixed rate mortgages that we intend to sell. Accordingly, we classify these loans as held for sale and carry them at the lower of cost or fair value. The cost includes a basis adjustment to the loan at funding resulting from the change in the fair value of the associated interest rate lock derivative from the date of commitment to the date of funding. These loans are primarily secured by first liens on one-to-four unit residential properties and generally have maturities of 30 years or less.

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

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

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

Depending upon market pricing for servicing, we sell loans either servicing retained or servicing released. When we sell loans servicing retained, we record gains or losses from these loans at the time of sale. We calculate gains or losses from our sale as the difference between the net sales proceeds and the allocated basis of the loans sold. We capitalize MSRs we acquire through either our purchase or origination of mortgage loans we have sold with servicing rights retained. We allocate the total cost of the mortgage loans sold to both the MSRs and to the mortgage loans without MSRs based on their relative fair values. We disclose our MSRs in our financial statements and include them as a component of the gain on sale of loans. We recognize impairment losses on the MSRs through a valuation allowance and record any associated provision as a component of loan servicing income (loss), net category. For further information, see Note 1 on page 75 and Note 11 on page 91 of Notes to the Consolidated Financial Statements.

Generally, we use hedging programs to manage the interest rate risk of our secondary marketing activities. For further information, see Asset/Liability Management and Market Risk on page 46.

We may exchange loans we originate for sale with government-sponsored agencies for mortgage-backed securities collateralized by these loans. Our cost for the exchange, a monthly guaranty fee, is expressed as a percentage of the unpaid principal balance and is deducted from interest income. The securities we receive can be used to collateralize various types of our borrowings at rates that frequently are more favorable than rates on other types of liabilities and also carry a lower risk-based capital requirement than whole loans. We carry these mortgage-backed securities available for sale at fair value. However, we record no gain or loss on the

exchange in our statement of income until the securities are sold to a third party, usually that same day. Before we sell these securities to third parties, we show all changes in fair value as a separate component of stockholders equity as accumulated other comprehensive income, net of income taxes.

Multi-Family and Commercial Real Estate Lending

We have provided permanent loans secured by multi-family and retail neighborhood shopping center properties. Our major loan officers conduct our multi-family and commercial real estate lending activities.

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

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

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

Construction Lending

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

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

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

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

Commercial Lending

We maintain traditional private banking credit products and services for our existing high net worth, relationship based customers. Our portfolio emphasis is toward secured, floating rate credit facilities. We also provide commercial deposit account products and services to meet the needs of business relationships maintained at the Bank.

Consumer Lending

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

Investment Activities

As a federally chartered savings association, the Bank s ability to make securities investments is prescribed under the OTS regulations and the Home Owners Loan Act. The Bank s authorized officers make investment decisions within guidelines established by the Bank s Board of Directors. The Bank manages these investments in an effort to produce the highest yield, while at the same time maintaining safety of principal, minimizing interest rate risk and complying with applicable regulations.

We carry securities held to maturity at amortized cost. We adjust these costs for amortization of premiums and accretion of discounts, which we recognize in interest income using the interest method. We carry securities available for sale at fair value. We exclude unrealized holding gains and losses, or valuation allowances established for net unrealized losses, from our earnings and report them as a separate component of our stockholders equity as accumulated other comprehensive income, net of income taxes, unless the security is deemed other than temporarily impaired. If the security is determined to be other than temporarily impaired, we charge the amount of the impairment to operations. For further information on the composition of our investment portfolio, see Investment Securities on page 39.

Deposit Activities

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

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

For further information, see Deposits on page 42.

Borrowing Activities

Besides deposits, we have utilized other sources to fund our loan origination and other business activities. We have at times relied upon our borrowings from the FHLB of San Francisco or the issuance of corporate debt as an additional source of funds. The FHLB of San Francisco makes advances to us through several different credit programs it offers.

From time to time, we obtain additional sources of funds by selling some of our securities and mortgage loans under agreements to repurchase. These reverse repurchase agreements are generally short-term and are collateralized by our mortgage-backed and investment securities or our mortgage loans. We only deal with investment banking firms that are recognized as primary dealers in U.S. government securities or major commercial banks in connection with these reverse repurchase agreements. In addition, we limit the amounts of our borrowings from any single institution.

Another source of funds has come from the issuance of debt through public underwritten offerings. This includes junior subordinated debentures issued to Downey Financial Capital Trust I ("Trust"), a wholly owned, special purpose entity, whose sole purpose was to raise money through the sale of capital securities. However, we have since redeemed our junior subordinated debentures and in turn redeemed the capital securities with the proceeds received through the issuance of senior debt.

For further information, see Borrowings on page 43.

Earnings Spread

Our primary source of earnings comes from our net interest income. We determine our net interest income or the interest rate spread by calculating the difference between:

- the yield we earn on our interest-earning assets like loans, mortgage-backed securities and investment securities; and
- the cost we pay on our interest-bearing liabilities like deposits and borrowings.

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

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

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

For information regarding our net income and the components thereof and for management s analysis of our financial condition and results of operations, see Management s Discussion and Analysis of Financial Condition and Results of Operations beginning on page 24. For information regarding the return on our assets and other selected financial data, see Selected Financial Data on page 22.

Asset/Liability Management

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

For further information, see Lending Activities on page 2 and Asset/Liability Management and Market Risk on page 46.

Insurance Agency Activities

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

REAL ESTATE INVESTMENT ACTIVITIES

In addition to our primary business of banking, which has been described above, we are also involved in real estate investment activities, which are conducted primarily through DSL Service Company, a wholly owned subsidiary of the Bank. DSL Service Company is a diversified real estate development company which was established in 1966 as a neighborhood shopping center and residential tract developer. Today its capabilities include development, construction and property management activities relating to its portfolio of projects primarily within California, but also in Arizona. In addition, DSL Service Company associates with other qualified developers

to engage in joint ventures. The primary revenue sources of our real estate investment activities include net rental income and gains from the sale of real estate investments. The primary expenses of our real estate investment activities are interest expense and general and administrative expense.

Due to federal law, the Bank is prohibited from making new investments in real estate development and joint venture operations and is required to deduct the full amount of its investment in DSL Service Company in calculating its applicable ratios under the core, tangible and risk-based capital standards. Savings associations generally may invest in service corporation subsidiaries, like DSL Service Company, to the extent of 2% of the association s assets, plus up to an additional 1% of assets for investments which serve primarily community, inner-city or community development purposes.

