DOWNEY FINANCIAL CORP
Form 10-Q
May 01, 2002

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2002

OR

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

Commission File Number 1-13578
DOWNEY FINANCIAL CORP.
(Exact name of registrant as specified in its charter)

DELAWARE	33-0633413
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3501 JAMBOREE ROAD, NEWPORT BEACH, CA	92660
(Address of principal executive office	(Zip Code)

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

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

Title of each class	Name of each exchange on which registered
COMMON STOCK, $0.01 PAR VALUE	NEW YORK STOCK EXCHANGE PACIFIC EXCHANGE

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

NONE

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

At March 31, 2002, 28,213,048 shares of the Registrant's Common Stock, $0.01 par value were outstanding.

DOWNEY FINANCIAL CORP.

MARCH 31, 2002 QUARTERLY REPORT ON FORM 10-Q

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PART I - FINANCIAL INFORMATION

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Balance Sheets

(Dollars in Thousands, Except Per Share Data)	March 31, 2002
ASSETS	
Cash	$ 120,000
Federal funds	28,800
Cash and cash equivalents	148,800
U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value	248,322
Municipal securities held to maturity, at amortized cost (estimated fair value of $6,373 at March 31, 2002 and December 31, 2001 and $6,534 at March 31, 2001)	6,388
Mortgage loans purchased under resale agreements	10,000
Loans held for sale, at lower of cost or fair value	388,468
Mortgage-backed securities available for sale, at fair value	90,803

Loans receivable held for investment	9,608,842
Investments in real estate and joint ventures	26,384
Real estate acquired in settlement of loans	11,917
Premises and equipment	111,465
Federal Home Loan Bank stock, at cost	114,842
Mortgage servicing rights, net	68,581
Other assets	78,189
	$ 10,913,001
LIABILITIES AND STOCKHOLDERS' EQUITY	
Deposits	$ 8,598,890
Federal Home Loan Bank advances	1,320,386
Other borrowings	--
Accounts payable and accrued liabilities	62,282
Deferred income taxes	43,821
Total liabilities	10,025,379
Company obligated mandatorily redeemable capital securities of subsidiary trust holding solely junior subordinated debentures of the Company ("Capital Securities")	120,000
STOCKHOLDERS' EQUITY	
Preferred stock, par value of $0.01 per share; authorized 5,000,000 shares; outstanding none	--
Common stock, par value of $0.01 per share; authorized 50,000,000 shares; outstanding 28,213,048 shares at March 31, 2002 and December 31, 2001 and 28,211,048 shares at March 31, 2001	282
Additional paid-in capital	93,400
Accumulated other comprehensive income (loss)	(1,288)
Retained earnings	675,228
Total stockholders' equity	767,622
	$ 10,913,001

See accompanying notes to consolidated financial statements.

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DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Income

	Three Months Ended March 31,	
(Dollars in Thousands, Except Per Share Data)	2002	200
INTEREST INCOME		
Loans receivable	$160,277	$212,
U.S. Treasury securities and agency obligations	3,033	4,
Mortgage-backed securities	1,274	
Other investments	1,814	2,

Total interest income	166,398	219,
INTEREST EXPENSE		
Deposits	68,359	114,
Borrowings	15,053	25,
Capital securities	3,041	3,
Total interest expense	86,453	143,
NET INTEREST INCOME	79,945	76,
PROVISION FOR LOAN LOSSES	1,447	
Net interest income after provision for loan losses	78,498	76,
OTHER INCOME, NET		
Loan and deposit related fees	11,518	10,
Real estate and joint ventures held for investment, net	2,997	1,
Secondary marketing activities:		
Loan servicing loss, net	(588)	(8,
Net gains on sales of loans and mortgage-backed securities	16,201	2,
Net gains on sales of mortgage servicing rights	294	-
Net gains on sales of investment securities	190	
Other	741	
Total other income, net	31,353	6,
OPERATING EXPENSE		
Salaries and related costs	29,437	23,
Premises and equipment costs	7,133	6,
Advertising expense	1,044	1,
Professional fees	564	
SAIF insurance premiums and regulatory assessments	786	
Other general and administrative expense	6,211	5,
Total general and administrative expense	45,175	37,
Net operation of real estate acquired in settlement of loans	(58)	
Amortization of excess of cost over fair value of branch acquisitions	111	
Total operating expense	45,228	37,
INCOME BEFORE INCOME TAXES	64,623	44,
Income taxes	27,309	19,
NET INCOME	$ 37,314	$ 25,
PER SHARE INFORMATION		
BASIC	$ 1.32	$ 0
DILUTED	$ 1.32	$ 0
CASH DIVIDENDS DECLARED AND PAID	$ 0.09	$ 0
Weighted average diluted shares outstanding	28,271,172	28,275,

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(In Thousands)	Three Months Ende March 31, 2002	200
Net income	$ 37,314	$ 25,8
OTHER COMPREHENSIVE INCOME (LOSS), NET OF INCOME TAXES (BENEFITS)		
Unrealized gains (losses) on securities available for sale:		
U.S. Treasury securities, agency obligations and other investment securities available for sale, at fair value	(1,356)	6
Mortgage-backed securities available for sale, at fair value	(938)	
Less reclassification of realized gains included in net income	(110)	(
Unrealized losses on cash flow hedges:		
Net derivative instruments	(517)	(1,3
Less reclassification of realized losses included in net income	1,872	1,1
Total other comprehensive income (loss), net of income taxes (benefits)	(1,049)	4
COMPREHENSIVE INCOME	$ 36,265	$ 26,3

See accompanying notes to consolidated financial statements.

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DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(In Thousands)	2
CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	$
Adjustments to reconcile net income to net cash used for operating activities:	
Depreciation and amortization	
Provision for losses on loans, real estate acquired in settlement of loans, investments in real estate and joint ventures, mortgage servicing rights and other assets	
Net gains on sales of loans and mortgage-backed securities, mortgage servicing rights, investment securities, real estate and other assets	(
Net change in interest capitalized on loans (negative amortization)	
Federal Home Loan Bank stock dividends	
Loans originated for sale	(1,2
Proceeds from sales of loans held for sale, including those sold	

via mortgage-backed securities	1,3
Other, net	(
Net cash provided by (used for) operating activities	1
CASH FLOWS FROM INVESTING ACTIVITIES	
Proceeds from sales of:	
U.S. Treasury securities, agency obligations and other investment securities available for sale	
Wholly owned real estate and real estate acquired in settlement of loans	
Proceeds from maturities of U.S. Treasury securities, agency obligations and other investment securities available for sale	1
Purchase of:	
U.S. Treasury securities, agency obligations and other investment securities available for sale	(
Mortgage loans under resale agreements	(
Loans receivable held for investment	
Premises and equipment	
Originations of loans receivable held for investment (net of refinances of $183,227 at March 31, 2002 and $146,113 at March 31, 2001)	(8
Principal payments on loans receivable held for investment and mortgage-backed securities available for sale	7
Net change in undisbursed loan funds	
Proceeds from (investments in) real estate held for investment	
Other, net	
Net cash provided by investing activities	

See accompanying notes to consolidated financial statements.