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

For further information, see Investments in Real Estate and Joint Ventures on page 40.

COMPETITION

We face competition both in attracting deposits and in making loans. Our most direct competition for deposits has historically come from other savings institutions and from commercial banks located in our principal market areas, including many large financial institutions based in other parts of the country or their subsidiaries. In addition, we face additional significant competition for investors funds from short-term money market securities and other corporate and government securities. Our ability to attract and retain savings deposits depends, generally, on our ability to provide a rate of return, liquidity and risk comparable to that offered by competing investment opportunities and the appropriate level of customer service.

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

EMPLOYEES

At December 31, 2004, we had 2,446 full-time employees and 621 part-time employees. We provide our employees with health and welfare benefits and a retirement and savings plan. Additionally, we offer qualifying employees participation in our stock purchase plan. Our employees are not represented by any union or collective bargaining group, and we consider our employee relations to be good.

REGULATION

General

Federal and state law extensively regulate savings and loan holding companies and savings associations. This regulation is intended primarily to protect our depositors and the SAIF and is not for the benefit of our stockholders. Below we describe some of the regulations applicable to us and the Bank. We do not claim this discussion is complete and qualify our discussion by reference to applicable statutory or regulatory provisions.

Regulation of Downey

General

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

Activities Restrictions

As a savings and loan holding company with only one savings and loan association subsidiary, we generally are not limited by OTS activity restrictions, provided the Bank satisfies the qualified thrift lender test or meets the definition of a domestic building and loan association in the Internal Revenue Code. If we acquire

control of another savings association as a separate subsidiary of Downey, we would become a multiple savings and loan holding company. As a multiple savings and loan holding company, our activities, other than the activities of the Bank or any other SAIF-insured savings association, would become subject to restrictions applicable to bank holding companies unless these other savings associations were acquired in a supervisory acquisition and each also satisfies the qualified thrift lender test or meets the definition of a domestic building and loan association. Furthermore, if in the future we sold control of the Bank to any other company, such company would not succeed to our grandfathered status as a unitary thrift holding company and would be subject to the same business activity restrictions as a bank holding company. For more information, see Qualified Thrift Lender Test on page 13.

Restrictions on Acquisitions

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

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

The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 addresses accounting oversight and corporate governance matters, including:

- the prohibition of accounting firms from providing various types of consulting services to public clients and requiring accounting firms to rotate partners among public client assignments every five years;
- increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances;
- required executive certification of financial presentations;
- increased requirements for board audit committees and their members;
- enhanced disclosure of controls and procedures and internal control over financial reporting;
- enhanced controls on, and reporting of, insider trading; and
- statutory separations between investment bankers and analysts.

The new legislation and its implementing regulations have resulted in increased costs of compliance, including certain outside professional costs.

Regulation of the Bank

General

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

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

The Bank must file reports with the OTS and the FDIC concerning its activities and financial condition. In addition, the Bank must obtain regulatory approvals before entering into some transactions like mergers with or acquisitions of other financial institutions. This regulation and supervision establishes a comprehensive

framework of activities in which an institution may engage and is intended primarily to protect the SAIF and our depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies regarding the classification of assets and adequate loan loss reserves for regulatory purposes. Any change in regulations, whether by the OTS, the FDIC, the Federal Reserve or the Congress, could have a material adverse impact on us, the Bank and our operations.

Insurance of Deposit Accounts

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

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

The FDIC charges an annual assessment for the insurance of deposits based on the risk a particular institution poses to its deposit insurance fund. Under this system during 2003, SAIF members paid within a range of 0% to 0.27% of insured domestic deposits, depending upon the institution s risk classification. This risk classification is based on an institution s capital group and supervisory subgroup assignment.

The Bank also pays, in addition to its normal deposit insurance premium as a member of the SAIF, assessments towards the retirement of the Financing Corporation Bonds (known as FICO Bonds) issued in the 1980s to assist in the recovery of the savings and loan industry. These assessments will continue until the FICO Bonds mature in 2017. For the fourth quarter of 2004, this assessment was equal to 0.0146% of insured deposits.

Regulatory Capital Requirements

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

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

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

- has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration of credit risk, other risks arising from nontraditional activities, or similar risks or a high proportion of off-balance sheet risk;
- is growing, either internally or through acquisitions, at a rate that presents supervisory issues; or
- may be adversely affected by activities or the condition of its holding company, affiliates, subsidiaries or other persons, or savings associations with which it has significant business relationships.

The Bank is not required to meet any individual minimum regulatory capital requirement. At December 31, 2004, the Bank s regulatory capital exceeded all minimum regulatory capital requirements.

As a result of a number of federally insured financial institutions extending their lending risk selection standards to attract lower credit quality borrowers due to their loans having higher interest rates and fees, the federal banking regulatory agencies jointly issued Interagency Guidelines on Subprime Lending. Subprime lending involves extending credit to individuals with less than perfect credit histories.

Page 11 **Navigation Links**

The guidelines consider subprime lending a high-risk activity that is unsafe and unsound if the risks associated with subprime lending are not properly controlled. Specifically, the 2002 guidelines direct examiners to expect regulatory capital one and one-half to three times higher than that typically set aside for prime assets for institutions that:

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

Our subprime portfolio, pursuant to our definition, represented 114% of Tier 1 capital as of year-end 2004. The OTS notified us that as of March 31, 2003, we were required to risk weight our subprime residential loans at 75% versus their current 50% risk weighting. This change increased the required regulatory capital associated with our subprime loans by one and one-half times that of prime residential loans.

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

Prompt Corrective Action

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

The regulation establishes five categories of capital classification:

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

The regulation uses an institution s risk-based capital, leverage capital and tangible capital ratios to determine the institution s capital classification. At December 31, 2004, the Bank exceeded the capital requirements of a well capitalized institution under applicable OTS regulations.

Predatory Lending

The term "predatory lending," much like the terms "safety and soundness" and "unfair and deceptive practices," is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But typically predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower s ability to repay an obligation ("asset-based lending");
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); and/or
- engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Federal Reserve Bank regulations aimed at curbing such lending significantly widen the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994, a federal law that requires extra disclosures and consumer protections to borrowers. In addition, the regulation bars loan flipping by the same lender or loan servicer within a year. Lenders also will be presumed to have violated the law which says loans should not be made to people unable to repay them unless they document that the borrower has the ability to repay. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid.