DOWNEY FINANCIAL CORP. AND SUBSIDIARIES

Consolidated Statements of Cash Flows (Continued)

	Three Month March	
(In Thousands)	2002	
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase (decrease) in deposits	$ (20,676)	$
Proceeds from Federal Home Loan Bank advances	1,316,200	
Repayments of Federal Home Loan Bank advances	(1,518,519)	
Net decrease in other borrowings	(7)	
Proceeds from exercise of stock options	--	
Cash dividends	(2,539)	
Net cash provided by (used for) financing activities	(225,541)	
Net increase (decrease) in cash and cash equivalents	5,720	
Cash and cash equivalents at beginning of period	143,080	
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 148,800	$

Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	$ 82,061	$
Income taxes	5,202	
Supplemental disclosure of non-cash investing:		
Loans transferred to held for investment from held for sale	614	
Loans exchanged for mortgage-backed securities	1,225,243	
Real estate acquired in settlement of loans	4,903	
Loans to facilitate the sale of real estate acquired in settlement of loans	4,336	

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE (1) - BASIS OF FINANCIAL STATEMENT PRESENTATION

In the opinion of Downey Financial Corp. and subsidiaries ("Downey," "we," "us" and "our"), the accompanying consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary for a fair presentation of Downey's financial condition as of March 31, 2002, December 31, 2001 and March 31, 2001 and the results of operations, comprehensive income, and changes in cash flows for the three months ended March 31, 2002 and 2001. Certain prior period amounts have been reclassified to conform to the current period presentation.

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial statements and are in compliance with the instructions for Form 10-Q and therefore do not include all information and footnotes necessary for a fair presentation of financial condition, results of operations, comprehensive income and cash flows. The following information under the heading Management's Discussion and Analysis of Financial Condition and Results of Operations is written with the presumption that the interim consolidated financial statements will be read in conjunction with Downey's Annual Report on Form 10-K for the year ended December 31, 2001, which contains among other things, a description of the business, the latest audited consolidated financial statements and notes thereto, together with Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2001 and for the year then ended. Therefore, only material changes in financial condition and results of operations are discussed in the remainder of Part I.

NOTE (2) - EARNINGS PER SHARE

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

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

	Three Months Ended March			
	2002			
(Dollars in Thousands, Except Per Share Data)	Net Income	Weighted Average Shares Outstanding	Per Share Amount	Net Income
Basic earnings per share	$37,314	28,213,048	$1.32	$25,864
Effect of dilutive stock options	--	58,124	--	--
Diluted earnings per share	$37,314	28,271,172	$1.32	$25,864

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NOTE (3) - BUSINESS SEGMENT REPORTING

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

(In Thousands)	Banking	Real Estate Investment	Elimination
THREE MONTHS ENDED MARCH 31, 2002			
Net interest income	$ 79,940	$ 5	$ --
Provision for loan losses	1,447	--	--
Other income	28,062	3,291	--
Operating expense	45,006	222	--
Net intercompany income (expense)	93	(93)	--
Income before income taxes	61,642	2,981	--
Income taxes	26,085	1,224	--
Net income	$ 35,557	$ 1,757	$ --
AT MARCH 31, 2002			
Assets:			
Loans and mortgage-backed securities	$10,088,113	$ --	$ --
Investments in real estate and joint ventures	--	26,384	--
Other	819,407	4,060	(24,963)
Total assets	10,907,520	30,444	(24,963)
Equity	$ 767,622	$ 24,963	$ (24,963)
THREE MONTHS ENDED MARCH 31, 2001			
Net interest income	$ 76,134	$ 28	$ --
Provision for loan losses	52	--	--
Other income	4,745	1,268	--
Operating expense	36,990	260	--
Net intercompany income (expense)	97	(97)	--

Income before income taxes	43,934	939	--
Income taxes	18,625	384	--
Net income	$ 25,309	$ 555	$ --
AT MARCH 31, 2001			
Assets:			
Loans and mortgage-backed securities	$10,272,222	$ --	$ --
Investments in real estate and joint ventures	--	18,690	--
Other	755,324	3,337	(18,471)
Total assets	11,027,546	22,027	(18,471)
Equity	$ 648,592	$ 18,471	$ (18,471)

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NOTE (4) - MORTGAGE SERVICING RIGHTS

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

	Three Month		
(Dollars in Thousands)	March 31, 2002	December 31, 2001	September 2001
Gross balance at beginning of period	$ 65,630	$ 61,651	$ 55,84
Additions	14,997	15,300	10,29
Amortization	(2,916)	(2,956)	(2,49
Sales of mortgage servicing rights	(35)	(4,916)	(58
Impairment write-down	(2,762)	(3,449)	(1,41
Gross balance at end of period	74,914	65,630	61,65
Allowance balance at beginning of period	8,735	24,144	13,70
Provision for (reduction of) impairment	360	(11,960)	11,85
Impairment write-down	(2,762)	(3,449)	(1,41
Allowance balance at end of period	6,333	8,735	24,14
Total mortgage servicing rights, net	$ 68,581	$ 56,895	$ 37,50
Estimated fair value (1)	$ 70,532	$ 58,047	$ 37,50
Weighted average expected life (in months)	87	82	5
Custodial account earnings rate	4.61%	4.36%	2.8
Weighted average discount rate	9.13	9.16	9.2
AT PERIOD END			
Mortgage loans serviced for others:			
Total	$ 6,408,812	$ 5,805,811	$ 5,458,97
With capitalized mortgage servicing rights (1):			
Amount	6,196,137	5,379,513	5,078,08

Weighted average interest rate	6.85%	6.97%	7.1
Custodial escrow balances	$ 6,103	$ 10,596	$ 15,41