We do not expect these rules and potential state action in this area to have a material impact on our financial condition or results of operation.

Loans-to-One-Borrower

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

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

Savings associations are additionally authorized to make loans to one borrower,

- by order of the Director of OTS, in an amount not to exceed the lesser of $30 million or 30% of unimpaired capital and surplus to develop residential housing, provided:
    - the purchase price of each single-family dwelling in the development does not exceed $500,000;
    - the savings association is in compliance with its capital requirements; and
    - the loans comply with applicable loan-to-value requirements.

At December 31, 2004, the Bank s loans-to-one-borrower limit was $181 million based upon the 15% of unimpaired capital and surplus measurement, or $301 million for loans secured by readily marketable collateral. The Bank s largest lending relationship consisted of two loans to a non-related party totaling a commitment of $26 million, of which $16 million had been disbursed as of December 31, 2004.

Qualified Thrift Lender Test

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

The FHLB also relies on the qualified thrift lender test. A savings association will only enjoy full borrowing privileges from an FHLB if the savings association is a qualified thrift lender. As of December 31, 2004, the Bank was in compliance with its qualified thrift lender test requirement and met the definition of a domestic building and loan association.

Extensions of Credit to Insiders and Transactions with Affiliates

The Federal Reserve Act and Federal Reserve Bank Regulation O place limitations and conditions on loans or extensions of credit to:

- a bank s or bank holding company s executive officers, directors and principal shareholders (i.e., in most cases, those persons who own, control or have power to vote more than 10% of any class of voting securities),
- any company controlled by any such executive officer, director or shareholder, or
- any political or campaign committee controlled by such executive officer, director or principal shareholder.

Loans and leases extended to any of the above persons must comply with loan-to-one-borrower limits, require prior full board approval when aggregate extensions of credit to the person exceed specified amounts, must be made on substantially the same terms (including interest rates and collateral) as, and follow credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions with non-insiders, and must not involve more than the normal risk of repayment or present other unfavorable

Page 13 **Navigation Links**

features. In addition, Regulation O provides that the aggregate limit on extensions of credit to all insiders of a bank as a group cannot exceed the bank s unimpaired capital and unimpaired surplus. Regulation O also prohibits the Bank from paying an overdraft on an account of an executive officer or director, except pursuant to a written pre-authorized interest-bearing extension of credit plan that specifies a method of repayment or a written pre-authorized transfer of funds from another account of the officer or director at the Bank.

The Bank also is subject to certain restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of, any affiliates, the purchase of, or investments in, stock or other securities thereof, the taking of such securities as collateral for loans, and the purchase of assets of any affiliates. Such restrictions prevent any affiliates from borrowing from us unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments by us to or in any affiliate are limited, individually, to 10% of the Bank s capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20% of the Bank s capital and surplus. Some entities included in the definition of an affiliate are parent companies, sister banks, sponsored and advised companies, investment companies whereby the bank its affiliate serves as investment advisor, and financial subsidiaries of the Bank. Additional restrictions on transactions with affiliates may be imposed on us under the prompt corrective action provisions of federal law. See Prompt Corrective Action on page 12.

Capital Distribution Limitations

A savings association that is a subsidiary of a savings and loan holding company, such as the Bank, must file an application or a notice with the OTS at least 30 days before making a capital distribution. Savings associations are not required to file an application for permission to make a capital distribution and need only file a notice if the following conditions are met:

- they are eligible for expedited treatment under OTS regulations;
- they would remain adequately capitalized after the distribution;
- the annual amount of capital distribution does not exceed net income for that year to date added to retained net income for the two preceding years; and
- the capital distribution would not violate any agreements between the OTS and the savings association or any OTS regulations.

Any other situation would require an application to the OTS. The OTS may disapprove an application or notice if the proposed capital distribution would:

- make the savings association undercapitalized, significantly undercapitalized or critically undercapitalized;
- raise safety or soundness concerns; or
- violate a statute, regulation or agreement with the OTS (or with the FDIC), or a condition imposed in an OTS approved application or notice.

Privacy

Federal banking regulations limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to those rules, financial institutions must provide:

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

These privacy provisions affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

USA Patriot Act of 2001

The USA Patriot Act of 2001 and its implementing regulations significantly expanded the anti-money laundering and financial transparency laws. Under the USA Patriot Act, financial institutions are subject to

prohibitions regarding specified financial transactions and account relationships as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers. For example, the enhanced due diligence policies, procedures, and controls generally require financial institutions to take reasonable steps:

- to conduct enhanced scrutiny of account relationships to guard against money laundering and report any suspicious transaction;
- to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, each account as needed to guard against money laundering and report any suspicious transactions;
- to ascertain for any foreign bank, the shares of which are not publicly traded, the identity of the owners of the foreign bank, and the nature and extent of the ownership interest of each such owner; and
- to ascertain whether any foreign bank provides correspondent accounts to other foreign banks and, if so, the identity of those foreign banks and related due diligence information.

Under the USA Patriot Act, financial institutions are required to establish and maintain anti-money laundering programs which include:

- the establishment of a customer identification program;
- the development of internal policies, procedures, and controls;
- the designation of a compliance officer;
- an ongoing employee training program; and
- an independent audit function to test the programs.

The Bank has adopted comprehensive policies and procedures to address the requirements of the USA Patriot Act.

Consumer Protection Laws and Regulations

The bank regulatory agencies are focusing greater attention on compliance with consumer protection laws and their implementing regulations. Examination and enforcement have become more intense in nature, and insured institutions have been advised to monitor carefully compliance with such laws and regulations. The Bank is subject to many federal consumer protection statutes and regulations, some of which are discussed below.

The Community Reinvestment Act, or CRA, is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal regulatory agencies, in examining insured depository institutions, to assess a bank s record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations. The agencies use the CRA assessment factors in order to provide a rating to the financial institution. The ratings range from a high of "outstanding" to a low of "substantial noncompliance." In its last examination for CRA compliance, as of February 25, 2002, the Bank was rated "satisfactory."

The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act, or FACT, requires financial firms to help deter identity theft, including developing appropriate fraud response programs, and gives consumers more control of their credit data. It also reauthorizes a federal ban on state laws that interfere with corporate credit granting and marketing practices. In connection with FACT, financial institution regulatory agencies proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer s election to opt out would be applicable for at least five years.

The Check Clearing for the 21st Century Act, or Check 21, facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a "substitute check," which is the legal equivalent of an original check. Check 21, effective October 28, 2004, does not require banks to create substitute checks or accept checks electronically; however, it does require banks to accept a legally equivalent substitute check in place of an original.

The Equal Credit Opportunity Act, or ECOA, generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The Truth in Lending Act, or TILA, is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

The Fair Housing Act, or FH Act, regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered, illegal under the FH Act, including some that are not specifically mentioned in the FH Act itself.

The Home Mortgage Disclosure Act, or HMDA, grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a "fair lending" aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes.

Finally, the Real Estate Settlement Procedures Act, or RESPA, requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts. Penalties under the above laws may include fines, reimbursements and other penalties. Due to heightened regulatory concern related to compliance with the CRA, TILA, FH Act, ECOA, HMDA and RESPA generally, the Bank may incur additional compliance costs or be required to expend additional funds for investments in its local community.

Activities of Subsidiaries

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

Federal Home Loan Bank System

The Bank is a member of the FHLB system. Among other benefits, each FHLB serves as a reserve or central bank for its members within its assigned region. Each FHLB is financed primarily from the sale of consolidated obligations of the FHLB system. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB. As an FHLB member, we are required to own a certain amount of capital stock in the FHLB. At December 31, 2004, we were in compliance with the stock requirements.

Federal Reserve System

The Federal Reserve requires all depository institutions to maintain non-interest-bearing reserves at specified levels against their transaction accounts and non-personal time deposits. These transaction accounts include checking, NOW and Super NOW checking accounts. These reserves may also be used to satisfy the OTS s liquidity requirements. At December 31, 2004, the Bank was in compliance with these requirements.

Proposed Legislation

From time to time, new laws are proposed that could have an effect on the financial institutions industry. For example, legislation is currently being considered in the U.S. House of Representatives Financial Institutions Subcommittee which would:

- merge the Bank Insurance Fund ("BIF") and the SAIF;

Page 16 **Navigation Links**

- increase the current deposit insurance coverage limit for insured deposits to $130,000 and index future coverage limits to inflation;
- increase deposit insurance coverage limits for municipal deposits;
- double deposit insurance coverage limits for individual retirement accounts; and
- smooth out bank deposit insurance premiums to avoid sharp increases during times of recession.

While we cannot predict whether such proposals will eventually become law, they could have an effect on our operations and the way we conduct business.

Regulation of DSL Service Company

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

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

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

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

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

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

TAXATION

Federal

Savings institutions are taxed like other corporations for federal income tax purposes, and are required to comply with income tax statutes and regulations similar to those applicable to large commercial banks. The Bank s bad debt deduction is determined under the specific charge-off method, which allows the Bank to take an income tax deduction for loans determined to be wholly or partially worthless.

In addition to the regular income tax, corporations are also subject to an alternative minimum tax. This tax is computed at 20% of the corporation s regular taxable income, after taking certain adjustments into account.

Page 17 **Navigation Links**

The alternative minimum tax applies to the extent that it exceeds the regular income tax liability.

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

State

The Bank uses California s financial corporation income tax rate to compute its California franchise tax liability. This rate is higher than the California non-financial corporation income tax rate because the financial corporation rate reflects an amount "in lieu" of local personal property and business license taxes that are paid by non-financial corporations, but not by banks or other financial corporations. The financial corporation income tax rate was 10.84% for both 2004 and 2003.

The Bank files a California franchise tax return on a combined reporting basis. Additional income and franchise tax returns are filed on a separate-entity basis in various other states.

The Internal Revenue Service has examined the Bank s tax returns for all tax years through 2002, while state taxing authorities have reviewed tax returns through 2000. 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.

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS

In addition to the other information contained in this report, the following risks may affect us. If any of these risks occur, our business, financial condition or operating results could be adversely affected.

Our California business focus and economic conditions in California could adversely affect our operations.

Downey is headquartered in and its operations are concentrated in California. As a result of this geographic concentration, our results depend largely upon economic and business conditions in this state. Deterioration of economic conditions in California could have a material adverse impact on the quality of our loan and real estate portfolios and the demand for our products and services.

Significant changes in interest rates could adversely affect our performance and results of operations.

If interest rates vary substantially from present levels, our results may differ materially from recent levels. Changes in interest rates will influence the growth of loans, investments, deposits and borrowings and affect the rates received on loans and investment securities and paid on deposits and borrowings. Changes in interest rates also affect the value of our recorded MSRs on loans we service for others, generally increasing in value as interest rates rise and declining as interest rates fall. If interest rates were to increase significantly, the economic feasibility of real estate investment activities also could be adversely affected.

We are subject to government regulation and federal monetary policy that could limit or restrict our activities, which could adversely affect our operations.

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

Competition may adversely affect our performance.

The banking and financial services business in our market areas is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the expectation of continued consolidation among financial services providers. Increasing levels of competition in the banking and financial services businesses may reduce our market share or cause the prices we charge for our products to decline. Our results may differ in future periods depending on the nature or level of competition.

If a significant number of borrowers, guarantors and related parties fail to perform as required by the terms of their loans, we will sustain losses.

A significant source of risk arises from the possibility that losses will be sustained because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans. While we have adopted underwriting and loan quality monitoring systems, procedures and credit policies, including the establishment and review of the allowance for loan losses, such policies and procedures may not prevent unexpected losses that could materially affect our results.

Because Downey operates as a holding company, changes in the ability of the Bank to pay dividends may adversely affect Downey s ability to pay dividends and service its debt.

Although we have been paying regular quarterly dividends to our stockholders and paying interest on our debt, our ability to do so depends to a large extent upon the dividends we receive from the Bank. Dividends paid by the Bank are subject to restrictions under various federal and state banking laws. In addition, the Bank must maintain certain capital levels, which may restrict the ability of the Bank to pay dividends to us. The Bank s regulators have the authority to prohibit the Bank or us from engaging in unsafe or unsound practices in conducting our business. As a consequence, the Bank regulators could deem the payment of dividends by the Bank to be an unsafe or unsound practice, depending on the Bank s financial condition or otherwise, and prohibit such payments. If the Bank were unable to pay dividends to us, we might cease paying debt service and dividends to stockholders until such time that the Bank could again pay us dividends.