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

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

(Dollars in Thousands)	Expected Prepayment Speeds	Value of Custodial Accounts	Discount Rate	Combinatio
Increase rates 100 basis points:				
Fair value (1)	$ 13,269	$ 4,010	$ (2,389)	$ 13,920
Reduction of (increase in) valuation allowance ...	5,363	1,465	(909)	5,480
Decrease rates 100 basis points:				
Fair value (2)	(17,660)	(4,010)	2,541	(20,312
Reduction of (increase in) valuation allowance ...	(15,711)	(2,184)	728	(18,362

The components of loan servicing income (loss) included in Downey's results of operations are summarized as follows:

Three Months Ended			
March 31,	December 31,	September 30,	June 30,

(In Thousands)	2002	2001	2001	2001
Income from servicing operations	$ 2,688	$ 2,477	$ 2,576	$ 1,752
Amortization of MSRs	(2,916)	(2,956)	(2,495)	(2,299)
(Provision for) reduction of impairment ...	(360)	11,960	(11,852)	(2,351)
Total loan servicing income (loss), net	$ (588)	$ 11,481	$(11,771)	$ (2,898)

NOTE (5) - ACCOUNTING FOR DERIVATIVES AND HEDGING ACTIVITIES

Derivatives

We offer short-term interest rate lock commitments to help us attract potential home loan borrowers. The commitments guarantee a specified interest rate for a loan if our underwriting standards are met, but do not obligate the potential borrower. The residential one-to-four unit interest rate lock commitments we ultimately expect to sell in the secondary market are treated as derivatives. Consequently, as derivatives, the hedging of the expected rate lock commitments do not qualify for hedge accounting. Associated fair value adjustments are recorded in current earnings under net gains on sales of loans and mortgage-backed securities with an offset to the balance sheet in either other assets, or accounts payable and accrued liabilities. Fair values for interest rate lock commitments are based on observable market prices acquired from third parties. The carrying amount of loans held for sale includes a basis adjustment to the loan at funding resulting from the change in the fair value of the interest rate lock derivative from the date of commitment to the date of funding. At March 31, 2002, we had rate lock commitments estimated to sell as part of our secondary marketing activities of $235 million, with an estimated fair value of $236 million, including a $2.7 million gain associated with mortgage servicing rights.

Hedging Activities

As part of our secondary marketing activities, we typically utilize short-term forward sale and purchase contracts--derivatives--that mature in less than one year to offset the impact of changes in market interest rates on the value of our residential one-to-four unit interest rate lock commitments and loans held for sale. We do not generally enter into derivative transactions for purely speculative purposes. Contracts designated to loans held for sale are accounted for as cash flow hedges because these contracts have a high correlation to the price movement of the loans being hedged (within a range of 80% - 125%). The measurement approach for determining the ineffective aspects of the hedge is established at the inception of the hedge. Changes in forward sale contract values not designated to loans held for sale and the ineffectiveness of hedge transactions that are not perfectly correlated are recorded in net gains on sales of loans and mortgage-backed securities. Changes in forward sale contract values designated as cash flow hedges for loans held for sale are recorded in other comprehensive income, net of tax, provided cash flow hedge requirements are met. The offset to these changes in forward

sale contract values are recorded in the balance sheet as either other assets, or accounts payable and accrued liabilities. The amounts recorded in accumulated other comprehensive income will be recognized in the income statement when the hedged forecasted transactions settle. We estimate that all of the related unrealized gains or losses in accumulated other comprehensive income will be reclassified into earnings within the next three months. Fair values for forward sale contracts are based on observable market prices acquired from third parties. At March 31, 2002, forward sale contracts amounted to $623 million, with an estimated fair value of $628 million, of which $392 million were designated as cash flow hedges, and there were no forward purchase contracts.

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

The following table contains the amount of expected rate lock commitment derivatives for loans originated for sale, loans held for sale and the notional amounts for their associated hedging derivatives (i.e., forward sale contracts). Also shown is the impact from non-qualifying hedges and the ineffectiveness of cash flow hedges on net gains (losses) on sales of loans and mortgage-backed securities (i.e., SFAS 133 effect), as well as the impact to other comprehensive income (loss) from qualifying cash flow transactions.

(In Thousands)	March 31, 2002	December 31, 2001	September 30, 2001
AT PERIOD END			
Non-qualifying hedge transactions:			
Expected rate lock commitments	$ 235,099	$ 269,315	$ 422,606
Associated forward sale contracts	230,660	278,319	404,177
Qualifying cash flow hedge transactions:			
Loans held for sale, at lower of cost or fair value	388,468	499,024	373,489
Associated forward sale contracts	392,099	508,706	369,335
THREE MONTHS ENDED			
Net gains (losses) on non-qualifying hedge transactions	$ 4,864	$ (3,834)	$ (1,149)
Net gains (losses) on qualifying cash flow hedge transactions:			
Unrealized hedge ineffectiveness	--	--	(27)
Less reclassification of realized hedge ineffectiveness	--	--	27
Total net gains (losses) recognized in sales of loans and mortgage-backed securities (SFAS 133 effect)	4,864	(3,834)	(1,149)
Other comprehensive income (loss)	1,355	501	(2,477)

NOTE (6) - INCOME TAXES

Downey and its wholly owned subsidiaries file a consolidated federal income tax return and various state income and franchise tax returns on a calendar year basis. The Internal Revenue Service and state taxing authorities have examined Downey's tax returns for all tax years through 1995 and are currently reviewing returns filed for the 1996 and 1997 tax years. Tax years subsequent to 1997 remain open to review by federal and state tax authorities. Downey's management believes it has adequately provided for potential exposure with regard to issues that may be raised in the years currently under examination and open to review.

NOTE (7) - CURRENT ACCOUNTING ISSUES

Statement of Financial Accounting Standards No. 142. SFAS 142 applies to all acquired intangible assets whether acquired singularly, as part of a group, or in a business combination. The Statement supersedes APB Opinion No. 17, "Intangible Assets," and carries forward provisions in Opinion 17 related to internally developed intangible assets. The Statement changes the accounting for goodwill from an amortization method to an impairment-only approach. Goodwill should no longer be amortized, but instead tested for impairment at least annually at the reporting unit level. The accounting provisions are effective for fiscal years beginning after December 31, 2001. Our intangible assets and goodwill are related to branch acquisitions and not within the scope of SFAS 142. However, this may change as the Financial Accounting Standards Board is currently reconsidering the exclusion of amortization of goodwill related to branch acquisitions and is expected to issue a final Statement in the fourth quarter of 2002. We recognized an unidentified intangible asset for branch acquisitions because the fair value of the liabilities assumed exceeded the fair value of the assets acquired. For the first quarter of 2002, our amortization of excess of cost over fair value of branch acquisitions was $0.1 million and as of March 31, 2002, this asset totaled $3.0 million.