ITEM 2. PROPERTIES

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

At December 31, 2004, we had 165 branches throughout California and four in Arizona. We owned the building and land occupied by 61 of our branches, we owned one branch building on leased land and we had one branch under construction. We operate branches in 107 locations (including 93 in-store locations) with leases or licenses expiring at various dates through September 2014, with options to extend the terms.

The net book value of our owned branches, including the one on leased land, totaled $84 million at December 31, 2004, and the net book value of our leased branch offices totaled $3 million at December 31, 2004. The net book value of our furniture and fixtures was $9 million at December 31, 2004. We utilize a mainframe computer system and use various internally developed and third-party vendors software for retail deposit operations, loan servicing, accounting and loan origination functions, including our operations conducted over the Internet. The net book value of our electronic data processing equipment, including personal computers and software, was $10 million at December 31, 2004.

For additional information regarding our offices and equipment, see Note 1 on page 75 and Note 8 on page 90 of Notes to Consolidated Financial Statements.

ITEM 3. LEGAL PROCEEDINGS

On July 23, 2004, two former in-store banking employees brought an action against the Bank in Los Angeles Superior Court, Case No. BC318964, entitled "Michelle Cox and Mary Ann Tierra et al. v. Downey Savings and Loan Association." The complaint seeks unspecified damages for alleged unpaid overtime wages, inadequate meal and rest breaks, and other unlawful business practices and related claims. The plaintiffs also seek class action status to represent all other current and former California employees who held the position of branch manager or assistant manager at in-store branches who (a) were treated as exempt and not paid overtime between July 23, 2000 and November 2002 and (b) allegedly received inadequate meal/rest periods since October 1, 2000. With the Court s approval, the parties have reached an informal agreement to participate in a mediation in March 2005 and to stay the lawsuit, including discovery, until completion of the mediation. Based on a review of the current facts and circumstances with retained counsel, management has provided for what is believed to be a reasonable estimate of the loss exposure for this matter. 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.

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

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

No matters were submitted to stockholders during the fourth quarter of 2004.

PART II

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

Our common stock is traded on the New York Stock Exchange ("NYSE") and the Pacific Exchange ("PCX") under the trading symbol "DSL." At February 28, 2005, we had approximately 933 stockholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 27,853,783 outstanding shares of common stock.

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

	2004				*2003*			
	4th Quarter	*3rd Quarter*	*2nd Quarter*	*1st Quarter*	*4th Quarter*	*3rd Quarter*	*2nd Quarter*	*1st Quarter*
High	$59.34	$56.18	$54.40	$55.27	$50.15	$48.68	$45.25	$41.41
Low	53.10	50.92	47.50	47.50	45.50	40.19	40.15	37.59
End of period	57.00	54.96	53.25	52.90	49.30	46.73	41.30	39.41

During 2004, we paid quarterly cash dividends of $0.10 per share, or $0.40 per share annually, compared to quarterly cash dividends of $0.09 per share, or $0.36 per share annually during 2003. Total cash dividends were $11.2 million in 2004 and $10.1 million in 2003. On February 25, 2005, we paid a $0.10 per share quarterly cash dividend, aggregating $2.8 million.

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

The payment of dividends by the Bank to Downey is subject to OTS regulations. For further information regarding these regulations, see Capital Distribution Limitations on page 14.

On July 24, 2002, the Board of Directors authorized a share repurchase program of up to $50 million of our common stock. To initially fund the program, the Bank paid a special $50 million dividend during the third quarter of 2002 to the holding company. The shares were repurchased from time-to-time in open market transactions. The timing, volume and price of purchases were made at our discretion, and were contingent upon our overall financial condition, as well as market conditions in general. On September 27, 2004, the Board of Directors terminated the stock repurchase authorization due to significant asset growth this year. A total of 420,800 shares of our common stock were repurchased at an aggregate cost of $43.68 per share. During 2004, 39,561 shares of treasury stock were reissued below cost upon the exercise of Downey stock options at an average exercise price of $21.32.

Common stock repurchases were as follows:

		Common Stock		
		Number of Shares	*Average Price*	*Available Repurchases*
Authorized share repurchase program	July 24, 2002	-	$ -	$ 50,000,000
August 2002		212,300	41.04	41,287,128
November 2002		94,000	36.78	37,829,808
August 2004		114,500	54.24	31,619,328
Balance [(a)]		420,800	$ 43.68	$ -

[(a)] *On September 27, 2004, the Board of Directors terminated the stock repurchase authorization.*

ITEM 6. SELECTED FINANCIAL DATA

(Dollars in Thousands, Except Per Share Data)	*2004*	*2003*	*2002*	*2001*	*2000*
Income statement data					
Total interest income	$ 567,710	$ 522,450	$ 633,038	$ 808,381	$ 784,360
Total interest expense	249,823	233,837	318,012	503,183	522,257
Net interest income	317,887	288,613	315,026	305,198	262,103
Provision for (reduction of) loan losses	2,895	(3,718)	939	2,564	3,251
Net interest income after provision for (reduction of) loan losses	314,992	292,331	314,087	302,634	258,852
Other income, net:					
Loan and deposit related fees	60,539	53,076	47,220	50,486	30,089
	13,902	9,835	10,250	3,885	8,798

Real estate and joint ventures held for investment, net					
Secondary marketing activities:					
Loan servicing loss, net	(19,225)	(27,060)	(39,629)	(11,373)	(3,628)
Net gains on sales of loans and mortgage-backed securities	54,443	61,436	45,860	22,432	3,297
Net gains on sales of mortgage servicing rights	616	23	331	934	-
Net losses on trading securities	-	(10,449)	-	-	-
Net gains (losses) on sales of investment securities	(16,103)	8	219	329	(106)
Gain on sale of subsidiary (a)	-	-	-	-	9,762
Litigation award	-	2,851	-	-	-
Loss on extinguishment of debt	(4,111)	-	-	-	-
Other	1,324	1,222	2,803	2,215	2,714
Total other income, net	91,385	90,942	67,054	68,908	50,926
Operating expense:					
General and administrative expense	229,766	207,999	186,644	162,496	136,189
Net operation of real estate acquired in settlement of loans	(256)	(929)	11	239	818
Amortization of excess cost over fair value of branch acquisitions (b)	-	-	-	457	462
Total operating expense	229,510	207,070	186,655	163,192	137,469
Net income (a)	$ 107,662	$ 101,741	$ 112,293	$ 120,181	$ 99,251
Per share data					
Earnings per share Basic (a)	$ 3.86	$ 3.64	$ 3.99	$ 4.26	$ 3.52
Earnings per share Diluted (a)	3.85	3.64	3.99	4.25	3.51
Book value per share at end of period	36.18	32.83	29.47	26.01	22.15
Stock price at end of period	57.00	49.30	39.00	41.25	55.00
Cash dividends paid	0.40	0.36	0.36	0.36	0.36
Selected financial ratios					
Effective interest rate spread	2.34 %	2.61 %	2.91 %	2.91 %	2.65 %