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

Statement of Financial Accounting Standards No. 144. Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"), addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This Statement supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of," and the accounting and reporting provisions of APB Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions," for the disposal of a segment of a business. This Statement also eliminates the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of this Statement are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The provisions of this Statement generally are to be applied prospectively. It is anticipated that the financial impact of this Statement will not have a material effect on Downey.

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

Certain statements under this caption may constitute "forward-looking statements" under the Private Securities Litigation Reform Act of 1995 which involve risks and uncertainties. Our actual results may differ significantly from the results discussed in such forward-looking statements. Factors that might cause such a difference include, but are not limited to, economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation.

OVERVIEW

Our net income for the first quarter of 2002 totaled $37.3 million or $1.32 per share on a diluted basis, up 44.3% from the $25.9 million or $0.91 per share in the year-ago first quarter.

The increase in net income between first quarters was due to higher net income from both of our business segments as follows:

- Banking operations contributed $10.2 million to the increase in net income reflecting:
  - a $14.3 million increase in net gains from sales of loans and mortgage-backed securities, and mortgage servicing rights;
  - a $7.6 million improvement in our loan servicing activity primarily due to a smaller addition to the valuation allowance for mortgage servicing rights;
  - a $3.8 million increase in net interest income due to an increase in our effective interest rate spread; and
  - a $1.3 million increase in loan and deposit related fees.

  Those favorable items were partially offset by:

  - an $8.0 million increase in operating expenses reflecting an increased number of branch locations and higher loan origination activity; and
  - a $1.4 million increase in provision for loan losses.
- Real estate investment activities contributed $1.2 million to the increase in net income reflecting:
  - a recapture of $1.3 million of a previously established valuation allowance; and
  - an increase of $0.3 million in net gains to a total of $0.6 million.

In addition to higher net income, our key performance measures also improved between first quarters as follows:

- our efficiency ratio (the percentage of our net interest income and other income, excluding income from real estate investment activities and investment securities gains or losses, used to cover our general and administrative expense) improved from 45.8% to 41.8%;
- our return on average assets improved from 0.94% to 1.36%; and
- our return on average equity improved from 16.28% to 19.96%.

Our single family loan originations totaled $2.259 billion in the first quarter of 2002, up 57.1% from the $1.438 billion we originated in the first quarter of 2001 but down 9.6% from the record $2.500 billion we originated in the previous quarter. Of the current quarter total, $992 million represented originations of loans for portfolio, of which $107 million represented subprime credits. In addition to single family loans, we originated $46 million of other loans in the quarter.

At quarter-end, our assets totaled $10.9 billion and our deposits totaled $8.6 billion, both of which were down slightly from a year ago. During the quarter, six new in-store branches and one new traditional branch were opened, bringing our total branches at quarter end to 144, of which 74 are in-store. A year ago, branches totaled 121, of which 56 were in-store.

Our non-performing assets increased $1 million during the quarter to $94 million or 0.86% of total assets. This increase was due to a rise in commercial real estate non-accrual loans of $2 million due primarily to a shopping center loan whose principal tenant declared bankruptcy during the quarter and ceased paying rent.

At March 31, 2002, our primary subsidiary, Downey Savings and Loan Association, F.A. (the "Bank") exceeded all regulatory capital tests, with capital-to-asset ratios of 7.61% for both tangible and core capital and 15.39% 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.

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

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

- Allowance for losses on loans and real estate. For further information, see Financial Condition--Problem Loans and Real Estate--Allowance for Losses on Loans and Real Estate on page 31.

- Allowance for mortgage servicing rights. For further information, see Note 4 on page 8 of Notes to Consolidated Financial Statements.

RESULTS OF OPERATIONS

NET INTEREST INCOME

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

Our net interest income totaled $79.9 million in the first quarter of 2002, up $3.8 million or 5.0% from the same period last year. The improvement between first quarters reflected an increase in our effective interest rate spread, which averaged 3.03% compared to 2.87% a year ago. The improvement between first quarters was due to our cost of funds declining more rapidly than our yield on earning assets. This is indicative of what typically happens when interest rates decline, as there is an administrative lag in the repricing of our loans which are primarily priced to the Federal Home Loan Bank ("FHLB") Eleventh District Cost of Funds Index ("COFI"). Our earning assets averaged $10.5 billion during the quarter, slightly below the year-ago level.

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

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

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

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

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

	Three Months Ended					
	March 31, 2002			December 31, 2001		
(Dollars in Thousands)	Average Balance	Interest	Average Yield/ Rate	Average Balance	Interest	Aver Yie Ra
Interest-earning assets:						
Loans	$ 9,973,808	$160,277	6.43%	$10,000,631	$178,335	7.
Mortgage-backed securities	106,375	1,274	4.79	36,623	449	4.
Investment securities	464,447	4,847	4.23	420,718	4,700	4.

Total interest-earning assets	10,544,630	166,398	6.31	10,457,972	183,484	7.
Non-interest-earning assets	398,488			370,537		
Total assets	$10,943,118			$10,828,509		
Transaction accounts:						
Non-interest-bearing checking .	$ 285,156	$ --	-- %	$ 354,231	$ --	--
Interest-bearing checking (1) .	425,162	413	0.39	414,470	424	0.
Money market	110,715	507	1.86	103,247	533	2.
Regular passbook	2,442,994	15,394	2.56	1,646,412	11,184	2.
Total transaction accounts ..	3,264,027	16,314	2.03	2,518,360	12,141	1.
Certificates of deposit	5,259,181	52,045	4.01	6,214,429	76,494	4.
Total deposits	8,523,208	68,359	3.25	8,732,789	88,635	4.
Borrowings	1,425,878	15,053	4.28	1,114,446	12,093	4.
Capital securities	120,000	3,041	10.14	120,000	3,041	10.
Total deposits, borrowings and capital securities	10,069,086	86,453	3.48	9,967,235	103,769	4.
Other liabilities	126,079			150,070		
Stockholders' equity	747,953			711,204		
Total liabilities and stockholders' equity	$10,943,118			$10,828,509		
Net interest income/interest rate spread		$ 79,945	2.83%		$ 79,715	2.
Excess of interest-earning assets over deposits, borrowings and capital securities	$ 475,544			$ 490,737		
Effective interest rate spread			3.03			3.

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

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

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

	Three Months Ended			
	March 31, 2002 Versus March 31, 2001 Changes Due To			
(In Thousands)	Volume	Rate	Rate/ Volume	Net
Interest income:				
Loans	$ (4,329)	$(49,156)	$ 1,000	$(52,485)
Mortgage-backed securities	1,626	(35)	(445)	1,146
Investment securities	549	(2,578)	(200)	(2,229)
Change in interest income	(2,154)	(51,769)	355	(53,568)
Interest expense:				
Transaction accounts:				
Interest-bearing checking (1) .	46	(248)	(18)	(220)
Money market	150	(217)	(52)	(119)
Regular passbook	14,045	(1,594)	(3,484)	8,967
Total transaction accounts ..	14,241	(2,059)	(3,554)	8,628
Certificates of deposit	(25,159)	(39,093)	9,182	(55,070)
Total interest-bearing deposits	(10,918)	(41,152)	5,628	(46,442)
Borrowings	(4,406)	(7,180)	677	(10,909)
Capital securities	--	--	--	--
Change in interest expense	(15,324)	(48,332)	6,305	(57,351)
Change in net interest income	$ 13,170	$ (3,437)	$ (5,950)	$ 3,783

PROVISION FOR LOAN LOSSES

Provision for loan losses was $1.4 million in the current quarter, up from $0.1 million in the first quarter of 2001. For further information regarding our allowance for loan losses, see Financial Condition--Problem Loans and Real Estate--Allowance for Losses on Loans and Real Estate on page 31.

OTHER INCOME

Our total other income was $31.4 million in the first quarter of 2002, up $25.3 million from a year ago reflecting:

- a $14.3 million increase in net gains on sales of loans and mortgage-backed securities, and mortgage servicing rights;
- a $7.6 million improvement in our loan servicing activity primarily due to a smaller addition to the valuation allowance for mortgage servicing rights;
- a $2.0 million increase from real estate held for investment due primarily to sales activity; and
- a $1.3 million increase in loan and deposit related fees.

LOAN AND DEPOSIT RELATED FEES

Loan and deposit related fees totaled $11.5 million in the first quarter of 2002, up $1.3 million from a year ago. Our deposit related fees increased by $0.7 million or 18.8%, primarily due to higher fees from our checking accounts. Our loan related fees accounted for $0.6 million of the increase between first quarters, of which $0.2 million represented higher loan prepayment fees.

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

(In Thousands)	Three Months Ended March 31, 2002	December 31, 2001	September 30, 2001	June 30, 2001
Loan related fees:				
Prepayment fees	$ 4,686	$ 5,475	$ 6,384	$ 7,455
Other fees	2,167	2,477	2,257	2,251
Deposit related fees:				
Automated teller machine fees	1,543	1,670	1,671	1,650
Other fees	3,122	3,224	2,962	2,780
Total loan and deposit related fees	$11,518	$12,846	$13,274	$14,136

REAL ESTATE AND JOINT VENTURES HELD FOR INVESTMENT

Income from our real estate and joint ventures held for investment totaled $3.0 million in the first quarter of 2002, up from $1.0 million a year ago. The $2.0 million increase in our income from real estate held for investment was due primarily to sales activity. Sales in the first quarter of 2002 resulted in the recapture of $1.3 million of a previously established valuation allowance and an increase of $0.3 million in net gains to a total of $0.6 million. Those gains primarily relate to joint venture projects and are reported in the category of equity in net income from joint ventures.

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

(In Thousands)	Three Months Ended March 31, 2002	December 31, 2001	September 30, 2001	Jun 2
Rental operations, net of expenses	$ 823	$ 1,026	$ 259	$
Equity in net income from joint ventures	745	212	12	
Interest from joint venture advances	111	83	101	
Net gains on sales of wholly owned real estate	--	127	--	
(Provision for) reduction of losses on real estate and joint ventures	1,318	(1)	374	
Income from real estate and joint ventures held for				

investment, net	$ 2,997	$ 1,447	$ 746	$

SECONDARY MARKETING ACTIVITIES

Sales of loans and mortgage-backed securities we originated increased in the first quarter of 2002 to $1.381 billion from $597 million a year ago. Net gains associated with these sales totaled $16.2 million in the first quarter of 2002, up from $2.1 million a year ago. Net gains included the capitalization of mortgage servicing rights of $15.0 million in the first quarter of 2002, compared to $5.4 million a year ago.

A loss of $0.6 million was recorded in loan servicing from our portfolio of loans serviced for others during the first quarter of 2002, an improvement from a loss of $8.2 million in the year-ago period. This $7.6 million improvement primarily reflected a smaller addition to the valuation allowance for mortgage servicing rights, $0.4 million in the current quarter compared to $8.3 million a year ago. At March 31, 2002, we serviced $6.4 billion of loans for others compared to $5.8 billion at December 31, 2001 and $4.3 billion at March 31, 2001.

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

	Three Months Ended				
(In Thousands)	March 31, 2002	December 31, 2001	September 30, 2001	June 30, 2001	
Income from servicing operations	$ 2,688	$ 2,477	$ 2,576	$ 1,752	$
Amortization of MSRs	(2,916)	(2,956)	(2,495)	(2,299)	
(Provision for) reduction of impairment	(360)	11,960	(11,852)	(2,351)	
Total loan servicing income (loss), net	$ (588)	$ 11,481	$(11,771)	$ (2,898)	$

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

OPERATING EXPENSE

Our operating expense totaled $45.2 million in the current quarter, up $8.0 million or 21.4% from the first quarter of 2001 because of higher general and administrative expense. That increase was primarily due to higher costs associated with an increased number of branch locations and higher loan origination activity.