Efficiency ratio [c]	57.52	56.70	50.23	43.93	46.23
Return on average assets [a]	0.77	0.89	1.00	1.11	0.97
Return on average equity [a]	11.37	11.65	14.42	17.81	17.17
Dividend payout ratio	10.38	9.88	9.02	8.45	10.22
Loan activity					
Loans originated	$ 15,399,403	$ 10,548,675	$ 10,445,978	$ 8,128,285	$ 5,217,421
Loans and mortgage-backed securities purchased	305,477	706,949	1,497,645	216,214	19,775
Loans and mortgage-backed securities sold	6,886,502	6,581,856	7,103,861	4,553,944	1,662,600

[a] In 2000, a $5.6 million after-tax gain was recognized from the sale of Downey Auto Finance Corp. Excluding the gain, 2000 net income would have been $93.6 million or $3.33 per share on a basic basis and $3.32 per share on a diluted basis, the return on average assets would have been 0.92% and the return on average equity would have been 16.20%.
[b] During the fourth quarter of 2002, we adopted SFAS 147, which required us to cease the amortization of goodwill as of January 1, 2002.
[c] The amount of general and administrative expense expressed as a percentage of net interest income plus other income, excluding income associated with real estate held for investment, loss on extinguishment of debt and litigation award.

ITEM 6. SELECTED FINANCIAL DATA (CONTINUED)

(Dollars in Thousands, Except Per Share Data)	*2004*	*2003*	*2002*	*2001*	*2000*
Balance sheet summary (end of period)					
Total assets	$ 15,648,808	$ 11,645,980	$ 11,981,878	$ 11,108,757	$ 10,897,590
Loans and mortgage-backed securities	14,542,778	10,396,510	10,976,942	10,132,413	10,084,353
Investments, cash and cash equivalents	616,511	803,514	590,092	551,823	439,968
Deposits	9,657,978	8,293,758	9,238,350	8,619,566	8,082,689
Borrowings	4,757,546	2,253,022	1,747,795	1,646,423	2,102,283
Stockholders equity	1,007,651	917,018	823,104	733,896	624,636
Loans serviced for others	6,672,984	9,313,948	8,316,236	5,805,811	3,964,462
Average balance sheet data					
Assets	$ 13,971,819	$ 11,458,956	$ 11,234,112	$ 10,854,441	$ 10,221,129
Loans	12,791,590	10,445,684	10,336,951	10,033,155	9,514,978
Deposits	9,097,861	8,787,851	8,768,204	8,701,424	7,290,850
Stockholders equity	947,153	873,051	778,463	674,972	577,979
Capital ratios					
Average stockholders equity to average assets	6.78 %	7.62 %	6.93 %	6.22 %	5.65 %
Bank only end of period [a]					
Core and tangible capital	7.09	7.96	6.92	7.10	6.42
Risk-based capital	13.71	15.55	14.08	14.53	12.94

Selected asset quality data (end of period)					
Total non-performing assets	$ 34,189	$ 48,631	$ 79,814	$ 92,632	$ 54,974
Non-performing assets as a percentage of total assets	0.22 %	0.42 %	0.67 %	0.83 %	0.50 %
Allowance for loan losses:					
Amount	$ 34,714	$ 30,330	$ 34,999	$ 36,120	$ 34,452
As a percentage of non-performing loans	109.74 %	70.82 %	51.89 %	46.76 %	76.63 %

[a] *For more information regarding these ratios, see Regulatory Capital Compliance on page 63.*

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

Certain statements under this caption may constitute "forward-looking statements" under the Private Securities Litigation Reform Act of 1995, which involve risks and uncertainties. Forward-looking statements do not relate strictly to historical information or current facts. Some forward-looking statements may be identified by use of terms such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," or words of similar meaning, or future or conditional verbs such as "will," "would," "should," "could" or "may." Our actual results may differ significantly from the results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. For additional information concerning these factors, see Factors That May Affect Future Results Of Operations on page 18.

OVERVIEW

Our net income for 2004 totaled $107.7 million or $3.85 per share on a diluted basis, up 6% from last year s $101.7 million or $3.64 per share. A key contributor to the increase between years was a lower effective tax rate, due to a $5.6 million reduction in current year federal income tax expense associated with the settlement of prior-year tax returns.

Pre-tax income was little changed between years, up $0.7 million, primarily reflecting:

- a $29.3 million or 10% increase in net interest income due to growth in average interest-earning assets;
- a $7.8 million improvement in loan servicing activities;
- a $7.5 million increase in loan and deposit related fees; and
- a $4.1 million increase in income from real estate and joint ventures held for investment due to higher gains from sales.

Those favorable pre-tax items were partially offset by:

- a $21.8 million or 10% increase in general and administrative expense;
- a $7.0 million decline in net gains on sales of loans and mortgage-backed securities due primarily to a lower gain per dollar of loan sold;
- a $6.6 million unfavorable change in our provision for loan losses primarily reflecting growth in our loan portfolio;
- a $5.7 million unfavorable change associated with securities gains/losses, virtually all of which related to a partial economic hedge against value changes of mortgage servicing rights ("MSRs"); and
- a $4.1 million loss on extinguishment of debt, which represented the recognition in 2004 of deferred issuance costs associated with the redemption of $124 million of 10% junior subordinated debentures prior to their maturity and redemption of the related capital securities. This debt was replaced with lower cost senior debt of approximately $75 million more than the amount required to repay the debentures.

For 2004, our return on average assets was 0.77% and our return on average equity was 11.37%. These compare to our 2003 returns of 0.89% on average assets and 11.65% on average equity.