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

(In Thousands)	Three Months Ended March 31, 2002	December 31, 2001	September 30, 2001	June 30, 2001
Salaries and related costs	$ 29,437	$ 27,075	$ 24,943	$ 24,646
Premises and equipment costs	7,133	7,303	6,628	6,042
Advertising expense	1,044	1,168	939	1,127
Professional fees	564	839	2,432	1,604
SAIF insurance premiums and regulatory assessments	786	792	786	741
Other general and administrative expense	6,211	6,339	5,981	5,973
Total general and administrative expense ..	45,175	43,516	41,709	40,133
Net operation of real estate acquired in settlement of loans	(58)	237	110	(106
Amortization of excess of cost over fair value of branch acquisitions	111	113	116	114
Total operating expense	$ 45,228	$ 43,866	$ 41,935	$ 40,141

PROVISION FOR INCOME TAXES

Income taxes for the first quarter totaled $27.3 million, resulting in an effective tax rate of 42.3%, compared to $19.0 million and 42.4% for the like quarter of a year ago. For further information regarding income taxes, see Notes To Consolidated Financial Statements--Note (6)--Income Taxes on page 10.

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BUSINESS SEGMENT REPORTING

The previous sections of the Results of Operations discussed our consolidated results. The purpose of this section is to present data and discussion on the results of operations of our two business segments--banking and real estate investment. For further information regarding business segments, see Notes To Consolidated Financial Statements--Note (3)--Business Segment Reporting on page 7.

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

(In Thousands)	Three Months Ended March 31, 2002	December 31, 2001	September 30, 2001	June 30, 2001	Ma
Banking net income	$ 35,557	$ 38,225	$ 22,301	$ 33,619	$
Real estate investment net income (loss)	1,757	871	(535)	(164)	
Total net income	$ 37,314	$ 39,096	$ 21,766	$ 33,455	$

Banking

Net income from our banking operations for the first quarter of 2002 totaled $35.6 million, up $10.2 million or 40.5% from $25.3 million in the first quarter of 2001. The increase between first quarters primarily reflected the following:

- a $14.3 million increase in net gains from sales of loans and mortgage-backed securities, and mortgage servicing rights;
- a $7.6 million improvement in our loan servicing activity primarily due to a smaller addition to the valuation allowance for mortgage servicing rights, $0.4 million in the current quarter compared to $8.3 million a year ago;
- a $3.8 million increase in net interest income due to an increase in our effective interest rate spread; and
- a $1.3 million increase in loan and deposit related fees.

Those favorable items were partially offset by the following:

- an $8.0 million increase in operating expenses reflecting an increased number of branch locations and higher loan origination activity; and
- a $1.4 million increase in provision for loan losses due primarily to a commercial real estate loan that became impaired during the quarter.

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

	Three Months Ended			
(In Thousands)	March 31, 2002	December 31, 2001	September 30, 2001	June 30, 2001
Net interest income	$ 79,940	$ 79,730	$ 73,473	$ 76,236
Provision for loan losses	1,447	1,290	791	431
Other income	28,062	31,397	5,987	21,211
Operating expense	45,006	43,680	40,071	38,863
Net intercompany income	93	96	92	84
Income before income taxes	61,642	66,253	38,690	58,237
Income taxes	26,085	28,028	16,389	24,618
Net income	$ 35,557	$ 38,225	$ 22,301	$ 33,619
AT PERIOD END				
Assets:				
Loans and mortgage-backed securities	$10,088,113	$10,132,413	$ 9,912,489	$ 9,981,213
Other	819,407	966,942	797,775	837,387
Total assets	10,907,520	11,099,355	10,710,264	10,818,600
Equity	$ 767,622	$ 733,896	$ 698,475	$ 680,719

Real Estate Investment

Net income from our real estate investment operations totaled $1.8 million in the first quarter of 2002, up from $0.6 million in the year-ago quarter. The increase was primarily attributed to higher sales activity that resulted in the recapture of $1.3 million of a previously established valuation allowance and an increase of $0.3 million in net gains that totaled $0.6 million in the current quarter.

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

	Three Months Ended			
(In Thousands)	March 31, 2002	December 31, 2001	September 30, 2001	June 30, 2001
Net interest income (loss)	$ 5	$ (15)	$ (26)	$ 10
Other income	3,291	1,773	1,083	1,072
Operating expense	222	186	1,864	1,278
Net intercompany expense	93	96	92	84
Income (loss) before income taxes (benefit) ...	2,981	1,476	(899)	(280)
Income taxes (benefit)	1,224	605	(364)	(116)
Net income (loss)	$ 1,757	$ 871	$ (535)	$ (164)
AT PERIOD END				
Assets:				
Investment in real estate and joint ventures	$26,384	$38,185	$38,043	$19,950
Other	4,060	2,003	1,629	1,673
Total assets	30,444	40,188	39,672	21,623
Equity	$24,963	$34,513	$33,642	$18,307

Our investment in real estate and joint ventures amounted to $26 million at March 31, 2002, compared to $38 million at December 31, 2001 and $19 million at March 31, 2001.

For information on valuation allowances associated with real estate and joint venture loans, see Financial Condition--Problem Loans and Real Estate--Allowances for Losses on Loans and Real Estate on page 31.

FINANCIAL CONDITION

LOANS AND MORTGAGE-BACKED SECURITIES

Total loans and mortgage-backed securities, including those we hold for sale, declined $44 million during the first quarter to a total of $10.1 billion or 92.4% of assets at March 31, 2002. The decrease represented a lower level of loans held for sale and mortgage-backed securities available for sale, as loans held for investment increased by $94 million. Given the low interest rate environment and borrower preference for fixed rate loans, our annualized prepayment speed in the current quarter was 39%, compared to 27% a year ago and 37% during the previous quarter.

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

	Three Months Ended			
(In Thousands)	March 31, 2002	December 31, 2001	September 30, 2001	June 30, 2001
Loans originated for investment:				
Residential one-to-four units:				
Adjustable	$ 988,063	$ 884,312	$ 867,271	$ 814,696
Fixed	4,366	1,788	4,445	10,849
Other	45,752	51,488	56,554	43,492
Total loans originated for investment	1,038,181	937,588	928,270	869,037
Loans originated for sale (1)	1,266,430	1,613,671	1,116,589	1,296,877
Total loans originated	$2,304,611	$2,551,259	$2,044,859	$2,165,914

Originations of one-to-four unit residential loans totaled $2.259 billion in the first quarter of 2002, of which $992 million or 44% were for portfolio, with the balance for sale in the secondary market. This was 9.6% below the $2.500 billion originated in the fourth quarter of 2001, but 57.1% higher than the $1.438 billion we originated in the year-ago first quarter. Of the current quarter originations for portfolio, $107 million represented originations of subprime credits as part of our continuing strategy to enhance the portfolio's net yield. During the current quarter, 80% of our residential one-to-four unit originations represented refinancing transactions. This is down from 82% in the previous quarter, but up from 71% in the year-ago first quarter. In addition to single family loans, we originated $46 million of other loans in the current quarter.

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

Our adjustable rate mortgages:

- generally 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;

- generally provide that the maximum interest rate we can charge borrowers cannot exceed the incentive rate by more than six to nine percentage points, depending on the type of loan and the initial rate offered; and

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

Most of our adjustable rate mortgages adjust the interest rate monthly and the payment 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 indicates an increased risk that the fair value of the underlying collateral on the loan would be insufficient to satisfy fully the outstanding principal and interest. A loan-to-value ratio is the ratio of the principal amount of the loan to the lower of the sales price or appraised value of the property securing the loan at origination. We currently impose a limit on the amount of negative amortization. The principal plus the added amount cannot exceed 125% of the original loan amount, except for subprime loans and loans with loan-to-value ratios of 80% or greater wherein the borrower has obtained private mortgage insurance to reduce the effective loan-to-value ratio to between 70% and 78%. In those two instances, the principal plus negative amortization cannot exceed 110% of the original loan amount.

At March 31, 2002, $6.7 billion of the adjustable rate mortgages in our loan portfolio were subject to negative amortization, of which $166 million represented the amount of negative amortization included in the loan balance.

We also continue to originate residential fixed interest rate mortgage loans to meet consumer demand, but we intend to sell the majority of these loans. We sold $1.381 billion of loans in the first quarter of 2002, compared to $1.472 billion in the previous quarter and $597 million in the first quarter of 2001. All were secured by residential one-to-four unit property, and at March 31, 2002, loans held for sale totaled $388 million.

At March 31, 2002, our unfunded loan application pipeline totaled $1.3 billion. Within that pipeline, we had commitments to borrowers for short-term interest rate locks of $660 million, of which $289 million were related to residential one-to-four unit loans being originated for sale in the secondary market. Furthermore, we had commitments on undrawn lines and letters of credit of $89 million and loans in process of $56 million. We believe our current sources of funds will enable us to meet these obligations.

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

	Three Mon		
(In Thousands)	March 31, 2002	December 31, 2001	Septemb 2001
INVESTMENT PORTFOLIO			
Loans originated:			
Loans secured by real estate:			
Residential one-to-four units:			
Adjustable	$ 880,729	$ 801,751	$ 767
Adjustable - subprime	107,334	82,561	100
Total adjustable	988,063	884,312	867
Fixed	4,336	1,577	3
Fixed - subprime	--	211	1
Residential five or more units:			
Adjustable	--	--	
Fixed	--	--	
Total residential	992,399	886,100	871
Commercial real estate	--	133	
Construction	13,672	32,025	27
Land	18,542	5,153	4
Non-mortgage:			
Commercial	1,361	4,006	8
Automobile	376	275	
Other consumer	11,801	9,896	7
Total loans originated	1,038,151	937,588	921
Real estate loans purchased:			
One-to-four units	30	--	
One-to-four units - subprime	--	--	
Other (1)	--	--	6
Total real estate loans purchased	30	--	6
Total loans originated and purchased	1,038,181	937,588	928
Loan repayments	(942,811)	(945,582)	(968
Other net changes (2)	(936)	(12,036)	(24
Net increase (decrease) in loans held for investment ..	94,434	(20,030)	(64
SALE PORTFOLIO			
Residential one-to-four units:			
Originated whole loans	1,264,559	1,610,470	1,115
Loans purchased	1,871	3,201	1
Loans transferred to the investment portfolio	(614)	(3,167)	(1
Originated whole loans sold	(156,206)	(181,632)	(129
Loans exchanged for mortgage-backed securities	(1,225,243)	(1,290,355)	(991
Other net changes	(789)	(404)	
Capitalized basis adjustment (3)	5,866	(12,578)	2
Net increase (decrease) in loans held for sale	(110,556)	125,535	(3
Mortgage-backed securities, net:			
Received in exchange for loans	1,225,243	1,290,355	991
Sold	(1,225,243)	(1,290,355)	(991
Purchased	--	115,597	
Repayments	(26,553)	(773)	
Other net changes	(1,625)	(405)	

Net increase (decrease) in mortgage-backed securities available for sale	(28,178)	114,419	
Net increase (decrease) in loans held for sale and mortgage-backed securities available for sale	(138,734)	239,954	(3
Total net increase (decrease) in loans and mortgage-backed securities	$ (44,300)	$ 219,924	$ (68

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

(In Thousands)	March 31, 2002	December 31, 2001	September 2001
INVESTMENT PORTFOLIO			
Loans secured by real estate:			
Residential one-to-four units:			
Adjustable	$ 7,574,205	$ 7,364,677	$ 7,191,9
Adjustable - subprime	1,423,661	1,491,416	1,588,5
Fixed	295,228	334,384	375,5
Fixed - subprime	13,099	15,303	17,4
Total residential one-to-four units	9,306,193	9,205,780	9,173,4
Residential five or more units:			
Adjustable	5,920	6,055	6,1
Fixed	4,230	5,124	5,2
Commercial real estate:			
Adjustable	40,650	40,900	41,9
Fixed	69,691	71,609	100,4
Construction	78,202	84,942	99,1
Land	36,303	22,028	21,1
Non-mortgage:			
Commercial	21,182	22,017	22,7
Automobile	20,902	24,529	29,1
Other consumer	48,067	50,908	53,2
Total loans held for investment	9,631,340	9,533,892	9,552,8
Increase (decrease) for:			
Undisbursed loan funds	(65,813)	(61,280)	(62,8
Net deferred costs and premiums	80,622	77,916	79,5
Allowance for losses	(37,307)	(36,120)	(35,0
Total loans held for investment, net	9,608,842	9,514,408	9,534,4
SALE PORTFOLIO, NET			
Loans held for sale:			
Residential one-to-four units	392,928	509,317	371,2
Residential one-to-four units - subprime	--	33	--
Capitalized basis adjustment (1)	(4,460)	(10,326)	2,2

Total loans held for sale	388,468	499,024	373,4
Mortgage-backed securities available for sale:			
Adjustable	73,792	101,562	4,5
Fixed	17,011	17,419	--
Total mortgage-backed securities available for sale	90,803	118,981	4,5
Total loans held for sale and mortgage-backed securities available for sale	479,271	618,005	378,0
Total loans and mortgage-backed securities ...	$ 10,088,113	$ 10,132,413	$ 9,912,4

We carry loans for sale at the lower of cost or fair value. At March 31, 2002, no valuation allowance was required as the fair value exceeded book value on an aggregate basis.