Our loan originations, including purchases, increased from $11.3 billion in 2003 to a record $15.7 billion in 2004, of which $6.8 billion were originated for sale in the secondary market. Of the 2004 total, $8.3 billion represented originations of single family loans for portfolio, of which $828 million were subprime credits. In addition to single family loans, we originated $629 million of other loans during the year, including $528 million of home equity lines of credit.

Our assets increased $4.0 billion or 34% during 2004 to $15.6 billion at year end, following a 3% decline during 2003. The increase was primarily in loans held for investment, as originations outpaced payoffs and the fourth quarter sale of approximately $1 billion of our single family loans on a servicing released basis. The loans sold were seasoned adjustable rate mortgages tied to the 12-month moving average of annual yields on actively traded U.S. Treasury securities adjusted to a constant maturity of one year ("MTA"). Prior to the end of the first quarter of 2005, we expect to replace the MTA loans sold and to meet our previously stated objective of managing balance sheet growth in line with the growth of retained earnings. We expect to replace these MTA loans with higher yielding loans to achieve a breakeven point for lost interest income in the second quarter of 2005 when considering the 2004 fourth quarter gain from this loan sale.

Additionally, in the fourth quarter of 2004, we sold approximately 80% of our MSRs on loans we service for others. Those sales are expected to reduce our earnings volatility, since the amount of MSRs we now own is significantly lower. Given that reduced volatility, we also sold securities that we had purchased as a partial economic hedge against future value changes in our MSRs.

Deposits increased $1.4 billion or 16% during 2004 to a year-end level of $9.7 billion, following a 10% decline during 2003. Borrowings increased $2.5 billion or 111% to a year-end level of $4.8 billion, following a 29% increase in 2003. In June 2004, we issued $200 million 6.5% 10-year senior notes. On July 23, 2004, we used a portion of the net proceeds from the senior notes to redeem, in whole, our 10.0% junior subordinated debentures before maturity at a price of 100% of principal amount plus accrued and unpaid interest and contemporaneously redeemed all the outstanding capital securities and common securities issued by Downey Financial Capital Trust I, a wholly owned special purpose entity. In connection with our redemption of the capital securities, we incurred in the current year a pre-tax charge of $4.1 million. This charge represented the recognition of the remaining unamortized issuance cost for the capital securities. That charge, however, will be offset within a year due to the lower interest rate being paid on the funds that were used to redeem the capital securities. The remaining net proceeds from the senior notes as well as other cash at the holding company was used during the year to make a $117 million equity contribution into Downey Savings and Loan Association, F.A. (the "Bank") to support our asset growth.

Non-performing assets totaled $34 million at December 31, 2004, down from $49 million a year ago. The decrease was due primarily to a decline in our residential non-performers. When measured as a percentage of total assets, our non-performing assets dropped to 0.22% at year-end 2004 from 0.42% at year-end 2003.

At December 31, 2004, the Bank exceeded all regulatory capital tests, with capital-to-asset ratios of 7.09% for both tangible and core capital and 13.71% for risk-based capital. These capital levels are significantly above the "well capitalized" standards defined by the federal banking regulators of 5% for core and tangible capital and 10% for risk-based capital. For further information, see Insurance of Deposit Accounts on page 11, Investments in Real Estate and Joint Ventures on page 40 and Regulatory Capital Compliance on page 63.

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 Note 1 of Notes to the Consolidated Financial Statements beginning on page 75. 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 we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Actual results could differ significantly from these estimates and assumptions which could have a material impact on the carrying value of assets and liabilities at the balance sheet dates and our results of operations for the reporting periods. 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 significant estimates and assumptions, which are particularly susceptible to significant change in the preparation of our financial statements:

- The valuation of expected 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, adjusted by an anticipated fallout factor for interest rate lock commitments that are not expected to fund. At December 31, 2004, an asset was recorded for interest rate lock derivatives of $2 million, compared to the prior year-end asset balance of $0.1 million. For further information, see Interest Rate Lock Derivatives on page 64 and Note 1 on page 75 and Note 23 on page 102 of Notes to the Consolidated Financial Statements.
- The allowance for losses on loans and real estate. The allowance for losses on loans and real estate are maintained at an amount management deems adequate to cover inherent losses in the portfolios. We use an internal asset review system and loan loss allowance methodology designed to provide for the detection of problem assets and an adequate allowance to cover loan losses. In determining the allowance for loan losses related to loans over $5 million, we evaluate the loans on an individual basis, including an analysis of the creditworthiness, cash flows and financial status of the borrower, and the condition and the estimated value of the collateral. Generally, we 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, unless an individual loan or borrower relationship warrants separate analysis. This allowance is determined by applying against asset balances the associated factors for each major asset type that consider past loss experience and asset duration or loss statistics against current classified asset balances. At December 31, 2004, the allowance totaled $36 million, compared to the prior year-end allowances of $32 million. For further information, see Allowance for Losses on Loans and Real Estate on page 55 and Note 1 of Notes to the Consolidated Financial Statements on page 75.
- The valuation of MSRs. The fair value of MSRs is measured using a discounted cash flow analysis based on available market quotes, market-adjusted discount rates and anticipated prepayment speeds. 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. We capitalize and measure MSR impairment on a disaggregated basis based on predominant risk characteristics of the underlying mortgage loans, which include fixed-rate mortgage loans by loan term and coupon rate (less than 7%, 150 basis point increments between 7% and 10%, and greater than 10%) and adjustable rate mortgages by loan term. 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). At December 31, 2004, the MSR valuation allowance totaled $3 million, compared to the prior year-end allowance of $13 million. For further information, see Note 1 on page 75 and Note 11 on page 91 of Notes to the Consolidated Financial Statements.
- The prepayment reserves related to sales of loans and of MSRs. 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 s 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. At December 31, 2004, the reserves were $7 million, compared to reserves of less than $1 million at December 31, 2003. For further information, see Secondary Marketing Activities on page 31, Note 1 on page 75 and Note 11 on page 91 of Notes to the Consolidated Financial Statements.