At March 31, 2002, our residential one-to-four units subprime portfolio consisted of approximately 80% "A-" credit, 17% "B" credit and 3% "C" credit loans. At March 31, 2002, the average loan-to-value ratio at origination for these loans was approximately 75%.

We carry mortgage-backed securities available for sale at fair value which, at March 31, 2002, reflected an unrealized loss of $2.9 million. The current quarter-end unrealized loss, less the associated tax effect, is reflected within a separate component of other comprehensive income (loss) until realized.

DEPOSITS

At March 31, 2002, our deposits totaled $8.6 billion, down slightly from both the year-ago level and year-end 2001. Compared to the year-ago period, our certificates of deposit declined $2.1 billion or 29.9%, which was partially offset by an increase in our lower-rate transaction accounts--i.e., checking, regular passbook and money market--of $2.0 billion, more than double the year-ago level. Within transaction accounts, approximately 99% of the increase was in our passbook accounts, as depositors moved monies from certificates of deposit because they seemed more interested in liquidity given the relatively low level of interest rates. At March 31, 2002, the average deposit size of our traditional branches was $105 million, while the average size of our in-store branches was $17 million, or $21 million excluding the 18 new in-store branches opened within the past 12 months.

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

	March 31, 2002		December 31, 2001		September 30, 2001		June 3
(Dollars in Thousands)	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate
Transaction accounts:							

Non-interest-bearing checking	-- %	$ 312,962	-- %	$ 263,165	-- %	$ 327,335	-- %
Interest-bearing checking (1)	0.25	436,612	0.35	423,776	0.42	403,134	0.42
Money market	1.82	112,646	2.01	108,747	2.29	97,548	2.79
Regular passbook ...	2.57	2,789,500	2.46	2,131,048	2.96	1,308,959	3.44
Total transaction accounts	2.05	3,651,720	1.92	2,926,736	2.00	2,136,976	2.11
Certificates of deposit:							
Less than 3.00%	2.45	1,467,532	2.41	970,854	2.41	39,217	2.48
3.00-3.49	3.29	1,080,673	3.20	458,511	3.26	379,901	3.36
3.50-3.99	3.84	527,613	3.84	532,634	3.83	508,383	3.83
4.00-4.49	4.23	830,142	4.22	892,517	4.22	888,123	4.29
4.50-4.99	4.76	495,530	4.76	555,885	4.73	815,711	4.74
5.00-5.99	5.21	356,605	5.30	921,510	5.36	1,883,498	5.50
6.00 and greater	6.32	189,075	6.37	1,360,919	6.46	2,216,973	6.59
Total certificates of deposit	3.66	4,947,170	4.54	5,692,830	5.24	6,731,806	5.82
Total deposits ..	2.98%	$8,598,890	3.65%	$8,619,566	4.46%	$8,868,782	5.08%

BORROWINGS

During the current quarter, our borrowings declined $202 million to $1.3 billion, due to a decrease in FHLB advances. This followed an increase of $595 million during the fourth quarter of 2001.

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

(Dollars in Thousands)	March 31, 2002	December 31, 2001	September 30, 2001	
Federal Home Loan Bank advances	$1,320,386	$1,522,705	$ 927,398	$
Other borrowings	--	7	29	
Total borrowings	$1,320,386	$1,522,712	$ 927,427	$
Weighted average rate on borrowings during the period	4.28%	4.31%	5.01%	
Total borrowings as a percentage of total assets	12.10	13.71	8.65	

CAPITAL SECURITIES

On July 23, 1999, we issued $120 million in capital securities through Downey Financial Capital Trust I. The capital securities pay quarterly cumulative cash distributions at an annual rate of 10.00% of the liquidation value of $25 per share. Interest expense on our capital securities, including the amortization of deferred issuance costs, was $3.0 million for the first quarter of 2002.

ASSET/LIABILITY MANAGEMENT AND MARKET RISK

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

In addition to the market risk associated with our lending and deposit taking activities, we also have market risk associated with our secondary marketing activities. Changes in mortgage interest rates, primarily fixed rate mortgages, impact the fair value of loans held for sale as well as our off-balance sheet commitments where we have committed to an interest rate with a potential borrower for a loan we intend to sell (known as an interest rate lock derivative). Our objective is to hedge against fluctuations in interest rates through use of forward sale and purchase contracts with government-sponsored enterprises and whole loan sale contracts with various parties. These contracts are typically obtained at the time the interest rate lock commitments are made. Therefore, as interest rates fluctuate, the changes in the fair value of our interest rate lock commitments and loans held for sale tend to be offset by changes in the fair value of the hedge contracts. Although we continue to hedge as previously done, SFAS 133, as applied to our risk management strategies, may increase or decrease reported net income and stockholders' equity, depending on levels of interest rates and other variables affecting the fair values of derivative instruments and hedged items, but will have no effect on the overall economics of the transactions.

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

We currently do not enter into hedging contracts for speculative purposes.

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

One measure of our exposure to differential changes in interest rates between assets and liabilities is shown in the following table which sets forth the repricing frequency of our major asset and liability categories as of March 31, 2002, as well as other information regarding the repricing and maturity differences between our interest-earning assets and total deposits, borrowings and capital securities in future periods. We refer to these differences as "gap." We have determined the repricing frequencies by reference to projected maturities, based upon contractual maturities as adjusted for scheduled repayments and "repricing mechanisms"--provisions for changes in the interest and dividend rates of assets and liabilities. We assume prepayment rates on substantially all of our loan portfolio based upon our historical loan prepayment experience and anticipated future prepayments. Repricing mechanisms on a number of our assets are subject to limitations, such as caps on the amount that interest rates and payments on our loans may adjust, and accordingly, these assets do not normally respond to changes in market interest rates as completely or rapidly as our liabilities. The interest rate sensitivity of our assets and liabilities illustrated in the following table would vary substantially if we used different assumptions or if actual experience differed from the assumptions set forth.

	March 31, 200			
(Dollars in Thousands)	Within 6 Months	7 - 12 Months	1 - 5 Years	6 Y
Interest-earning assets:				
Investment securities				