RESULTS OF OPERATIONS

Net Interest Income

Net interest income is the difference between the interest and dividends earned on loans, mortgage-backed securities and investment securities ("interest-earning assets") and the interest paid on deposits 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 $317.9 million in 2004, up $29.3 million or 10.1% from 2003 and $2.9 million or 0.9% from 2002. The improvement during 2004 reflected higher average interest-earning assets which increased by $2.5 billion or 22.7% to $13.6 billion. Our effective interest rate spread averaged 2.34% in 2004, down from 2.61% in 2003 and 2.91% in 2002. The decline in 2004 was due to our yield on interest-earning assets declining more rapidly than our cost of funds. Although the market indices to which our adjustable rate loans are tied began to rise in mid-2004, on average they were lower in 2004 than 2003. Lower indices along with our positive interest rate gap (i.e., more interest-earning assets reprice to market interest rates within one year than do interest-bearing liabilities) were the primary contributors to our more rapid decline in our yield on interest-earning assets. In addition, the decline in our effective interest rate spread also reflected a higher proportion of lower yielding adjustable rate mortgages tied to MTA that had lower fully-indexed yields than those tied to the FHLB Eleventh District Cost of Funds Index ("COFI") and a lower percentage of higher yielding subprime loans. During the fourth quarter of 2004, we sold approximately $1 billion of MTA loans. While the sale temporarily results in assets growing more slowly than growth in retained earnings, we expect asset growth to be more in line with the growth in retained earnings and we expect to replace the MTA loans that were sold by the end of the first quarter of 2005. Initially, the sale will reduce net interest income until the loans are replaced. However, it is expected a breakeven point for the lost net interest income will occur by mid-year 2005, when considering the gain from this sale. After mid-2005, overall profits should be enhanced from the higher yielding loans.

The following table presents for the years 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 year.

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 years 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 year using the average of each month s daily average balance during the years indicated.

	2004			*2003*			*2002*		
llars in Thousands)	*Average Balance*	*Interest*	*Average Yield/ Rate*	*Average Balance*	*Interest*	*Average Yield/ Rate*	*Average Balance*	*Interest*	*Average Yield/ Rate*
erest-earning assets:									
ans	$ 12,791,590	$ 540,138	4.22 %	$ 10,445,684	$ 504,480	4.83 %	$ 10,336,951	$ 612,762	5.93 %
ortgage-backed securities	322	12	3.73	1,714	61	3.56	76,250	3,637	4.77
vestment and trading curities [(a)]	770,190	27,560	3.58	608,256	17,909	2.94	420,142	16,639	3.96
otal interest-earning assets	13,562,102	567,710	4.19	11,055,654	522,450	4.73	10,833,343	633,038	5.84
n-interest-earning assets	409,717			403,302			400,769		
tal assets	$ 13,971,819			$ 11,458,956			$ 11,234,112		
nsaction accounts:									
on-interest-bearing checking	$ 503,432	$ -	- %	$ 415,995	$ -	- %	$ 306,890	$ -	- %
erest-bearing checking [(b)]	537,295	2,007	0.37	446,582	1,164	0.26	421,590	1,391	0.33
oney market	146,806	1,539	1.05	131,134	1,485	1.13	113,862	1,929	1.69

egular passbook	3,528,345	38,458	1.09	3,958,567	53,109	1.34	3,042,839	69,113	2.27
otal transaction accounts	4,715,878	42,004	0.89	4,952,278	55,758	1.13	3,885,181	72,433	1.86
tificates of deposit	4,381,983	110,254	2.52	3,835,573	106,067	2.77	4,883,023	172,108	3.52
tal deposits	9,097,861	152,258	1.67	8,787,851	161,825	1.84	8,768,204	244,541	2.79
LB advances and other rowings [(c)]	3,555,454	83,651	2.35	1,492,034	59,477	3.99	1,410,762	60,936	4.32
nior notes and junior ordinated bentures [(d)]	172,571	13,914	8.06	123,711	12,535	10.13	123,711	12,535	10.13
tal deposits and borrowings	12,825,886	249,823	1.95	10,403,596	233,837	2.25	10,302,677	318,012	3.09
er liabilities	198,780			182,309			152,972		
ckholders equity	947,153			873,051			778,463		
tal liabilities and ockholders equity	$ 13,971,819			$ 11,458,956			$ 11,234,112		
interest income/interest e spread		$ 317,887	2.24 %		$ 288,613	2.48 %		$ 315,026	2.75 %
cess of interest-earning ets over posits and borrowings	$ 736,216			$ 652,058			$ 530,666		
ective interest rate spread			2.34			2.61			2.91

[(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)] Starting in the first quarter of 2004, the impact of interest rate swap contracts was included, 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.
[(d)] In June 2004, we issued $200 million of 6.5% 10-year senior notes. In July 2004, we redeemed our junior subordinated debentures before their maturity.

 Navigation Links

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 years 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 annual average balances computed using the average of each month s daily average balance during the years indicated.

2004 Versus 2003	*2003 Versus 2002*
Changes Due To	*Changes Due To*

(In Thousands)	Volume	Rate	Rate/ Volume	Net	Volume	Rate	Rate/ Volume	Net
Interest income:								
Loans	$ 113,297	$ (63,400)	$ (14,239)	$ 35,658	$ 6,446	$ (113,534)	$ (1,194)	$ (108,282)
Mortgage-backed securities	(50)	3	(2)	(49)	(3,556)	(923)	903	(3,576)
Investment and trading securities	4,768	3,856	1,027	9,651	7,450	(4,269)	(1,911)	1,270
Change in interest income	118,015	(59,541)	(13,214)	45,260	10,340	(118,726)	(2,202)	(110,588)
Interest expense:								
Transaction accounts:								
Interest-bearing checking	236	505	102	843	82	(292)	(17)	(227)
Money market	177	(110)	(13)	54	293	(640)	(97)	(444)
Regular passbook	(5,772)	(9,962)	1,083	(14,651)	20,798	(28,289)	(8,513)	(16,004)
Total transaction accounts	(5,359)	(9,567)	1,172	(13,754)	21,173	(29,221)	(8,627)	(16,675)
Certificates of deposit	15,110	(9,561)	(1,362)	4,187	(36,919)	(37,075)	7,953	(66,041)
Total interest-bearing deposits	9,751	(19,128)	(190)	(9,567)	(15,746)	(66,296)	(674)	(82,716)
FHLB advances and other borrowings	82,137	(24,193)	(33,770)	24,174	3,403	(4,770)	(92)	(1,459)
Senior notes and junior subordinated debentures	4,954	(2,563)	(1,012)	1,379	-	-	-	-